Exemption Strategies After *Law v. Siegel*

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I. Introduction

In this paper, we will examines the impact of the Supreme Court's decision in *Law v. Siegel*, 134 S. Ct. 1188 (2014) on exemption planning. The article begins with a brief overview of exemptions before discussing widely accepted pre-*Law* principles concerning abusive and/or prejudicial exemption strategies. Finally, the article examines *Law* and its potential impact on exemption planning.

II. How Exemptions Work

Section 541(a) encompasses all of the debtor's property, both legal and equitable, *including* exempt property. *Taylor v. Freeland & Kronz*, 503 U.S. 638, 642 (1992). Section 522(b)(1), however, allows the debtor to prevent the distribution of certain property by claiming it as exempt. *Id.; see also* 11 U.S.C. § 522(b)(1) ("*Notwithstanding section 541 of this title*, an individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection." (emphasis supplied)). Read together, it would seem that sections 541(a) and 522's inclusion of exempt property into the bankruptcy estate provides the bankruptcy court both jurisdiction over exempt property and the requisite Constitutional authority to enter final judgments. *See, e.g., In re Okwonna-Felix* 2011 WL 3421561 (Bankr. S.D. Tex. 2011).

A. A (Very) Brief History of Exemptions

"The historical purpose of exemption laws has been to protect a debtor from his creditors, to provide him with the basic necessities of life so that even if his creditors levy on all of his nonexempt property, the debtor will not be left destitute and a public charge. [This] purpose has not changed." H.R.Rep. No. 95-595, at 126 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6087). In furtherance of providing the debtor with the "basic necessities of life . . . [such that] he will not be left . . . a public charge," an "allowed exemption revests the exempt property in the debtor free from *most* prebankruptcy claims.[1] 11 U.S.C.

[1] Under section 522(c), the protection from prepetition claims applies regardless of whether the claims are dischargeable or nondischargeable, except that exempt property can be reached to satisfy: (1) A prepetition debt for certain domestic support obligations (523(a)(5)) and certain taxes (523(a)(1)); (2) A debt secured by a lien that was not avoided and void, or a tax lien; (3) A debt attributable to fraud or willful and malicious injury "owed by an institution-affiliated party of an insured depository institution to a Federal depository institutions regulatory agency acting in its capacity as conservator, receiver, or liquidating agent for such institution"; or (4) A debt attributable to fraud in

§ 522(c). *Davis v. Cox*, 356 F.3d 76 (1st Cir. 2004) (exempt property is generally not liable for prepetition debts).

B. Federal Versus State Exemption Schemes

Section 522 of the Bankruptcy Code provides that a debtor may choose to exempt assets under either the Bankruptcy Code or pursuant to applicable non-bankruptcy (i.e., federal, state or local) law. 11 U.S.C. § 522(b)(1). Debtors must make their election; a debtor may not pick and choose among state and Bankruptcy Code exemptions. *In re Bradley*, 960 F.2d 502 (5th Cir. 1992). Under section 522(b)(2), the Bankruptcy Code's exemption scheme is only available to debtors to the extent permitted by the debtors' state jurisdiction. 11 U.S.C. § 522(b)(2); *In re Lamb*, 179 B.R. 419 (Bankr. D.N.J. 1994); *In re Fromal*, 151 B.R. 730 (Bankr. E.D. Va. 1993). Although some states have opted out of the Bankruptcy Code's exemption scheme, all states within the First Circuit with the exception of Maine allow debtors to elect the so-called federal exemptions. States that have opted out of the Bankruptcy Code's exemption scheme may establish their own exemption categories and limits. *Rhodes v. Stewart*, 705 F.2d 159 (6th Cir.), *cert. denied* 464 U.S. 983 (1983); *In re Butcher*, 189 B.R. 357 (Bankr. D. Md. 1995); *but see In re Parrish*, 19 B.R. 331 (Bankr. D. Colo. 1982).

C. The Burden is on the Debtor to Claim the Exemption

Section 522(1) places the burden on the debtor to file a list of property that the debtor claims as exempt and, "unless a party in interest objects, the property claimed as exempt on such list is exempt." 11 U.S.C. § 522(l); *see also* Fed. R. Bankr. P. 4003(a).

D. Objection to Exemptions

Accordingly, an objection must be filed to prevent a claimed exemption from being allowed.

1. Timing

Rule 4003(b)(1) provides the time for filing objections to a claim of exemptions as follows: "(1) Except as provided in paragraphs (2) and (3), a party in interest may file an objection to the list of property claimed as exempt within 30 days after the meeting of creditors held under § 341(a) is concluded

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obtaining a scholarship, loan, tuition, award, or other financial assistance, related to higher education assistance covered by the Higher Education Act of 1965. 11 U.S.C. § 522(c).

or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later." Fed. R. Bankr. 4003(b).

Determining the date of conclusion of the 341 meeting is crucial. Trustees frequently continue 341 meetings, often multiple times, to accommodate a debtor's production of documents or information and to afford the trustee sufficient time to investigate the debtor's financial affairs. To preserve the right to later object to exemptions, the trustee must be sure to continue the meeting to a date certain. Failure to do so, even where the meeting is continued generally (or "to a future date" or "to my next rotation"), is insufficient and will usually be determined to be a conclusion of the meeting. *In re Newman*, 428 B.R. 257 (1st Cir. BAP 2010) (superseded in other matters by rule). This is particularly an issue when neither debtor nor counsel appears for the hearing and the trustee fails to go on record to record the continuance.

2. Consequences of Failure to File a Timely Objection

Once the deadline for objections has passed, the debtor's claim of exemption is automatically valid. In *Taylor,* 503 U.S. at 638, the Supreme Court held that a trustee could not contest the validity of a claimed exemption after the 30-day period had expired, even though the debtor had no colorable basis for claiming the exemption. *See also In re Barroso-Herrans*, 524 F.3d 341 (1st Cir. 2008) (in absence of objection, debtor's exemption claim is allowed, even if improper). After *Taylor*, an untimely objection will be lost if the debtor's schedule is merely deficient in some respect, such as in an overstated claim of exemption. However, in instances where the debtor exempts property by kind and without claiming a specific amount, the Supreme Court further held that the debtor may only exempt that portion of an asset which falls within the limits under the appropriate exemption statute. *See Schwab v. Reilly*, 560 U.S. 770, 783–84 (2010) (limiting debtor to cap despite exemption claim for full asset value). The Court in the *Schwab* case recognized that the debtor's claim was legitimate in kind, just not in amount. Accordingly, the Court did not impose a requirement on the trustee to object to the claim in order to preserve the estate's right.

3. What Exactly is the Debtor Exempting?

In *Schwab*, 560 U.S. at 770, the Supreme Court held that when an exemption allows a specific dollar amount of the debtor's "interest" in property, it is not an exemption in the property *itself*; therefore, despite the debtor's claimed exempt value being allowed in full without objection, and that exempt value being listed as equal to the debtor's assessment of the property's value, the trustee could sell the asset and pay the debtor the claimed amount. *See also In re Massey*, 465 B.R. 720, 729 (B.A.P. 1st Cir. 2012) ("We agree with the consensus which has emerged from the foregoing cases [decided after *Schwab*]

that the Debtors' exemption claim of '100% of FMV' was facially invalid.") We can take away from *Schwab* that, when the exemption is limited to a dollar amount and the debtor claims an exemption within that cap, an objection to the exemption claim may not be required in order to preserve the Trustee's ability to sell the property and simply pay the debtor the dollar amount of the claimed exemption. State law may provide a similar result. *See, e.g.*, 14 Me. Rev. Stat. § 4424 ("If the debtor's interest in any property exempt under [the exemption section] exceeds the exempt amount, the whole of the property may be sold.")

4. Is the Denial of an Exemption Claim a Final, Appealable Order?

In *Newman*, 428 B.R. at 257, the First Circuit Bankruptcy Appellate Panel held that an order sustaining the Chapter 7 trustee's objection to the debtors' homestead exemption was a final, appealable order. The Eleventh Circuit has, however, taken the opposite view, holding that – under the circumstances of the particular case – the denial of a claimed exemption was not final and therefore is not immediately appealable. *Matter of Wisz*, 778 F.2d 762, 764 (11th Cir. 1985).

E. Amending Exemptions

As discussed above, bankruptcy practitioners often feel tension between their responsibility to file schedules and statements which are complete, actual and truthful and their duty to advocate for their clients. This tension is most acute when attorney is faced with the decision whether to claim an exemption based on a novel and unsettled theory. In those instances, a practitioner must weigh the potential benefit to his client against the risk of losing his discharge or, potentially, the benefit a more favorable objection.

Generally, debtors enjoy a general right to amend their exemptions any time before a bankruptcy case is closed.[2] Courts have recognized that the language of Rule 1009(a) "comports with the well-established principle that exemptions should be liberally construed in furtherance of the debtor's right to a 'fresh start' . . ." *In re Gregoire*, 210 B.R. 432, 435 (Bankr. D.R.I. 1997). In

[2] "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. The debtor shall give notice of the amendment to the trustee and to any entity affected thereby. On motion of a party in interest, after notice and a hearing, the court may order any voluntary petition, list, schedule, or statement to be amended and the clerk shall give notice of the amendment to entities designated by the court." Fed. R. Bankr. P. 1009(a).

light of the permissive language of Rule 1009(a), the creative practitioner may be tempted to take a more aggressive position with respect to an exemption knowing that, if a party successfully objects, the schedules can be amended to reflect a more conservative exemption election. While this approach is not *per se* impermissible, debtors and practitioners alike are cautioned against believing the right to amend under Rule 1009(a) is completely unfettered.

While a debtor is entitled to a "fresh start" under the Bankruptcy Code, the bankruptcy process consists of the delicate balance between the often opposing interests of debtors and creditors. The First Circuit Court of Appeals has stated:

> [T]he very purpose of certain sections of the law . . . is to make certain that those who seek the shelter of the bankruptcy code do not play fast and loose with their assets or with the reality of their affairs. The statutes are designed to insure that complete, truthful, and reliable information is put forward at the outset of the proceedings so that decisions can be made by the parties in interest based on actual fact rather than fiction. As we have stated, '[t]he successful functioning of the bankruptcy act hinges both upon the bankrupt's veracity and his willingness to make a full disclosure.' Neither the trustee nor the creditors should be required to engage in a laborious tug-of-war to drag the simple truth in the glare of daylight. The bankruptcy judge must be deft and evenhanded in calibrating these scales.

Boroff v. Tully (In re Tully), 818 F.2d 106, 110 (1987) (citations omitted). Along these lines, it was well accepted pre-*Law* that courts had the discretion to deny a debtor the opportunity to amend his or her schedules in the event the amendment constituted bad faith or created prejudice to creditors. *See, e.g., Hannigan v. White (In re Hannigan)*, 409 F.3d 480, 481-482 (1st Cir. 2005); *Wood v. Premier Capital, Inc. (In re Wood)*, 291 B.R. 219, 229 (1st Cir. BAP 2003); *Snyder v. Rockland Trust Co. (In re Snyder)*, 279 B.R. 1, 7 (2002).

As set forth above, amendments to a debtor's schedules are liberally allowed when required in the interests of justice. *See, e.g., In re Seeley Tube & Box Co.*, 219 F.2d 389, (3d Cir. 1955), *cert. denied*, 350 U.S. 821 (1955). Liberal amendment of schedules, including exemptions, is tempered, however. *See, e.g., Barrows v. Christians (In re Barrows)*, 408 B.R. 239, 243 (8th Cir. BAP 2009) ("the right to freely amend exemptions is not absolute, however, and 'can be tempered by the actions of the debtor or the consequences to creditors'") (quoting *Kaelin v. Bassett (In re Kaelin)*, 308 F.3d 885, 889 (8th Cir. BAP 2003); *In re Bauer*, 298 B.R. 353, 356 (8th Cir. BAP 2003) (same); *In re Akulova*, 407 B.R. 602, 605 (Bankr. D. Del. 2009) ("a debtor's proffered amendment to the

schedule of property claimed as exempt is not to be allowed automatically, but may be reviewed with an equitable gloss.").

1. The Bad Faith Exception

The bad faith exemption is most commonly identified as an attempt on the part of a debtor to conceal or undervalue assets. *See, e.g.*, *In re Valentine*, 2009 WL 3336081 (Bankr. D.N.H. Oct. 14, 2009) (courts have found bad faith where debtors intentionally undervalued assets); *In re Orlando*, 359 B.R. 395, 400 (Bankr. D. Mass. 2007) (bad faith is often shown by intentional concealment of an asset); *In re Harris*, 2006 WL 3497821 (Bankr. D.N.H. Dec. 1, 2006) (intentional undervaluation of asset can form basis for bad faith finding). A determination of bad faith "turns on an analysis of the totality of the circumstances" and the objecting party bears the burden of establishing bad faith by clear and convincing evidence. *Orlando*, 359 B.R. at 400. *See also, Wood*, 291 B.R. at 228. A mere allegation of bad faith is insufficient and "simply because a bankruptcy court had the discretion to deny a debtor's request to amend her schedules due to bad faith, it is not compelled to do so." *Id.* *See also*, *In re Hernandez*, 2012 WL 2202931 *5 (D.P.R. 2012) ("an objection to the proposed amendment must be fact-intensive and through specific evidence"); *In re Monahan*, 171 B.R. 710, 715 (Bankr. D.N.H. 1994) ("The objecting party must demonstrate the bad faith of the debtor by specific evidence").

a. Undervaluation

With these well established principles in mind, courts in the First Circuit have found bad faith where debtors seek to amend their schedules to claim excess value in their homesteads after initially undervaluing the asset for strategic purposes. *See, e.g., Hannigan*, 409 F.3d at 484 (denying debtor an opportunity to amend his homestead exemption to the $300,000 limited after originally claiming a much lower exemption in an apparent attempt to disguise two separate parcels as a single homestead parcel); *In re Gonzalez*, 149 B.R. 9, 11 (Bankr. D. Mass. 1993) (overruled on other grounds) (denying debtors an opportunity to amend exemptions to claim excess value in homestead after debtors initially undervalued homestead in an unsuccessful attempt to avoid bank lien).

Undervaluation constitutes bad faith in these instances even when the strategy initially chosen by the debtor was "misguided" because it deprived the debtor of another, more advantageous exemption election or the undervaluation is immaterial. *Hannigan*, 409 F.3d at 483 (". . . bad faith may

encompass intentional misconduct that, in retrospect, was not in the actor's best interest"). *See also, In re Wunderlich*, 369 B.R. 80, 85 (Bankr. D.N.H. 2007) (rejecting debtor's argument that amendment was immaterial where debtor merely sought to amend value of, and claim exemption in, value of fully exempt retirement accounts which were previously schedules based on value shown in account statements predating petition date by more than eighteen months; "whether an undervaluation is material is not the point").

Notwithstanding the forgoing, the undervaluation must rise to the level of deception or reckless disregard in order to constitute bad faith. *Valentine*, 2009 WL 3336081 (finding that debtor who, at counsel's direction, initially valued her jewelry at liquidation value was not acting in bad faith in seeking to amend schedules to increase value of jewelry to reflect the cost value and exempt the additional value because, although initial valuation method may have been incorrect under the majority rule, the debtor had a reasonably basis for using that method).

Courts in other jurisdictions have applied similar reasoning. In *Bauer*, 298 B.R. at 356, the court held that the debtors' concealment of the true value of their real estate was precisely the sort of bad faith sufficient to preclude later amendment, and the Bankruptcy Appellate Panel for the Eighth Circuit upheld the decision. *Id.* at 357. As summarized by the BAP in the *Bauer* case:

> A discharge in bankruptcy and the associated fresh start are not fundamental rights….To the contrary, they are privileges. The opportunity for a completely unencumbered new beginning is limited to the ***honest but unfortunate debtor***.…The cost to the debtor for an unencumbered fresh start is minimal: ***the debtor must honestly and accurately disclose his or her financial affairs and must cooperate with the trustee***.

Id. (emphasis supplied).

The court in the *Bauer* case went on to recognize the irony that, had the debtors accurately disclosed the equity in the home from the outset, they would have been able to fully exempt it. Instead, the debtors only amended their schedules to reflect the actual value of their home after the trustee had discovered the true value of it. The court did not permit the debtors to claim otherwise valid exemptions only as a last resort once they had been caught in their scheme to defraud their creditors and the court.

b. Concealment

"Intentional concealment of estate property will bar the debtor from claiming such property as exempt, after it surfaces as an asset." *In re St. Angelo*, 189 B.R. 24, 27 (Bankr. D.R.I. 1995) (denying attempt claim exemption in personal injury claim where debtor "coyly" referred to asset in a misleading reference to the personal injury litigation in his initial schedules and then moved to amend schedules only after the chapter 7 trustee came into possession of the award).

"A debtor's intentional and deliberate delay in amending an exemption in order to obtain an economic or tactical advantage at the expense of the estate can constitute bad faith." *In re Orlando*, 359 B.R. at 400 (denying debtor's attempt to amend schedules and claim exemption in property settlement after initially attempting to conceal the asset). *See also, In re Donovan*, 2002 WL 1011298 *3-4 (Bankr. D.N.H. May 15, 2002) (finding debtor's mistaken omission of harassment claim from schedules did not constitute bad faith *but* debtor's delaying seeking exemption until it became "strategically necessary for her to do so" did constitute bad faith).

Concealment can form the basis for a bad faith finding even when the debtor discloses the existence of assets but conceals the value derived from use of those assets. *See, Harris*, 2006 WL 3497821 (denying amendment where assets initially scheduled at a "disposal value" of $8,600 were later sold for at least $85,000).

2. Prejudice

It was well established, pre-*Law*, that an objecting party need not demonstrate prejudice to the entire creditor body to be successful in opposing a motion seeking to amend exemptions. *Snyder,* 279 B.R. at 1. "Prejudice to the trustee or a single creditor will suffice." *Id.* Merely establishing prejudice, however, does not end the inquiry. The Court must also weigh the prejudice to the Debtor if the exemption is disallowed, against the prejudice to third parties in allowing the exemption. *In re Varela*, 2004 WL 3623507 *2 (Bankr. D.R.I. Nov. 16, 2004) (citations omitted). An objecting party must establish more than a mere "adverse effect" on creditors. *In re McComber*, 422 B.R. 334, 337 (Bankr. D. Mass. 2010) (overruling trustee's objection to debtor's motion seeking to switch to Massachusetts exemptions after originally, mistakenly electing to use federal exemptions where only shown prejudice was a reduction in distribution to creditors).

Most often, amendments to claim exemptions are denied on prejudice grounds because the debtor waits until after the estate trustee has spent estate resources recovering the asset. *See, e.g., Donovan*, 2002 WL 1011298 (finding prejudice where debtor did not initially disclose harassment suit and waited to amend schedules until after trustee negotiated and ultimately settled the claim

where settlement was negotiated with debtor's knowledge and on the condition that debtor would not receive any portion of the proceeds). *See also*, *Varela*, 2004 WL 3623507 at *2 (denying claim of exemption in settlement proceeds where proceeds were sole asset of chapter 7 estate, chapter 7 trustee invested considerable time and effort into prosecution of underlying claim and debtor's exemption in settlement proceeds, if allowed, would cover the entire amount of the settlement); *In re Cudeyro*, 213 B.R. 910 (Bankr. E.D. Pa. 1997) (determining prejudice existed where parties relied on debtor's elections). Where the trustee has taken or foregone action based upon the debtor's conduct in electing exemptions, courts are subsequently loathe to allow amendment. *Id.* Courts have similarly found prejudice where distributions have already been made. *Id.* Courts have even held that a debtor's inordinate delay constitutes prejudice. *Id.* ("[a]t some point, the debtor's election of either the state or federal exemptions must become irrevocable so as to avoid any unfair prejudice to the trustee and unsecured creditors.") (citations omitted).

3. Res Judicata or Collateral Estoppel

The doctrine of *res judicata* operates to bar debtors for asserting an amended claim of exemption which attempts to re-assert a claim in property previously unsuccessfully claimed as exempt. *See, e.g., In re Gress*, 2014 WL 4681708 (Bankr. M.D. Pa. 2014). In the *Gress* case, the debtors had listed property, claimed an exemption, and the trustee objected thereto. *Id.* at *1–3. The court sustained the trustee's objection and ordered the debtors to turn over the non-exempt assets. *Id.* at *3. The debtors then attempted to amend their schedules to re-claim the property as exempt under a different provision, and the trustee once again objected. Id.

The court in *Gress* sustained the objection and denied the debtors' exemption claims:

> Claim preclusion, or res judicata, "applies to claims that 'were or could have been raised' in a prior action involving the 'parties or their privies' when the prior action had been resolved by 'a final judgment on the merits.'"

Id. at *5 (citations omitted). The court went on to explain that claim preclusion applied in the context of resolving objections to exemption claims. *See id.*; *see also Cogliano v. Anderson (In re Cogliano)*, 355 B.R. 792 (9th Cir. BAP 2006); *In re Daniels*, 270 B.R. 417 (Bankr. E.D. Mich. 2001). The court held that orders regarding exempt status of property were final orders, and that debtors should thus not be allowed to amend schedules to effectively re-litigate claims exemptions. *See id.*

As the court set forth in *In re Samuels*, 2010 WL 2651909 (Bankr. D. Mass. 2010), res judicata precludes re-litigation of matters resolved by final orders. In the *Samuels* case:

> where the earlier order was entered by this court and in this very bankruptcy case, the court may take judicial notice of the judgment, pleadings, and rulings. The relevant facts are therefore readily ascertainable… The order to which the movants would give preclusive effect is an order of this court, a federal court. Federal law therefore determines whether that order has preclusive effect. A final judgment on the merits of an action precludes the parties or their privies from relitigating issues that were or could have been raised in that action.

Id. at 5.

Courts in this circuit have held that for *res judicata* purposes, a default judgment is a final judgment regarding the claims raised by the prevailing party. *See In re Hann*, 476 B.R. 344, 358 (1st Cir. BAP 2012). More particularly, the "allowance or disallowance of a claim in bankruptcy should be given like effect as any other judgment of a competent Court, in a subsequent suit against the bankrupt or any one in privity with him." *Id.*

4. Timeliness

Some courts have couched the discussion of "bad faith" in the broader term of "timeliness" but the analysis usually establishes that the ultimate consideration is whether the late amendment was made in bad faith or would prejudice creditors. *See Monahan*, 171 B.R. at 715 ("Although the debtor was arguably lethargic in amending his schedules, there is no evidence he or his wife intended to hide the asset from the trustee at any time"); *Gregoire*, 210 B.R. at 432 (sustaining trustee's objection to amended exemption to personal injury claim where debtor hindered trustee's attempts to initially obtain information regarding claim and failed to comply with an order approving compromise of the claim and directing debtor to amend his schedules within ten days). *But see*, *In re Lee*, 495 B.R. 107, 118 (Bankr. D. Mass. 2013) (debtor permitted to amend exemptions even though asset not disclosed where concealment resulted from poor representation by counsel.

III. Using (and Abusing) Exemptions

It is understood and encouraged for debtors and their counsel to work creatively to maximize the "basic necessities of life" provided for by exemption

statutes in order to provide the freshest "fresh" start possible. This creativity involves exemption planning, which is generally defined as "a strategy whereby financially-besieged debtors liquidate non-exempt assets and use the proceeds of that liquidation to purchase exempt property prior to filing a bankruptcy petition." *In re Carletta*, 189 B.R. 258, 261 (Bankr. N.D. N.Y. 1995) (*citing In re Johnson*, 80 B.R. 953, 957 (Bankr. D. Minn. 1987), *judgment aff'd*, 101 B.R. 997 (D. Minn. 1988)).

The contours of *permissible* liquidations of nonexempt assets in order to reinvest in exempt property, however, do not lend themselves to easy answers to the question: "should I recommend the debtor do that?" And, in light of the significant consequences to a court determination that the debtor *abused* the exemptions, this area can be unsettling even for the seasoned practitioner. Some common examples of the difficult consequences flowing from exemption planning abuse (of varying levels of actual deterrence) include: (1) The denial or limitation of an exemption; (2) Dismissal of the bankruptcy case; (3) Denial of discharge; (4) Rule 9011 sanctions; (5) Construing any ambiguity in the claim against the debtor; (6) Revocation of discharge; (7) Denial of confirmation; and (8) Criminal prosecution. *See generally* Bankr. Exemption Manual (2012 ed.); *see also Taylor,* 503 U.S. at 644–45.

Please note that the Supreme Court's decision in *Law,* 134 S. Ct. at 1188, discussed below, has impacted the bankruptcy court's use of its equitable authority, at least with respect to surcharging a debtor's otherwise valid exemption. *See also United States v. Ledée*, 772 F.3d 21, 29 (1st Cir. 2014) ("We note that the Supreme Court has recently held that bankruptcy courts do not have "a general, equitable power . . . to deny *exemptions* based on a debtor's bad-faith conduct." . . . . Although *Law* appears to overrule *Malley* and *Hannigan* to the extent they limited exemptions based on bad-faith conduct, the Supreme Court's ruling does not restrict the bankruptcy court's discretion concerning amendments unrelated to exemptions—as was the situation here.")

A. Types of Abuse

A variety of bad faith exceptions to amendment are set forth above in Section II.E.1. The reasons against allowing amendment of an exemption are the same reasons against allowing the claim of exemption initially. Although not exclusive – as creativity is limitless – some common themes that may tend toward a finding of abuse in exemption planning include: (1) property was omitted from the bankruptcy schedules or the intentional concealment of property; (2) property that was insufficiently described in the bankruptcy schedules; (3) the debtor's general bad faith in the case; and (4) a fraudulent intent in converting nonexempt assets into exempt assets. *See generally*

Bankr. Exemption Manual (2012 ed.); *see also* § 1. The Bad Faith Exception, *supra*.

B. Remedies for Abuse

The general denial of an exemption is a natural, reflexive sanction for bad behavior with respect to the property claimed as exempt; however, the deterrent force of this sanction is often questioned. Here are some other, perhaps more retributive, options.

1. Sanctions

There is a duty of reasonable diligence to complete all requisite documents fully and accurately. 11 U.S.C. § 521. The debtor's attorney also has a separate duty to ensure that all the required documents are accurate and complete. *See In re Withrow*, 405 BR 505, 51 (1st Cir. BAP 2009) ("Any attorney who files schedules and statements on a debtor's behalf makes a certification regarding the representations contained therein. Although the certification is not an absolute guaranty of accuracy, it must be based upon the attorney's best knowledge, information and belief, formed after an inquiry reasonable under the circumstances." The First Circuit has held that the standard to be applied is "an objective standard of reasonableness under the circumstances."). Failure to fulfill this obligation could lead to sanctions.

2. Construing Ambiguous Exemptions Against the Debtor

Scheduled exemptions with a value of "unknown," "to be determined," or "$1" are neon lights to trustees and creditors alike. Moreover, where property is omitted or insufficiently described in a debtor's bankruptcy schedules, the ambiguity may be construed against the debtor. *See Barroso-Herrans*, 524 F.3d at 341, in which Chapter 7 debtor claimed an $8,000 exemption in two lawsuits, although the damages demanded were over $4 million. The trustee settled the suits for $100,000, and the court allowed the debtor just $8,000, construing the ambiguity over whether the debtor intended to exempt the "full value" against the debtor. *Id.; in accord Schwab,* 560 U.S. at 770.

3. Denial Based on Failure to Meet the Statutory Requirements

Provided there has been a timely objection, an exemption that does not meet the statutory requirements will be denied. *In re Bennett*, 192 B.R. 584 (Bankr. D. Me. 1996) (discussing contours of Maine homestead exemption).

4. Dismissal of Case

Section 707(a) authorizes the court to dismiss a case for cause. Of course, "cause" is not limited to the examples listed in section 707, and the debtor's failure to file complete and accurate schedules may form the basis for dismissal of the case. A practical person might question how effective a dismissal is as a remedy since the creditors of the debtor will be faced with a situation where the debtor can simply re-file the bankruptcy petition. Instead, creditors may be better served by either a denial of the exemptions—leaving more assets in the estate for distribution, or a denial of discharge—leaving the debtor indebted and the assets subject to execution. *See In re Schwarb*, 150 B.R. 470, 472 (Bankr. M.D. Fla. (1992).

5. Criminal Referral and Prosecution

Trustees and the U.S. Trustee are required to report any reasonable ground for criminal violation to the U.S. attorney. 18 U.S.C. § 3057(a).

6. Denial of Discharge

The fresh start—the ultimate goal of the individual debtor in bankruptcy—is not a right, but a privilege available only to the open and honest debtor. *See, e.g.*, *In re Tabibian*, 289 F.2d 793 (2d Cir. 1961); *In re Pimpinella*, 133 B.R. 694 (Bankr. E.D.N.Y. 1991). While bad faith may not be sufficient grounds to deny the claim of exemption, courts frequently impose the ultimate sanction of denial of the discharge to unscrupulous debtors. *See In re Kaplan*, 245 F. 222 (D.C. Mass. 1917).

IV. Did *Law v. Siegel* Change the Landscape?

In a unanimous opinion, the Supreme Court held in *Law,* 134 S. Ct. at 1188, 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.

A. Law – The Facts

The Chapter 7 debtor asserted that his home was subject to two voluntary liens: one in favor of Washington Mutual Bank and a second in favor of "Lin's Mortgage & Associates." When combined with his $75,000 homestead exemption, the debtor asserted he had no equity in his home subject to the Chapter 7 trustee's administration. Unconvinced, the trustee challenged the lien in favor of Lin's Mortgage & Associates as being fraudulent and, *after five years of costly litigation*, the bankruptcy court determined that the debtor created the obligation and related security instrument in order to preserve the equity in his home. The court said the "most plausible conclusion" was that the debtor "authored, signed, and filed some or all of these papers."

The bankruptcy court then determined that the trustee spent more than $500,000 in attorneys' fees overcoming the debtor's fraudulent misrepresentations, and granted the trustee's motion to "surcharge" the entirety of the debtor's $75,000 homestead exemption to pay a portion of those fees. The 9th Circuit affirmed.

The Supreme Court, however, reversed and remanded, holding that the provisions of section 105 cannot overcome section 522(k)'s express command that "[p]roperty the debtor exempts under this section is not liable for payment of any administrative expense." Therefore, by ordering a surcharge to pay a portion of the trustee's attorney's fees (*i.e.*, an administrative expense), "the court exceeded the limits of its authority under section 105(a) and its inherent powers."

B. Law – The Law

The Supreme Court believed it was "hornbook" law that section 105(a) "does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code." *Citing* 2 Collier on Bankruptcy ¶ 105.01[2], p. 105–6 (16th ed. 2013). The Supreme Court did conclude that bankruptcy courts retain the ability to sanction debtor misconduct by denying the debtor's discharge, by imposing sanctions pursuant to Rule 9011, and by imposing other appropriate sanctions under Section 105 and the court's inherent authority "[b]ut [that], it may not contravene express provisions of the Bankruptcy Code by ordering that the debtor's exempt property be used to pay debts and expenses for which that property is not liable under the Code."

Importantly, and unusually, the Supreme Court did not end its analysis upon resolution of the question presented; i.e., whether a trustee may surcharge an exempt asset as a sanction against a debtor's bad faith. Rather, the Supreme Court went on to pronounce dicta on a wholly separate issue—the long settled question of whether concealment of an asset precludes its subsequent exemption:

> Siegel points out that a handful of courts have claimed authority to disallow an exemption (or to bar a debtor from amending his schedules to claim an exemption, which is much the same thing) based on the debtor's fraudulent concealment of the asset alleged to be exempt. [citations omitted]. He suggests that those decisions reflect a general, equitable power in bankruptcy courts to deny exemptions based on a debtor's bad-faith conduct. For the reasons we have given, the Bankruptcy Code admits no such power.

Law, 134 S.Ct. at 1196. In a stroke, and with no case or controversy before it, the Supreme Court reversed years of established caselaw with respect to bad faith exemption claims.

C. Law – What Changes After?

The analysis of bad faith in connection with exemption claims arises in two areas. In the first instance, courts routinely consider the impact of bad faith—whether by fraud, concealment, conversion or otherwise—on the debtor's original or amended claims of exemption. In the second and less common instance, courts weigh whether to allow a trustee to surcharge a debtor's otherwise exempt assets in order to address a debtor's bad faith in some other, unconnected area of the case. The *Law* case has significantly changed the likely outcome of cases in both of these areas.

1. Exemption Claims and Amendments

Prior to *Law*, courts had established the proposition that failure to disclose an asset precludes a subsequent claim of exemption in such asset. *See, e.g.*, *In re Yonikus*, 996 F.2d 866 (7th Cir. 1993) ("Fraudulent concealment, being clear evidence of debtor's bad faith, was a proper ground for denying the exemption in that asset."); *In re Doan*, 672 F.2d 831 (11th Cir. 1982) (recognizing bad faith, including concealment, as proper grounds for denial of exemption); *In re Morgan*, 2011 WL 5025333 (Bankr. D. Mass. 2011) (same); *St. Angelo*, 189 B.R. at 24 ("If debtors could omit assets at will, with the only penalty that they had to file an amended claim once caught, cheating would be altogether too attractive."). Put most simply, "concealment of an asset will bar exemption of that asset." *Yonikus*, 996 F.2d at 874.

Following the *Law* decision, courts have struggled to reconcile this rule with the Supreme Court's holding and, importantly, dicta. *See, e.g.*, *In re Elliot*, 523 B.R. 188 (9th Cir. 2014); *In re Bogan*, 2015 WL 1598056 (W.D. Wis. 2015); *In re Van Erem*, 2015 WL 1293525 (S.D. Tex. 2015); *In re Baker*, 514 B.R. 860 (E.D. Mich. 2014); *In re Mateer*, 525 B.R. 559 (Bankr. D. Mass. 2015); *In re Dickey*, 517 B.R. 5 (D. Mass. 2014); *In re Reade*, 2014 WL 7359053 (Bankr. C.D. Cal. 2014); *In re Woolner*, 2014 WL 7184042 (Bankr. E.D. Mich. 2014).

In the *Mateer* case, the debtor fraudulently concealed insurance proceeds in connection with a loss suffered on his residence. When such proceeds were discovered, the debtor claimed them as exempt under Massachusetts law, which extends the homestead exemption to cover insurance proceeds resulting from a loss to the property in question. The trustee objected to the claim, citing the debtor's bad faith in concealing the asset. The court in *Mateer* specifically acknowledged the pre-*Law* rule annunciated in the caselaw above;

no disclosure means no exemption. *Id.* at 565. Nevertheless, the court went on to discuss the impact of *Law* in abrogating this line of cases:

> Up until March 4, 2014, I would have stood on solid ground in denying Mr. Mateer's claim of exemption in the insurance proceeds based on his attempt to conceal their existence… On that date, the ground shifted dramatically as a result of the decision of the Supreme Court of the United States in *Law v. Siegel*…

Id. The court in *Mateer* relied on the Supreme Court's dicta in *Law*, suggesting that, although it was not binding, such dicta did indicate a change in the course of caselaw on the issue.

Like the Justices in the *Law* case, the *Mateer* court did not rest there. The Supreme Court limited the scope of its dicta, applying it only to the question of federal exemptions under the Bankruptcy Code. It left open the issue as applied to state law exemptions, such as the issue before the court in *Mateer*, which was one arising out of the Massachusetts homestead statute. Nonetheless, the court in *Mateer* extended application of the dicta, discarding the distinction drawn by the Supreme Court.

The Supreme Court in *Law* and lower courts applying the ruling offer similar arguments in reaching the conclusion that exemptions may not be defeated even with respect to assets that were previously concealed. Namely, the courts rely on specific, statutory exceptions to exemption claims, such as provided under section 522(o) of the Bankruptcy Code, to demonstrate that the absence of such a provision covering concealment means that no such power has been granted. In effect, the courts seem to say that Congress was well aware of how to prevent or limit exemptions, and thus clearly did not choose to do so with respect to situations of concealment (as opposed to transfer under section 522(o)).

In any event, virtually every case post-*Law* has ruled that a debtor's claim of exemption in an asset is nearly absolute, and is not affected by the debtor's previous concealment of or fraud or bad faith with respect to such asset. The only exception found to date is the *Woolner* case, wherein the court declines to apply the *Law* dicta, citing overriding public policy concerns to the contrary. *Woolner*, 2014 WL 7184042 at *4. The court summarizes its analysis in quoting a Supreme Court Justice on the value of dicta:

> I own that it is a good deal of a mystery to me how judges, of all persons in the world, should put their faith in dicta. A brief experience on the bench was enough to reveal to me all

> sorts of cracks and crevices and loopholes in my own opinions when picked up a few months after delivery, and reread with due contrition ... But dicta are not always ticketed as such, and one does not recognize them always at a glance. There is a constant need, as every law student knows, to separate the accidental and the non-essential from the essential and inherent.

Id. (quoting Benjamin N. Cardozo, *The Nature of the Judicial Process* 29–30 (Yale Univ. Press 1949)).

2. Surcharging Exemptions

The second area of exemption practice is both more rare and more complex. This concerns the ability of the trustee to reach otherwise exempt assets as a sanction for the debtor's bad faith or conduct in wholly unrelated areas of the case. Prior to *Law*, cases very recently were developing in the direction of allowing trustee's to do so.

In a case before the Court of Appeals for the Ninth Circuit, the court held that a trustee could surcharge exempt assets due to bad faith conduct by the debtors. *See Latman v. Burdette*, 366 F.3d 774 (9th Cir. 2004). The debtors had liquidated assets in the several days intervening between the dismissal of their chapter 13 case and subsequent refiling of a chapter 7 proceeding. The debtors were unable to account for the disposition of a portion of the sale proceeds totaling $7,000. The trustee sought and obtained from the bankruptcy court an order surcharging the debtors' exemption in a completely unrelated asset, one of the debtors' vehicles. The Court of Appeals upheld the bankruptcy court's ruling, citing the inherent equitable powers of the bankruptcy court.

The Court of Appeals for the First Circuit reached a similar ruling in a more recent case. *See Malley v. Agin*, 693 F.3d 28 (1st Cir. 2012), where the First Circuit held that a bankruptcy court was acting within its statutory authority to a surcharge against the value of an otherwise exempt asset as a remedy for the Chapter 7 debtor's willful concealment of non-exempt funds he received and spent. The Court of Appeals in the *Malley* case relied on the "'broad authority granted to bankruptcy judges to take any action that is necessary or appropriate "to prevent an abuse of process…'" *Id.* at 30 (citations omitted). As is so often the case, the Court lit upon section 105(a) as the source of such authority. Section 105(a) does provide for broad powers, which are not enumerated.[3] This contrasts—often failingly—with the *Law* Court's contention that a power not enumerated is a power denied.

[3] Section 105 provides, in pertinent part:

Following the *Law* case, the power of a trustee to surcharge assets claims as exempt by a debtor would seem to be completely abrogated. The Supreme Court apparently left no room to distinguish its holding or to provide for any circumstance in which such power could be invoked. At the very least, no case has appeared in contradiction to the Supreme Court's holding or dicta in *Law*,

2. What Does This Mean For Debtors?

Prior to the *Law* decision, trustees had equitable, precedential and statutory grounds to deny or invade claims of exemption to redress bad faith conduct by debtors. While this preserved the integrity of the bankruptcy process, it also served a practical purpose. Absent such powers, the trustee would have no ability to fund the legal battle with the debtor over the issue or to return any distribution to unsecured creditors. Often the debtor's exempt assets represent the only property in the case. By removing such assets from the reach of the trustee (and, consequently, creditors), the Supreme Court has created a situation of disincentive for the trustee to pursue debtors for their bad faith misconduct while at the same time creating incentive for the dishonest debtor to attempt concealment of his or her assets. After all, if the debtor fails at concealing assets, he or she may simply claim them as exempt following their discovery. The court's fears in the *St. Angelo* case appear to have been realized.

Perhaps recognizing this result, courts have suggested that there remains a reasonable sanction against the dishonest debtor—the denial of the discharge. While the debtor may preserve the exemption claim, he or she does so at the cost of losing the discharge; admittedly, not much of a bargain for the debtor, who now faces continuing claims of creditors. Upon expiration of the automatic stay, moreover, creditors are no longer constrained by the Bankruptcy Code, and may in fact pursue otherwise exempt assets under applicable non-bankruptcy law. While this may act as some deterrent to unscrupulous debtors, it in no way provides incentive for the trustee to pursue the potentially lengthy and expensive adversary proceeding against the debtor

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> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a).

to deny the discharge. Despite very good grounds for denial of the discharge, many cases likely will never be brought due to this practical obstacle.