A CLOSER LOOK AT RECENT EXEMPTION DEVELOPMENTS: *LAW V. SIEGEL* AND LIEN AVOIDANCE

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EXEMPTIONS AND PROPERTY OF THE ESTATE: SELECTED CURRENT DEVELOPMENTS

"Surcharging" exempt property[1]

Law v. Siegel

In a unanimous opinion by Justice Scalia, the Supreme Court on March 4, 2014 held that the bankruptcy court had exceeded its authority when it surcharged the Chapter 7 debtor's homestead exemption for the payment of a portion of the trustee's administrative expense. Although a Chapter 7 case, the holding and reasoning of the Court is important for Chapter 13 cases, its trustees and creditors. The opinion contains significant reminders about the limits of the bankruptcy court's authority, as well as lessons about how the bad result might be avoided in future cases. *Law v. Siegel*, 571 U.S. ____, 134 S. Ct. 1188 (2014).

What is at play?[2]

In all bankruptcy cases, the individual debtor is entitled to claim exemptions. 11 U.S.C. § 522. "An individual debtor may exempt from property of the estate the property listed" under section 522(d) or applicable state law. Often, the choice will be driven by whether the applicable state law has opted out of the section 522(d) exemptions. Generally, objections to claimed exemptions must be timely, Fed. R. Bankr. P. 4003(b), with failure to timely object leading to allowance of the claimed exemptions. There are, of course, exceptions to the general rule of timely objection, as seen in *Schwab v. Reilly*, 130 S. Ct. 2652 (2010) (discussed below), but the Schwab rationale was not an issue in the *Law* opinion. If allowed, the exemptions, subject to specific statutory exceptions, are protected from pre-bankruptcy claims of creditors; that is, the exemptions survive discharge. 11 U.S.C. § 522(c). The Code specifically protects allowed exemptions from administrative expense claims in the case, again subject to certain exceptions, 11 U.S.C. § 522(k), and this last Code provision was critical to the *Law* decision

Overview of facts in *Law*

The debtor's only significant asset was his California home, which he valued at $363,348, and the debtor claimed the California homestead exemption of $75,000. The debtor had a first mortgage, apparently valid, for approximately

[1] This summary is based on a publication by William Houston Brown on the website of the Academy for Consumer Bankruptcy Education, the education arm of National Association of Chapter 13 Trustees, <www.ConsiderChapter13.org>, subsequently republished with reservation of rights in the materials of the Tennessee Bar Association Bankruptcy Forum, 2014 (adapted here with permission).

[2] This summary restricts itself to the exemption issues addressed in *Law*. See Brown, Ahern & MacLean, Bankruptcy Exemption Manual, for in-depth discussion of exemption issues.

$147,000, but he asserted that there was a second mortgage held by an individual. After much expensive litigation, the bankruptcy court determined that the second mortgage did not exist. The asserted second mortgage, which would have consumed all equity in the home, was intended to prevent the trustee's sale of the home. In the course of prolonged litigation, including avoidance of the fraudulent deed of trust, the trustee incurred $500,000 in attorney fees. No big surprise under these facts that the bankruptcy court, affirmed by the Ninth Circuit, approved a surcharge of the $75,000 exemption, permitting the trustee to recover a portion of the trustee fees from the real estate. There was appellate authority in that Circuit approving surcharge as an equitable remedy in appropriate cases.[3]

Some were surprised at the Supreme Court's grant of certiorari in a case with such bad facts, but there was a split in Circuit authority on at least portions of the surcharge issue. The First Circuit had followed the Ninth, holding that the bankruptcy court had authority to surcharge when the Chapter 7 debtor had willfully concealed nonexempt funds. *Malley v. Agin*, 693 F.3d 28 (1st Cir. 2012). The Tenth Circuit had earlier concluded that there was no statutory authority to surcharge. *In re Scrivner*, 535 F.3d 1258 (10th Cir. 2009), cert. denied, sub nom. *Mashburn v. Scrivner*, 556 U.S. 1126, 129 S. Ct. 1613 (2009).

Basic rule and context

The imposition of a surcharge is not authorized in the Code, and the bankruptcy court exceeded both its section 105(a) and inherent authority when it created a non-Code remedy. The Court concluded that Congress had created "meticulous—not to say mind-numbingly detailed—enumeration of exemptions and exceptions [which] confirms that courts are not authorized to create additional exceptions." *Law*, 556 S. Ct. 1196.

Although the ramifications of the *Law* opinion are not favorable for the trustee, who diligently pursued a deceitful debtor, the reasoning of the Court should not be a surprise. The crux of the opinion is that specific Code provisions prevail over equitable remedies, reasoning we have seen before. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988). As *Law* the Court said, "Section 105(a) confers authority to 'carry out' the provisions of the Code, but it is quite impossible to do that by taking action that the Code prohibits." *Law*, 556 S. Ct. 1195. Applying *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), the Supreme Court in *Law* observed that no surcharge could be imposed because no timely objection was filed to the claimed homestead exemption. The Court further stated that the surcharge contravened section 522(k), which prevented the allowed exemption from being liable for administrative expenses, and the trustee's attorney fees were clearly an administrative expense.

Where does this leave parties and the bankruptcy courts?

[3] See, e.g., Latman v. Burdette, 366 F.3d 774 (9th Cir. 2004).

First, *Law* is a reminder to timely object to all suspect exemptions. Of course, within the brief time for normal objections, the trustee or creditors may not yet know that the debtor's claimed exemption is improper, but remember that Rule 4003(b)(1) does permit extension of the objection time, provided such a motion is itself timely. Look at the basis for the debtor's exemption claim if made under State law, since there may be state-law remedies for an improper claim. The Court noted in *Law* that state-law remedies for debtor misconduct may exist when there is no Bankruptcy Code remedy, but such state-law remedies may be limited. There is no indication that any state-law remedies were available in *Law*. Of course, the Court alluded to the potential for criminal prosecution, which will not compensate the trustee.

Are there other remedies?

Under these types of facts, when the opportunity for objection to allowance has passed, *Law* points to the potential of denial of discharge, although that remedy does the trustee little good in the typical case. More important, the opinion makes a point in closing to say that the bankruptcy court does have authority under section 105(a), Rule 9011(c)(2) and inherent power to "impose sanctions for bad-faith litigation conduct," with such sanctions including reasonable attorney fees and expenses. *Law*, 556 S. Ct. 1198. "And because it arises post-petition, a bankruptcy court's monetary sanction survives the bankruptcy case and is thereafter enforceable through the normal procedures for collecting monetary judgments. See § 727(b)." *Id*. Of course, the reference to section 727(b) is no direct help in Chapter 13 cases, but it seems unlikely that an appropriate post-petition monetary sanction would be "provided for" in the plan in order to be dischargeable under section 1328(a).

It is not as simple as saying that whether the trustee and/or creditors prevail depends on what they call the remedy, but the concluding portion of *Law* sends a message: The bankruptcy court lacks authority to create an exemption-surcharge remedy, but the court does have authority to award fees as a sanction, including sanctions for litigation misconduct. Fabricating a mortgage to defeat the trustee's sale of property for the benefit of creditors, or to defeat the trustee's avoidance of the fraudulent mortgage, is surely litigation misconduct. When and how to raise the issue of sanctions for such conduct may be the real issue in future cases.

Lien Avoidance[4]

Reopening a case to amend Schedule C

[4] See Brown, Ahern & MacLean, Bankruptcy Exemption Manual, Ch. 6, Exemptions and Avoidance Powers (Section 522(f), (g), (h), (i), (j)) (pending for publication 2014), from which this section is adapted with permission, for an in-depth discussion of lien avoidance issues.

The closing of a bankruptcy case and subsequent satisfaction of a judicial lien may render a motion to reopen the case for avoidance purposes tardy, as suggested by the Bankruptcy Appellate Panel in *In re Wilding*, 332 B.R. 487 (B.A.P. 1st Cir. 2005). There, the Chapter 7 debtor received a discharge and the case was closed. Subsequently, the debtor refinanced a loan secured by the residence and satisfied a judicial lien that was unknown to the debtor at the time of the bankruptcy filing. The debtor then moved to reopen the case to avoid the judicial lien. The fact that the lien had been satisfied out of the proceeds of refinancing made it "too late to employ the benefits of § 522(f)." *Id*, at 491.

The court of appeals disagreed, however, tying avoidance to the time of the bankruptcy filing. *In re Wilding*, 475 F.3d 428 (1st Cir. 2007). Even though the judicial lien had been satisfied after the bankruptcy case was closed, the determinative time for avoidability, according to the Court of Appeals, is the petition date, when the lien was in existence and impaired the debtor's exemption. Section 522(f) uses the present tense "impairs," which must be tied to the petition date; thus, the lien remained avoidable throughout the case and even after closing/reopening. See also *In re Young*, 471 B.R. 715 (Bankr. E.D. Tenn. 2012) (citing other authority and holding that petition date is controlling for all section 522(f) determinations). In this view, if the court looks to the date of filing of the case for valuing the property, as well as the other elements of section 522(f) avoidance, there is no prejudice to the creditor in permitting the debtor to reopen a closed case and avoid a lien that would have been avoidable earlier.

In an unreported decision on January 22, 2014, the Bankruptcy Court for the Northern District of Illinois allowed the debtors to reopen their case, but denied their motion to avoid a lien, because they had never amended their Schedule C to list the property. *In re Dickson*, No. 08 B 16815 (Bankr. N.D. Ill. 2014). The denial was without prejudice. In explaining its ruling, the court analyzed the split of authority on the issue of whether a debtor can reopen his or her case to amend Schedule C:

> There is a split of authority as to whether a debtor can amend his schedules to add an exemption after the case has been closed and reopened. This court agrees with those courts that allow such amendment unless the debtor has acted in bad faith or the creditor has been prejudiced, because “there is no difference between an open case and a reopened case ...” and because “the critical date for determining exemption rights is the petition date.” *Goswami v. MTC Distributing (In re Goswami)*, 304 B.R. 386, 392, 393 (B.A.P. 9th Cir. 2003); see *Brodsky v. Taylor (In re Brodsky)*, 2007 WL 7136477 (Bankr. N.D. Ga. 2007); *In re Dougan*, 350 B.R. 892 (Bankr. D. Id. 2006). See also, *Rosinski v. Boyd (In re Rosinski)*, 759 F.2d 539 (6th Cir. 1985) (debtor allowed to reopen case to amend schedule to add creditor where no prejudice to creditor) and *Stark v. St. Mary’s Hospital (In re Stark)*, 717 F.2d 322 (7th Cir.

> 1983) (same). Contra, *In re Bartlett*, 326 B.R. 436 (Bankr. N.D. Ind. 2005). Simple delay, by itself, does not prejudice creditors; prejudice is shown when "creditors suffer an actual economic loss due to the debtor's delay in claiming her exemptions." Dougan, 350 B.R. at 895. Here, [the creditor holding the lien to be avoided] has not alleged either prejudice or bad faith by the debtor. The debtors are therefore free to amend their schedules after the reopening of the case to assert an exemption in their residence.

Id. at 2. Other reported opinions illustrate this conflict:

• The Bankruptcy Appellate Panel for the Ninth Circuit, in *Green v. Hapo Community Credit Union (In re Green)*, No. EW-12-1486-PaJuTa 2013 WL 4055846 (B.A.P. 9th Cir. Aug. 12, 2013), allowed avoidance of a lien after reopening the case, because the creditor had made no showing of prejudice. The bankruptcy court had simply stated that merely "[t]he length of time between the date of filing the bankruptcy petition and the date of lien avoidance prejudices the creditor ...." *Id*. at *2.

• The bankruptcy court in *In re Ervin*, 2013 WL 1867989 (Bankr. D.S.C. May 12, 2013), held that section 521(a)(2) does not preclude avoidance when the debtor does not timely file a statement of intention with respect to the property of the estate encumbered by the lien to be avoided and perform the stated intention with regard to a judicial lien secured by the property. *Id*. at *1. It was not necessary for the court to reopen the case, under a local rule:

> SC LBR 4003–2(c) permits filing a motion to avoid judicial lien in a closed case without the need to reopen the case pursuant to § 350, thus avoiding imposition of the automatic stay and other concerns that would have an impact on creditors that are not the subject of the motion.

Ervin, 2013 WL 1867989 at n. 3.

• The district court in *In re Clear*, 1992 WL 1359570 (N.D. Ind. May 26, 1992), provided the precedent on which *Bartlett* (cited in *Dickson*, discussed above) was based. The court held that amendment of Schedule C is precluded by the plain language of Rule 1009 of the Federal Rules of Bankruptcy Procedure: "A voluntary petition, list schedule, or statement may be amended by the debtor as a matter of course at any time *before the case is closed.*" *Clear*, 1992 WL 1359570 at *1 (emphasis in the original).

Other recent developments

1. State exception to homestead did not prevent lien avoidance

Applying *Owen v. Owen*, 500 U.S. 305 (1991), the fact that Missouri's homestead exemption had an exception that the homestead was subject to attachment and levy of execution for causes of action existing at the time of acquiring the homestead did not deprive the Chapter 13 debtor of using section 522(f) to avoid a judgment lien. *J & M Securities, LLC v. Moore (In re Moore)*, 495 B.R. 1 (B.A.P. 8th Cir. 2013). The First Circuit, in *In re Weinstein*, 164 F.3d 677 (1st Cir. 1999), was cited as the only court of appeals to directly address the issue, under Massachusetts' statutory exception to its homestead for liens attaching prior to acquisition. Section 522(c) protects certain debts from the effect of exemption in bankruptcy, but that statute preempts state law, which cannot interfere with the use of section 522(f). The opt out by Missouri does not change the conclusion.

2. Chapter 7 trustee's abandonment did not cut off jurisdiction

The bankruptcy court retained authority under section 522(f) to hear the Chapter 7 debtor's motion to avoid judicial lien, notwithstanding the trustee's prior abandonment of the cause of action. Under 28 U.S.C § 1334(e)(1), the court had jurisdiction over property of the estate and of the debtor. *Ramos v. Negron (In re Ramos)*, 498 B.R. 1 (B.A.P. 1st Cir. 2013).

3. Section 522(f) lien avoidance ended with redemption period

When the Chapter 7 debtor did not redeem a pawned vehicle within the time allowed under Georgia law, as extended by section 108, title to the vehicle vested in Titlemax, and section 522(f) was not available to avoid the lien, assuming that the pawn transaction in fact created a lien rather than transferring title. *In re Chastagner*, 498 B.R. 376 (Bankr. S.D. Ga. 2013).

4. Debtor must have valid exemption that could be asserted

Section 522(f) may not be used to avoid either a judgment lien or a security interest unless the underlying property would have been exempt. See *In re Anderson*, 2012 WL 1110056 (Bankr. D. Mont. Apr. 2, 2012) (citing *In re Morgan*, 149 B.R. 147 (B.A.P. 9th Cir. 1993) (requiring that "there must be an exemption to which the debtor 'would have been entitled' under subsection (b) of § 522")).

5. Application of section 522(f) partially

"[W]hen the market value of the property exceeds the sum of (1) all consensual (non-judicial) liens on the property and (2) the amount of the debtor's exempt interest under 11 U.S.C § 522(d)," then "section 522(f)(1) permits the avoidance of the targeted judicial lien only in part, not in its entirety." *In re Silveira*, 141 F.3d 34, 35 (1st Cir. 1998); see also *In re Young*, 471 B.R. 715

(Bankr. E.D. Tenn. 2012) (citing *In re Falvo*, 227 B.R. 662, 666 (B.A.P. 6th Cir. 1998) (holding partial lien avoidance appropriate)).

6. Judicial lien in former spouses' separate cases

In *White v. Commercial Bank and Trust Co. (In re White)*, 470 F. App'x. 538 (8th Cir. 2012), the Court of Appeals ruled that a judicial lien, securing a deficiency judgment, was voidable in separate Chapter 7 cases filed by a former husband and wife. The 80-acre parcels that each debtor owned as his or her rural homestead would be totally exempt in absence of the judgment lien, so the lien impaired the debtors' exemptions, assuming that the lien had not attached prior to debtors' acquisition of their interests in the parcels. The court concluded that dissolution of the entireties interest that the debtor-spouses possessed in the property, which they acquired more than a decade prior to entry of the deficiency judgment, and to lender's recording of its judgment, did not create a "break in the chain of title." The fact that they had subsequently divorced, with the tenancy converted to one in common, did not alter the fact that they had ownership interests before the lien attached.

On the other hand, in *McCoy v. Kuiken (In re Kuiken)*, 484 B.R. 766 (B.A.P. 9th Cir. 2013), the creditor recorded a judgment lien against real property owned by the debtor in 2009. On July 5, 2011, the debtor executed a deed, recorded on July 15, conveying fee title to an entity called Bayview for valuable consideration. Less than a month before the October 24, 2011, chapter 7 bankruptcy filing, Bayview executed a deed conveying title back to the debtor as a gift, recorded on October 11. The debtor claimed the property as exempt under California law. Reversing the bankruptcy court, the panel addressed what it described as a question of first impression in the First Circuit, holding that the debtor was not entitled to avoid the judicial lien under section 522(f)(1), because the debtor had not maintained a continuous interest in the property from the time the lien attached through the date of the filing of his bankruptcy petition. "When the interest once held is entirely extinguished by transfer, voluntary or, as a matter of law, a judicial lien which attached when a debtor had that interest cannot be avoided when the debtor acquires a new interest." *Id*. at 772.

7. Creditor required to return exempt social security benefits

In *Collect Access LLC v. Hernandez (In re Hernandez)*, 483 B.R. 713 (B.A.P. 9th Cir. 2012), the debtor filed a motion requesting, pursuant to section 542, an order requiring the judgment lien creditor to return exempt Social Security benefits levied upon pre-petition. The creditor resisted on the basis that the debtor's interest in the funds was terminated pre-petition when the funds were transferred to the levying officer. The bankruptcy court granted the debtor's motion, and the panel affirmed, noting that the benefits are exempt under state law and therefore not subject to collection efforts, so no transfer of ownership in the funds was effected by the levy, and concluding that the judgment lien creditor

merely had a lien on the levied funds, that the debtor maintained an interest in the funds at the time the petition was filed, that the funds constituted property of the debtor's estate, under section 541, and that the debtor could preserve his exemption in the levied funds by invoking section 522(g) and/or (h).

8. Section 522(h) is more limited than section 522(g)

Section 522(h) excludes some of the avoidance power listed in subsection (g):

Section 510(c)(2)	recovery of subordinated liens
Section 542	turnover of property of the estate
Section 543	turnover of property by a custodian
Section 551	automatic preservation of avoided transfers

None of these avoidance and other powers may be exercised by the debtor under section 522(h), but if such transfers are avoided by the trustee, they may be reached by the debtor under subsection (g). See, e.g., *Collect Access LLC v. Hernandez (In re Hernandez)*, 483 B.R. 713 (B.A.P. 9th Cir. 2012), discussed above.

9. Chapter 13 debtor had strong-arm standing under 522(h)

When the debtor had claimed homestead exemption within the statutory limits, the debtor had standing to bring an adversary proceeding under section 522(h) to avoid the fixing of an attorney's lien on the property that would otherwise be exempt. *McCarthy v. Law (In re McCarthy)*, 501 B.R. 89 (B.A.P. 8th Cir. 2013).

10. Debtor's avoidance is subject to defenses against trustee

The debtor who files an avoidance action is essentially stepping into the trustee's underlying statutory authority. An adversary proceeding commenced by complaint is required, rather than merely a motion. *In re Canelos*, 212 B.R. 249, 254, amended, 216 B.R. 159 (Bankr. D. Md. 1997). For the same reason, the defenses available against a trustee are triggered. *In re Sandoval*, 470 B.R. 195 (Bankr. D.N.M. 2012). In *In re Maus*, 282 B.R. 836 (Bankr. N.D. Ohio 2002), for example, the debtor brought a preference action to recover garnishments and was required to show that the garnishments exceeded the $600 limit in section 547(c)(8). For application of section 547(c)(8)’s statutory limitation, see In re Pierce, 504 B.R. 506 (B.A.P. 9th Cir. 2014).

11. Judgment lien avoidable against debtor’s interest in entireties property.

Considering the issue of whether a single-filing debtor may avoid a judgment lien against tenancy by entireties property, the court concluded that Maryland's homestead exemption created an exception to the general rule seen in *In re Alvarez,* 733 F.3d 130 (4th Cir. 2013). Maryland had opted out of the § 522(d) exemptions, and its homestead exemption provided that the debtor "may exempt the debtor's aggregate interest in. . .owner-occupied residential real property." *Alvarez* was a lien-stripping case under § 506(a), in which the Fourth Circuit held that the bankruptcy court lacked jurisdiction over a non-filing spouse's interest in entireties property. The Maryland homestead exemption was distinguished from *Alvarez,* with the court concluding that the Chapter 7 debtor could avoid the judicial lien only as to his interest in the residence, but not as to his non-filing spouse's interest. *Raskin v. Susquehanna Bank (In re Raskin),* 505 B.R. 684 (Bankr. D. Md. Feb. 12, 2014).

Other Exemption Decisions in 2014

Social Security Act protects benefits

Rejecting the Chapter 7 trustee's argument that Social Security benefits could be reached on equitable grounds when the debtor did not have present need for the benefits that had been paid and were held in bank account, the court applied *Law v. Siegel* to hold that it lacked such equitable authority. Moreover, "§ 407(a) [of the Social Security Act] implements a three-pronged protective regime for social security benefits, both paid and payable," including protecting those benefits from the operation of bankruptcy laws. *In re Franklin,* ___ B.R. ___, 2014 WL 960874 (Bankr. C.D. Ill. March 12, 2014).

Interest in retirement plan received through marital dissolution decree was exempt

The Chapter 7 debtor received $80,000 interest in former husband's tax-qualified employee retirement plan in a marital dissolution decree, and the funds were entitled to Illinois exemption, despite fact that the transfer meant that proceeds were no longer in hands of employee who had funded the plan. Under Illinois law, the retirement plan was marital property before the entry of marital dissolution, and the debtor's interest became quantified as her separate property on entry of the decree. Although that interest became property of the Chapter 7 estate, it was exempt, distinguishing *In re Clark,* 714 F.3d 559 (7th Cir. 2013). "The critical factor in *Clark* was that the IRA's retirement attributes had been lost upon inheritance by a non-spouse. In contrast, a retirement plan transferred pursuant to a QDRO is done expressly for the purpose of preserving the retirement nature of the plan." The trustee's objection to exemption was overruled. *In re West,* ___ B.R. ___, 2014 WL 1230067 (Bankr. N.D. Ill. March 26, 2014).

New objection period only for those amended exemptions

Under Bankruptcy Rule 4003(b) and the majority of opinions applying it, the filing of an amended list of exemptions does not restart the objection period for original exemptions, with a new 30-day objection period applying only for those exemptions that were amended. *In re Walker,* 505 B.R. 217 (Bankr. E.D. Tenn. 2014).

Debtor-husband not entitled to wildcard exemption in inheritance of debtor-wife

The Chapter 7 debtor-husband had no separate property interest in an inheritance received by his debtor-wife, rejecting the argument that the husband had an exemptible property interest based on equitable distribution rights that could be asserted in an unfiled divorce proceeding or probate. Under the majority view, "a spouse has no present property interest in the separate property of the other spouse unless and until the contingency occurs." Moreover, § 541(a)(5) defines property of the estate to include property acquired by "bequest, devise, or inheritance" within 180 days after the petition filing. *In re Hampshire,* 505 B.R. 668 (Bankr. E.D. Pa. 2014).

Inheritance received more than 180 days postpetition included in property of estate

Section 1306(a)(1) broadens § 541(a)'s definition of property of the estate, to include all property acquired after commencement of the case, not limited by § 541(a)(5)'s 180-day postpetition limit, agreeing with *Carroll v. Logan,* 735 F.3d 147 (4th Cir. 2013). The inheritance must be turned over, unless the debtors modified their plan to increase distribution to unsecured creditors. *Dale v. Maney (In re Dale),* 505 B.R. 8 (BAP 9th Cir. 2014).