

## OBJECTIONS TO EXEMPTIONS BAD FAITH AND THE EQUITABLE POWERS OF THE COURT

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United States Bankruptcy Court  
District of Minnesota*

"A fundamental component of an individual debtor's fresh start in bankruptcy is the debtor's ability to set aside certain property as exempt from the claims of creditors."  
4 COLLIER ON BANKRUPTCY, 522.01 (15th ed. 2003).

### I. NECESSITY OF A TIMELY FILED OBJECTION

#### A. STATUTORY FRAMEWORK

1. 11 U.S.C. § 541(a)(1) -

"[A]ll legal or equitable interests of the debtor in property as of the commencement of the case" are property of the estate.

2. 11 U.S.C. § 522(b)-

Allows debtors to exempt property from the estate, subject to certain limitations. Debtor may claim exemption under § 522(d) if authorized under state law or claim exemptions under the applicable state exemption statute.

3. 11 U.S.C. § 522(d) -

Lists the property that may be exempted under the federal exemptions.

4. 11 U.S.C. § 522(l) -

"The debtor shall file a list of property that the debtor claims as exempt under subsection (b) of this section.... Unless a party in interest objects, the property claimed as exempt on such list is exempt."

5. Federal Rule of Bankruptcy Procedure 4003(a) -

Requires the exemptions to be listed on a schedule of assets pursuant to Rule 1007.

6. Federal Rule of Bankruptcy Procedure 4003(b) -

Objection must be filed within 30 days after conclusion of meeting of creditors or an extension requested. *See* Fed. R. Bankr. P. 9006(b)(2) (“court may enlarge time for taking action under . . . 4003(b)”)

B. GENERALLY, PROPERTY CLAIMED EXEMPT IS EXEMPT UNLESS OBJECTION FILED.

1. Deadlines still apply even though the debtor has no colorable basis for claiming the objection. Taylor v. Freeland & Kronz, 503 U.S. 638 (1992).

In Taylor the debtor reported a lawsuit with an "unknown" value on her personal property schedule, and likewise exempted that lawsuit for an "unknown" amount. The lawsuit was settled for \$110,000, far in excess of the debtor's available exemption. The Supreme Court stated that, although the petitioner had been entitled to exempt no more than "a small portion of [the lawsuit's] proceeds," she "in fact claimed the full amount as exempt." Since the trustee had not timely objected to the debtor's exemption of the lawsuit, the debtor was entitled to the entire settlement fund.

- 2.. Trustee may not wait until the value of a contingent claim is established. Allen v. Green (In re Green), 31 F.3d 1098 (11<sup>th</sup> Cir. 1994).

In Green debtor listed a lawsuit at a value of one dollar, but the parties agreed that its value was contingent, not that it had an actual present value of one dollar. The parties also agreed that debtor exempted the lawsuit for its entire reported value of one dollar, and that the Trustee did not object to that exemption claim. In allowing the exemption the Eleventh Circuit held that “the trustee may not wait until the value of a contingent claim is established before deciding whether to object; instead, he must object within the period allowed by Bankruptcy Rule 4003.” *Id.* at 1101.

3. Trustee did not need to object to exemption since amount of exemption was defined by statute. *See* Stoebner v. Wick (In re Wick), 276 F. 3d. 412 (8<sup>th</sup> Cir. 2002).

Asset listed as unknown value may be exempt only to amount of statutory exemption when the Trustee and the debtor were aware that asset had a value and that amount claimed under 11 U.S.C. § 522(d)(5) was limited to \$3,925.00.

C. AMENDMENT TO EXEMPTIONS

1. The general rule allows liberal amendment of exemption claims. In re Harris, 886 F.2d 1011, 1015 (8th Cir. 1989); *see also* In re Williamson, 804 F.2d 1355, 1358 (5th Cir. 1986) ("[T]he general rule is to allow liberal amendment of exemption claims, absent bad faith, concealment of property, or prejudice to creditors.").
2. Federal Rule of Bankruptcy Procedure 1009(a) -  
  
"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."

## II. BAD FAITH OR PREJUDICE TO CREDITORS

Under the holding of Taylor v. Freeland & Kronz, bad faith is not an issue unless a timely objection is filed. Exemptions not limited to exemptions taken in good faith. 503 U.S. at 645. The more interesting question, not yet settled, is whether bad faith allows a bankruptcy court grounds to extend a filing deadline after the deadline has passed. I will explore that question in the sections that follow.

### A. BURDEN OF PROOF

Party objecting to the amendment has the burden to demonstrate that "exceptional circumstances"--prejudice or bad faith-- warrant denial of the opportunity to amend a debtor's exemption claims. Tignor v. Parkinson, 729 F.2d 977, 979 (4th Cir. 1984). After the Supreme Court's decision in Grogan v. Garner, 498 U.S. 279 (1991) holding that the "preponderance of the evidence" standard applied in nondischargeability actions under 11 U.S.C. § 522, "[i]t is not entirely clear whether bad faith or prejudice must be shown by a 'preponderance of the evidence' or 'clear and convincing' evidence." Arnold v. Gill ( In re Arnold), 252 B.R. 778, 784 n.10 (B.A.P. 9<sup>th</sup> Cir. 2000). Most courts have held that the party objecting to exemption on basis of bad faith or prejudice inuring to the trustee or creditors must prove it by a sufficiently clear showing. In re Yonikus, 996 F.2d 866, 872 (7<sup>th</sup> Cir. 1993); In re Magallanes, 96 B.R. 253, 256 (B.A.P. 9th Cir. 1988); In re Brown, 56 B.R. 954, 958 (E.D. Mich. 1986).

### B. WHAT CONSTITUTES BAD FAITH?

1. Not bad faith for Debtor to amend to claim an exemption in an asset debtor intends to abandon.

In Kaelin, debtor did not know his attorney committed malpractice until a creditor raised the issue almost two years after the petition was filed. Debtor amended his schedules to claim the cause of action exempt under

Missouri law. The Eighth Circuit, in reversing both the bankruptcy court and the BAP, found that the mere intent to abandon an asset and thereby deprive his creditors a potential means of recovery was not sufficient to find, under the totality of the circumstances, that the claim of exemption was made in bad faith. Since nothing in the record suggested that the debtor attempted to conceal the asset the debtor could exempt the asset. Kaelin v. Bassett (In re Kaelin), 308 F.3d 885 (8<sup>th</sup> Cir. 2002).

2. Intentionally undervaluing asset may deprive debtor of an exemption.

In Bauer the debtor significantly under valued his homestead and the Trustee objected. When debtor attempted to amend his exemption under § 522(d)2 to claim an exemption under the Minnesota homestead exemption, the bankruptcy court denied the exemption in its entirety finding that the debtor had intentionally under valued the asset in bad faith and therefore lost his right to exempt the property. Bauer v. Iannacone (In re Bauer), 298 B.R. 353 (B.A.P. 8<sup>th</sup> Cir. 2003).

3. Fraudulent concealment may result in the forfeiture of debtor's right to exempt *an* asset.

“Whether debtor knowingly concealed asset from court and trustee, so as to have forfeited whatever exemption he might otherwise have asserted therein, is question of fact or inference to be drawn by bankruptcy court from underlying facts.” Sheehan v. Lincoln Nat. Life, 257 B.R. 449 (N.D. W. Va. 2001);

- a. In In re Yonikus, 996 F.2d 866, 868 (7<sup>th</sup> Cir. 1993) the debtor failed to list his work-related personal injury as an asset in his bankruptcy schedule or claim it as exempt. He employed different law firms for the personal injury claims and the bankruptcy; he did not tell his bankruptcy attorney about the personal injury and he did not tell the personal injury attorneys about his bankruptcy. He did not tell the Trustee about the settlement money he received and the court revoked his discharge for concealing an asset, yet he still attempted to amend his schedule of exemptions to claim the property as exempt. The Seventh Circuit affirmed the bankruptcy courts denial of the exemption based on debtor's fraudulent concealment of the asset. See also In re Miller, 255 B.R. 221, 222 (Bankr. D. Neb. 2000) (concluding "a debtor may not claim as exempt property intentionally omitted from schedules"); In re Park, 246 B.R. 837, 840 (Bankr. E.D. Tex. 2000) ("A debtor may not claim as exempt property which he knowingly concealed and

failed to disclose to trustee which normally would be exempt had it been properly scheduled and claimed."); In re St. Angelo, 189 B.R. 24, 26 (Bankr. D.R.I. 1995) ("Intentional concealment of estate property will bar the debtor from claiming such property as exempt, after it surfaces as an asset.").

- b. In Doan v. Hudgins (In re Doan), 672 F.2d 831, 833 (11th Cir.1982) the bankruptcy court denied the debtor's exemption on the basis of failure to disclose an tax refund. The Eleventh Circuit, however, reversed holding that because they disclosed the expected refund in their initial filing, discussed the refund with the trustee and asked if a lien had been placed on it, and only spent the refund after seeking advice from their attorney. Their failure of not informing the trustee upon receipt of the refund did not show intentional or fraudulent concealment, or even bad faith. They were allowed to amend their exemption to claim the refund as exempt.
- c. In In re Barber, 223 B.R. 830 (Bankr. N.D. Ga. 1998) debtor was injured in an accident after filing a chapter 13 case. Shortly thereafter debtor's case was dismissed and he filed a chapter 7 case. Schedules in either case failed to disclose the existence of a personal injury claim. Although debtor disclosed the cause of action at the § 341 meeting debtor failed to amend his schedules. Debtor never disclosed the existence of his bankruptcy case to his personal injury attorney and he resisted the Trustee's efforts to obtain information about the claim. The evidence--including Debtor's frequent calls to his personal injury lawyer regarding the status of settlement negotiations before and after filing the Chapter 7 case supported a conclusion that debtor intended to conceal the personal injury claim as an asset and debtor's attempt to amend his schedules to exempt the asset was denied..

- 4. Fraudulent conduct may deprive a debtor of the right to exempt *any* assets.

In Bogan, the debtor embezzled \$400,000.00 while in a chapter 13 case. Upon conversion of the case to chapter 7 the bankruptcy court held that exceptional circumstances existed and denied the debtor "any and all exemptions from the bankruptcy estate." Pineo v. Bogan (In re Bogan), 2003 WL 22989538 (Bankr. W.D. Pa. Dec. 18, 2003).

- 5. If failure to disclose an asset was an inadvertent mistake, amendment to claim an exemption may be allowed.

A mistake is “inadvertent” only when, in general, the debtor either lacks knowledge of the undisclosed claims or has no motive for their concealment.” Mims v. Browning Manufacturing (In re Coastal Plains), 179 F.3d 197, 210 (5th Cir. 1999).

6. Debtor may lose standing to pursue a claim even if failure to disclose “inadvertent.”

In Barger v. City of Cartersville, 348 F.3d 1289 (11th Cir. 2003), debtor filed a discrimination suit against her employer seeking reinstatement. When she filed a chapter 7 bankruptcy petition her schedules failed to disclose the lawsuit. Approximately two months after filing her bankruptcy petition, debtor filed a motion to amend her complaint in District Court by adding claims for compensatory and punitive damages. The day after the District Court granted the motion, debtor attended a creditors' meeting as part of her bankruptcy case. At the meeting debtor told her bankruptcy attorney that she had a discrimination suit pending and she orally informed the bankruptcy trustee about the case's existence during the creditors meeting. However, when the trustee asked the debtor about the case, she told him that the discrimination suit merely sought reinstatement of her prior position. Although the bankruptcy court later found that the failure to list the discrimination suit in the debtor's Statement of Financial Affairs was caused by her bankruptcy attorney's "inadvertence" and had no substantive effect on the bankruptcy petition, the District Court refused to reconsider its finding that the debtor was judicially estopped from seeking damages since the debtor failed to disclose the amendment of her complaint for damages. The Eleventh Circuit held that the debtor lacked standing in District Court to pursue damages and that the Trustee was the real party in interest. In addition, the debtor was judicially estopped from asserting the discrimination claims that she failed to disclose in her bankruptcy petition. Debtor's knowledge of her discrimination claims and her motive to conceal them were sufficient evidence from which to infer her intentional manipulation. The debtor's limited disclosure to the trustee during the creditor's meeting did not sway the Court. Actually the disclosure misled the trustee to believe that she only sought reinstatement. *See also* Burnes v. Pemco Aeroplex, 291 F.3d 1282 (11th Cir. 2002); In re Coastal Plains, Inc., 179 F.3d 197, 208 (5th Cir. 1999) (The courts will not permit a debtor to obtain relief from the bankruptcy court by representing that no claims exist and then subsequently to assert those claims for his own benefit in a separate proceeding.).

7. Reliance on Attorney Advice a Limited Defense

Reliance on the advice of counsel can save a debtor from the consequences of failing to disclose assets only when that reliance is reasonable and in good faith. In re Colvin, 288 B.R. 477, 483 (Bankr. E.D. Mich. 2003). In Colvin the debtors failed to disclose their tax refund, but claimed that their attorney failed to advise them to disclose it. The bankruptcy court found that even if the debtors' attorney did not ask them about tax refunds Schedule B explicitly required the debtors to disclose tax refunds. "The defense of reliance on counsel is not available when it is transparently plain that the advice is improper." *Id.* (*quoting Zitwer v. Kelly (In re Kelly)*, 135 B.R. 459, 461 (Bankr. S.D.N.Y. 1992)). The bankruptcy court found that the schedules made it "transparently plain" to the debtors that they were required to disclose tax refunds even if their attorney did not inform them of that specific disclosure obligation and the court denied their exemption. See also Link v. Wabash R.R. Co., 370 U.S. 626, 633-34 (1962)("[t]here is certainly no merit to the contention that dismissal of petitioner's claim because of his counsel's unexcused conduct imposes an unjust penalty on the client. Petitioner voluntarily chose this attorney as his representative in the action, and he cannot now avoid the consequences of the acts or omissions of this freely selected agent.")

C. IS IT PREJUDICIAL TO CREDITORS?

1. If a proposed amendment to exempt a claim will prejudice creditors, a court may deny the debtor's motion to amend. See In re Calder, 973 F.2d 862, 867-68 (10th Cir. 1992).
2. Prejudice may accrue where a debtor exhibits "inordinate delay" in amending his exemption schedules. In re Jelinek, 97 B.R.429, 432 (Bankr. N.D. Ill. 1989).

In the Kaelin case, *supra*, two years was found not to be an "inordinate delay" since the debtor had no knowledge of the existence of a cause of action for malpractice against his attorney until just prior to claiming his exemption and he did not delay in amending his schedule once he had knowledge of the asset. Kaelin, 308 F.3d at 890.

3. Prejudice to creditors if late amendment harms the litigation posture of the creditors.

If the parties would have taken different actions or asserted different positions had the exemption been claimed earlier, and the interests of

those parties are detrimentally affected by the timing of the amendment, then the prejudice is sufficient to deny amendment. Moreover, an amendment is prejudicial if it impairs a trustee in the diligent administration of the estate. In re Talmo, 185 B.R. 637, 645 (Bankr. S.D. Fla. 1995).

4. Prejudice to creditor shown when untimely amendments delayed administration of the estate and distribution to creditors.

Prejudice to creditors occurred when the Trustee was required to expend resources to ferret out the asset and obtain and prosecute an Order to Show Cause to compel the Debtors to disclose and turnover the asset. The Debtors' "blatant dishonesty in preparing [their] schedules from which may be inferred an attempt to hinder the Trustee's administration of assets of the estate results in prejudice to the creditors." In re Grogan, 300 B.R. 804, 810 (Bankr. D. Utah 2003)(citations omitted).

5. Prejudice may arise if Trustee incurs costs that would not have been incurred if debtor timely claimed exemption.

Where a trustee has engaged in efforts to sell certain property, which efforts the trustee might have foregone had the debtor initially claimed such property as exempt. "[I]n those instances the trustee may be understood to have acted in reliance upon the debtor's initial schedules, and having taken such actions may be prejudiced if the amendments were allowed." In re Cudeyro, 213 B.R. 910, 919 (Bankr. E.D. Pa. 1997)

6. Prejudice if distributions already made to creditor

"Several cases have established that, if a distribution of assets has already been made on the basis of exemptions previously claimed, then it is unfairly prejudicial to creditors, and too late to change exemptions." In re Shaffer, 92 B.R. 632, 634

7. Prejudice may arise if the creditors suffer actual economic loss due to a debtor's delay in claiming his exemption. In re Arnold, 252 B.R. at 787.

### III. SECTION 105 AND THE EQUITABLE POWERS OF THE COURT

- A. 11 U.S.C. § 105(a)

"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."

- B. Issue of the bankruptcy court's power to disallow an exemption despite untimely objection or to grant an extension of time to file an objection after the deadline passed, is not resolved by Taylor or Kontrick v. Ryan, \_\_ U.S.\_\_, 2004 WL 57261 (U.S. Jan. 14, 2004).

The trustee in Taylor argued that the bankruptcy court had the power under § 105(a) to disallow exemptions not claimed in good faith. The Supreme Court declined to rule on that issue because it had been raised for the first time in the trustee's opening brief. 503 U.S. at 645-46.

Since Kontrick did not involve issues of equitable tolling the Supreme Court did not reach the issue of "whether the rule, despite their strict limitations, could be softened on equitable grounds[.]"

- C. Generally

The bankruptcy court "has the inherent power to correct mistakes and errors in order to prevent manifest injustice." In re Replogle, 70 B.R. 444, 446 (Bankr. D. Mont.

1987). However, a court may exercise its equitable power only as a means to fulfill some specific code provision; it may not use its equitable power to achieve a result not contemplated by the code. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988).

- D. The Deadline Established in Rule 4003(b) is Not Jurisdictional

There was a clear split among the Circuits over the issue of whether the deadlines in the Federal Rules of Bankruptcy Procedure regarding objections to exemptions and objections to discharge or dischargeability are jurisdictional. This split was resolved by the Supreme Court's decision in Kontrick.

In Kontrick the Court noted that courts, including the Supreme Court, have been less than meticulous at times using the term "jurisdictional" to describe emphatic time prescriptions in rules of court. It cited Taylor as a specific example where the Supreme Court referred to Fed. R. Bankr. P. 4003(b) as jurisdictional. But,

the Court said, "[C]lassify[ing] time prescriptions, even rigid ones, under the heading 'subject matter jurisdiction'" can be confounding.

1. Not Jurisdictional - Waivable

In In re Kontrick, 295 F.3d 724, 730-33 (7th Cir. 2002) aff'd Kontrick v. Ryan, \_ U.S. \_\_\_, 2004 WL 57261 (U.S. Jan. 14, 2004) the Seventh Circuit held that a debtor could waive his objection to an untimely filed objection to dischargeability if the debtor's objection was not timely brought. In distinguishing Taylor, the Seventh Circuit stated that the Supreme Court "did not hold, however, that the debtor had an unlimited time in which to object to the trustee's untimely objection or that Rule 4003(b) was not subject to the usual equitable doctrines that apply to other deadlines and statutes of limitations." Kontrick, 295 F.3d at 733 n.4. The Court concluded that the Supreme Court's decision in Taylor was not dispositive and held that the timeliness provisions are not jurisdictional. *Id.*

The Supreme Court, in affirming the Seventh Circuit, held that no reasonable construction of complaint- processing rules would allow a litigant situated as debtor to defeat a claim, as filed too late, after the party has litigated and lost the case on the merits.

2. Extension after Expiration of Discharge

The Second Circuit in European Am. Bank v. Benedict (In re Benedict), 90 F.3d 50, 54 (2d Cir. 1996) decided that the time period imposed by Rule 4007(c) was not jurisdictional and was subject to waiver, estoppel, and equitable tolling.

The Fourth Circuit in Farouki v. Emirates Bank Int'l, Ltd., 14 F.3d 244, 248 (4th Cir.1994), held that the Rule 4004(a) deadline is not jurisdictional and that the rules "do not preclude the bankruptcy court from exercising its equitable powers in extraordinary cases."

The Sixth Circuit held in Nardei v. Maughan (In re Maughan), 340 F.3d 337 (6th Cir. 2003), that the deadline for dischargeability complaints in Bankruptcy Rule 4007 is not jurisdictional and the bankruptcy court did not abuse its discretion in using its equitable power to allow an untimely objection. The creditor in Maughan failed to timely file an objection to discharge because the debtor failed to comply with a prior court order to produce documents and the delay was therefore the result of a creditor's conduct. The Court discussed five factors that should be considered when

deciding to apply the doctrine of equitable tolling. The factors are: (1) lack of actual notice of filing requirement; (2) lack of constructive knowledge of filing requirement; (3) diligence in pursuing one's rights; (4) absence of prejudice to the defendant; and (5) a plaintiff's reasonableness in remaining ignorant of the notice requirement.

3. Cases Finding the Rules Jurisdictional Are Now Abrogated.

In re Woods, 260 B.R. 41, 43 (Bankr. N.D. Fla. 2001)"[T]he deadlines provided for in the rules 'are to be interpreted strictly, and in a manner consistent with the Code's policies ... favor[ing the] fresh start for the debtor, and [the] prompt administration of the case.'" (citing Taylor v. Freeland & Kronz, 503 U.S. 638, (1992)).

In re Tucker, 263 B.R. 632, 637 (Bankr. M.D. Fla. 2001). "Absent extraordinary circumstances, the provisions of Rule 4007(c) are jurisdictional and non-waivable." See also First Deposit Nat'l Bank v. Glover (In re Glover), 212 B.R. 860, 862 (Bankr. S.D. Ohio 1997); Goodwin v. United States Fid. & Guar. Ins. Co. (In re Goodwin), 215 B.R. 710, 714 (Bankr. W.D. Tenn. 1997).

D. Use of Equitable Powers to Allow Informal Objection Disallowed

We hold that to the extent the bankruptcy court used its powers under § 105(a) to carve out an "informal" or *de facto* exception to the plain requirements of § 522(l) and Fed. R. Bankr. P. 4003, it abused its discretion. Canino v. Bleau (In re Canino), 185 B.R. 584, 594 (B.A.P. 9<sup>th</sup> Cir. 1995)