Can a Debtor's Exempt Assets Be Surcharged as a Sanction for Misconduct?

CASE AT A GLANCE

In chapter 7 bankruptcy, a debtor keeps certain statutorily defined "exempt" assets, while all other assets are sold to pay creditors. In exchange, most of the debtor's debts are discharged. In this case, the Court must decide whether a debtor may be sanctioned by the loss of exempt assets as an equitable remedy for trying to fraudulently claim excess exemptions or hide assets, with the forfeited assets awarded to the bankruptcy estate to recover litigation costs arising from the debtor's misconduct.

Law v. Siegel
Docket No. 12-5196

Argument Date: January 13, 2014
From: The Ninth Circuit

by Marshall Tracht
New York Law School, New York, NY

INTRODUCTION

A basic principle of bankruptcy law is that an honest but unfortunate debtor should be granted a "fresh start" by having most of his or her debts discharged while retaining a certain amount of "exempt" assets, generally defined by state law. The Bankruptcy Code states that exempt assets cannot be used to pay prepetition debts or administrative costs of the bankruptcy case, with a number of very limited exceptions based on specific categories of misconduct. At issue in this case is whether the court can use its equitable powers to "surcharge" some or all of a debtor's exempt assets and allocate them to cover the bankruptcy estate's litigation expenses, where the debtor has engaged in egregious misconduct regarding those assets during the bankruptcy case.

ISSUE

Does a bankruptcy court have the authority, under Bankruptcy Code § 105 or its inherent power to prevent abuse of the judicial process, to sanction a debtor who engages in egregious misconduct by attempting to wrongly inflate exemptions or hide assets during the bankruptcy case, by surcharging the debtor's exempt assets to compensate the bankruptcy trustee for the costs of litigation arising directly from the debtor's misconduct?

FACTS

The petitioner, Stephen Law, is a defendant in a tort case. In an effort to shield his home from any judgment that might be entered against him, he recorded a fraudulent mortgage in favor of "Lin's Mortgage and Associates," which would have priority over any lien in favor of the tort victim. The home was already subject to a legitimate mortgage of about $150,000 to Washington Mutual Bank; together these liens would absorb more than $318,000 of value in the home. In October 1999, about four months after the fraudulent mortgage was recorded, a judgment was entered against Law in the amount of $131,822. Under California law, a debtor is entitled to exempt up to $75,000 in the value of a homestead after paying off any mortgages, but ahead of any judgment liens. Thus, the tort claimant would receive nothing by foreclosing on the judgment lien unless the property sold for more than $393,000.

Law filed a chapter 7 bankruptcy case in 2004, listing the home as his only significant asset. His filings estimated the home's value at $363,000, and showed it subject to roughly $450,000 in liens: a $147,000 mortgage in favor of Washington Mutual, the fraudulent mortgage, and several judgment liens. If these values were correct, the bankruptcy trustee could be expected to abandon the house to Law and let lienholders foreclose on it because there would be no value for the bankruptcy estate after the liens were satisfied.

In fact, the bankruptcy trustee sold the house in 2006 for $680,000, leaving about $209,000 after liens (excluding the fraudulent mortgage) and costs of the sale. Of this, Law would normally have been entitled to $75,000 as his homestead exemption, with the remainder going to the bankruptcy estate to cover administrative expenses and Law's other debts and the excess, if any, being returned to Law. However, the trustee had expended inordinate amounts of time and money in litigation with Law over the fraudulent mortgage, with Law forging documents, filing countless motions, and obstructing discovery. Acting pro se, he filed at least 15 separate appeals over the course of the litigation.

The trustee moved to "surcharge" Law's exemption to pay for the costs of this litigation. Simplifying the proceedings that followed, the bankruptcy court granted that motion, which was then reversed on appeal (largely because the fraudulent nature of the mortgage had not yet been proven), and Law's position was affirmed by the Ninth Circuit. A second surcharge motion was filed and, after much litigation, the bankruptcy court again ruled for the trustee. This

time, the court expressly found that (1) the mortgage was fraudulent; (2) absent that fraud and Law's other misrepresentations to the court there would have been "ample funds" to cover administrative expenses and pay all creditors even after Law's $75,000 exemption, and (3) the bankruptcy estate had incurred more than $450,000 in legal fees as a direct result of Law's misconduct. The bankruptcy court therefore entered an order surcharging the homestead in its entirety, applying all $75,000 to the trustee's litigation costs.

This decision was upheld by a Bankruptcy Appellate Panel, and then by the Ninth Circuit Court of Appeals. The court of appeals held that a debtor's exemptions can be surcharged, but only in "exceptional circumstances" such as this case, "when a debtor engages in inequitable or fraudulent conduct that, when left unchallenged, denies creditors access to property in excess of that which is properly exempted under the Bankruptcy Code." This was in accord with a First Circuit decision written by Justice Souter, sitting by designation, *Malley v. Agin,* 693 F.3d 28 (1st Cir. 2012), and at odds with a Tenth Circuit case, *In Re Scrivner,* 535 F.3d 1258 (10th Cir. 2008).

CASE ANALYSIS

Section 522 of the Bankruptcy Code states that a debtor "may exempt" certain property, generally defined by state law, from the bankruptcy estate and that such property is not available to satisfy general prepetition claims or administrative costs of the bankruptcy case. This, together with the discharge of debts, permits individuals a fresh start and prevents debtors and their dependents from being left as wards of the state. The petitioner's main argument is that Congress set forth precise and limited exceptions to the protection given to exempt assets and that bankruptcy courts may not disregard the statute by crafting further exceptions.

First, the statute provides express limitations on some exemptions if a debtor has been found guilty of certain misconduct. For example, § 533(q)(1) caps homestead exemptions at $155,675 if the debtor "has been convicted of a felony … which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of this title."

Second, § 522(k) states that exempt assets may not be used to pay "any administrative expenses" other than those incurred specifically to recover the exempt asset. (That is, if the asset was transferred prepetition and the trustee brings an avoidance action and recovers the asset, only to have it exempted from the estate by the debtor, the trustee can recover the relevant litigation costs from the exempt asset.) Thus, Congress has set forth very clearly the circumstances in which "any administrative expense"—such as the legal fees incurred by the trustee in this case—can be charged against exempt assets.

Third, § 522(c) allows a small number of specific claims to be paid out of otherwise exempt assets, such as domestic support obligations, certain tax claims, and education loans procured by fraud. Permitting a court to surcharge exempt assets for other purposes would potentially harm these parties by putting the trustee's recovery ahead of them, even though Congress expressly chose to protect them by allowing them to reach assets unavailable to any other creditors.

The petitioner argues that Congress has defined the limited circumstances under which a debtor may be deprived of his or her statutory exemptions and narrowly circumscribed the ability of creditors or the trustee to reach exempt assets, and courts may not craft additional exceptions based on equitable principles. This follows from a canon of statutory construction: where Congress has explicitly enumerated exceptions to general prohibition, additional exceptions are not to be implied, in the absence of evidence of a contrary legislative intent.

Moreover, Congress has set forth various penalties for misconduct before or during the bankruptcy case, including dismissal of the bankruptcy case, denial of discharge, or even criminal charges in appropriate cases, but left no room in § 522 for courts to limit exemptions on discretionary or equitable grounds, having determined, petitioner argues, that "even culpable debtors should not be left penniless after bankruptcy." This may be because exemptions protect not only the debtor who engaged in wrongdoing, but also that debtor's dependents, who presumably have not.

In granting the motion to surcharge, the bankruptcy court relied on its inherent equitable power and on § 105(a) of the Bankruptcy Code, which provides:

> 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.

According to the petitioner, the bankruptcy court's order cannot be justified under § 105, because that order is directly at odds with § 522 and thus is not "carrying out the provisions of this title." Similarly, the order cannot be justified by the bankruptcy court's inherent equitable powers because "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197 (1988).

The respondent argues that bankruptcy courts have the authority under § 105 to take actions that are "appropriate" to carry out the provisions of the Code, an authority that goes beyond those orders that are strictly "necessary" (a limitation that had existed under the old Bankruptcy Act). Surcharging a debtor's exemptions may be appropriate to carry out various provisions, such as those requiring the debtor to honestly disclose his or her assets and liabilities (§ 521(a)(1)(B)(i)), to "cooperate with the trustee as necessary to enable the trustee to perform the trustee's duties" (§ 521(a)(3)), to "surrender to the trustee all property of the estate" (§ 521(a)(4)), and to exempt those assets the statute permits (§ 522(b)(1)). This is essentially the reasoning of the opinion drafted by Justice Souter, sitting by designation, in *Malley*. There, the court upheld a bankruptcy court's decision to surcharge exempt property on account of the concealment by the debtor of $25,000 he had received prepetition.

Moreover, respondent claims, bankruptcy courts have the inherent authority, as does any court, "to fashion an appropriate sanction for conduct which abuses the judicial process" (quoting *Chambers v. NASCO, Inc.,* 501 U.S. 32 (1991)). As Justice Souter wrote in *Malley:*

> There could not be a clearer example of foiling abuse of process than a surcharge order mitigating the effect of fraud in retaining non-exempt assets and thus enhancing the set-aside for a fresh start beyond the amount Congress provided for the honest debtor. Nor can one easily imagine an order more necessary, for although the enumerated remedies of dismissal or denial of discharge penalize the dishonest debtor, they add nothing to the pot for listed creditors, who would otherwise bear the brunt of the fraud.

Indeed, bankruptcy courts had denied exemptions on equitable grounds in a number of pre-Code cases, and the Bankruptcy Code generally will not be read to reverse pre-Code practice absent a "clear indication" that Congress so intended.

Respondent also relies in part on *Marrama v. Citizens Bank,* 549 U.S. 365 (2007), a 5-4 decision in which the Court examined whether a bankruptcy court could bar a debtor from converting a chapter 7 case to chapter 13 in "bad faith." The Bankruptcy Code provides that a debtor "may convert a case [under chapter 7] to a case under chapter 11, 12 or 13 at any time..." The Code's only express limitations on this right are if (1) the chapter 7 case had been originally converted from another chapter, or (2) the debtor is not otherwise eligible for the chapter to which it seeks to convert. The structure of the *Marrama* argument was essentially identical to that in the current case: whether the debtor's ability to take an act which the statute says he "may" take, and which is subject to certain specific exceptions in the Code, can be subject to further limitations imposed by a court.

Justice Stevens, writing for the majority in *Marrama,* noted two alternative bases for upholding the bankruptcy court's order: § 105, and the inherent power of any court to sanction abusive litigation practices. The dissent (written by Justice Alito, joined by Chief Justice Roberts and Justices Scalia and Thomas) would have held that the bankruptcy court's action was invalid because neither § 105 nor the court's inherent equitable powers can be used to "contravene the provisions of the Code" by imposing limitations beyond those set forth in the statute.

The respondent claims that disallowing an exemption on equitable grounds is not inconsistent with § 522 and its narrow express limitations. First, respondent argues, those limitations apply only after it has been determined that the debtor is entitled to a particular exemption and therefore do not come into play if a court finds that the exemption should be disallowed on equitable grounds. Second, the limitations in § 522 were adopted piecemeal, at various times and for various purposes, and were "not intended to work together as an exhaustive legislative pronouncement on how exemptions may be restricted." They are specific grounds for denying or limiting exemptions but do not purport to be the exclusive grounds for doing so. Thus, respondent argues, § 522 limitations should not be read to limit the court's power to sanction abusive litigation practices.

As noted above, § 522 specifically limits the ability to use exempt assets to cover administrative expenses. Respondent notes that § 522(k) protects exempt assets from being used for typical administrative expenses, which are defined by the Code as "the actual, necessary costs and expenses of preserving the estate"; respondent argues that the expenses at issue here are not "necessary" expenses of preserving the estate. Rather, they are "extraordinary expenses occasioned by abusive litigation conduct that unnecessarily drains the estate of value," and so are not covered by § 522(k).

Finally, the respondent argues that bankruptcy is intended to provide relief to "honest but unfortunate debtors." The fresh start is granted in exchange for the debtor disclosing and turning over all applicable property, and where the debtor has chosen to hide assets or commit fraud on the estate, there is no unqualified entitlement to keep exempt property. Petitioner responds by noting that the Code contains many other sanctions for dishonest conduct, and that denying exemptions is neither necessary in light of those alternatives nor justifiable given the provisions of § 522. This was the reasoning of the Tenth Circuit in *Scrivner,* which noted that the arguments for surcharging a dishonest debtor's exempt assets are "compelling" but still found surcharging inconsistent with the statute and unnecessary in light of the other tools available to sanction misconduct.

SIGNIFICANCE

Exemptions matter both for debtors and for their dependents, and while it is difficult to be sympathetic to one who perpetrates a fraud on the court and his creditors, one justification for exemptions is that the debtor's dependents should not become further victims of the debtor's misconduct, or wards of the state because of that misconduct. Various amici have stressed the importance of exemptions to the debtor's fresh start and to the well-being of the debtor's dependents.

Perhaps the most important aspect of this case is one that appears to have gone unnoted in the briefs. Chapter 7 trustees are compensated by a $60 administrative fee in each case, plus a percentage of the assets distributed to unsecured creditors (this excludes recoveries by secured creditors such as mortgage and auto lenders). However, the vast majority of chapter 7 cases are "no asset cases"—that is, there are no unencumbered assets other than those protected by the debtor's exemptions, so the administrative fee is all the trustee earns.

If exempt assets can be reached by the trustee in defined circumstances, trustees may have a substantial incentive to go after those assets. The amounts at stake can be substantial, including the equity in a debtor's home (a number of states allow an unlimited amount of home equity to be exempted) and retirement accounts, which are generally exempt. Moreover, while a trustee receives only a percentage on amounts recovered for unsecured creditors (25 percent on the first $5,000, 10 percent on the next $45,000, and less thereafter), administrative expenses such as attorney's fees are paid off the top—and chapter 7 trustees can and do hire their own firms to do litigation.

On the positive side, this is likely to result in closer policing of debtor misconduct by bankruptcy trustees; on the negative side, it may drive up the cost of chapter 7 bankruptcy cases and force even

honest debtors to settle with the trustee out of their otherwise exempt assets to avoid protracted litigation, impairing the fresh start. If the Court permits surcharging, the critical question will be the standards for imposing a surcharge—these would determine the nature and strength of the incentives for trustees.

Marshall Tracht is a professor of law at New York Law School. He can be reached at mtracht@nyls.edu or 212. 431.2139.

PREVIEW of United States Supreme Court Cases, pages 196–199.
© 2014 American Bar Association.

ATTORNEYS FOR THE PARTIES

For Petitioner Stephen Law (Matthew S. Hellman, 202.639.6000)

For Respondent Alfred H. Siegel (Steven T. Gubner, 818.827.9000)

AMICUS BRIEFS

In Support of Petitioner Stephen Law

Bankruptcy Law Scholars (Marc A. Hearron, 202.778.1663)

G. Eric Brunstad Jr. (G. Eric Brunstad Jr., 860.524.3999)

National Association of Consumer Bankruptcy Attorneys (Danielle Spinelli, 202.663.6000)

In Support of Respondent Alfred H. Siegel

National Association of Bankruptcy Trustees (Lynne F. Riley, 617.426.5900)

National Association of Chapter Thirteen Trustees (Henry E. Hildebrand III, 615.244.1101)

United States (Donald B. Verrilli Jr., Solicitor General, 202.514.2217)