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BUSINESS LAW TODAY

Keeping Current

The Trustee Fought Law (with Equity) and Law Won: The U.S. Supreme Court's Recent Decision in *Law v. Siegel*

By [Juliet M. Moringiello](#)

It is often said that bankruptcy provides relief for the “honest but unfortunate” debtor. In furtherance of that goal, the Bankruptcy Code (Code) contains numerous provisions denying the benefits of bankruptcy to individuals who behave in a dishonest manner before or during a bankruptcy case. For example, a debtor who fraudulently conceals or transfers assets or who makes a false oath in a bankruptcy case may be denied the ultimate benefit of bankruptcy – the discharge of his or her pre-bankruptcy debts.

Although the Code contains specific provisions denying relief to mendacious debtors, it lacks mechanisms for compensating those harmed by the debtor's malfeasance. For example, if the bankruptcy trustee discovers that a debtor has hidden cash, the court may deny that debtor a discharge, but if that cash is unavailable to creditors because the debtor has spent it, the Code provides no explicit remedy for the aggrieved creditors. In such cases, the trustee may ask the court to surcharge a debtor's exempt assets. Exemption laws protect certain assets of a debtor from the claims of unsecured creditors; a surcharge removes that protection in the amount of the surcharge. The surcharge request presents a problem, however, because the Code states that, except in enumerated circumstances, exempt property cannot be used to pay claims against the debtor. (11 U.S.C. § 522(c), (k).)

To circumvent the Code's prohibition against using exempt property to satisfy

claims, some trustees have asked the courts to use their equitable powers under the Code to order a surcharge. The Code authorizes a court to “issue any order, process, or judgment that is necessary or appropriate to carry out” its provisions. (11 U.S.C. § 105(a).) Section 105 does not grant a bankruptcy court unrestricted equitable powers, and a court may not use Section 105 to override an explicit Code mandate. If exempt property cannot be used to satisfy claims, how can a court order one without overriding an express Code mandate? The second sentence of Section 105(a) grants judges the authority to take “any action . . . necessary to prevent an abuse of process.” As a result, a circuit split developed as to whether Section 105(a) gives a court the power to surcharge a debtor's exempt assets in order to protect the integrity of the bankruptcy process. (See *Malley v. Agin*, 693 F.3d 28 (1st Cir. 2013), *Latman v. Burdette*, 366 F.3d 774 (9th Cir. 2004) (allowing surcharge); *In re Scrivner*, 535 F.3d 1258 (10th Cir. 2008) (denying surcharge).)

The Supreme Court recently addressed this split in *Law v. Siegel*, 571 U.S. ____ (2014), a wild ride involving a pro se debtor, a fake Chinese lender, and half a million dollars in trustee's fees. Someone needs to discover the debtor's wrongdoing, and often that person is the bankruptcy trustee. The debtor, Law, had engaged in such fraudulent and sneaky conduct that the trustee, Siegel, incurred about \$500,000

in legal fees to uncover it. To recover some of these costs, Siegel asked the bankruptcy court to surcharge Law's exempt property. The bankruptcy court did so, and both the Bankruptcy Appellate Panel and the Court of Appeals affirmed. The Supreme Court reversed, holding that a bankruptcy court cannot use Section 105(a) to override a specific Code provision, even if doing so would prevent an abuse of process.

Law's behavior was undoubtedly egregious. Under California law, Law could exempt up to \$75,000 of equity in his home from his bankruptcy estate. When he filed for Chapter 7 bankruptcy, he claimed to have less than that amount of equity in his home because the home was encumbered by two deeds of trust, both in the amount of roughly \$150,000, and he had valued the home at \$363,348. If this had been true, the trustee would not have been able to sell the house and recover money for the unsecured creditors because there was no value left in the house for those creditors. The second deed of trust turned out to be a complete fabrication. Law had claimed that someone named “Lili Lin” was the beneficiary of the deed of trust. When a former acquaintance with that name denied ever having loaned Law any money, another “Lili Lin,” this one a Chinese resident who spoke no English, surfaced and claimed that she was the true beneficiary of the deed of trust. This second Lili Lin, despite her inability to speak English, managed to engage in

lengthy and costly litigation to prove her interest in Law's house. Ultimately, the bankruptcy court concluded that Law, not Lili Lin, had authored, signed, and filed all of the litigation papers and had submitted false evidence in an attempt to convince the court that the second Lili Lin held the lien on his residence.

Without a doubt, Law deserved no relief from the bankruptcy court. Indeed, he received none. But Siegel, after spending over 1,500 hours of his time uncovering Law's wrongdoing, wanted relief as well, in the form of payment. (*In re Law*, 401 B.R. 447, 455 (Bankr. C.D. Cal. 2012).) He thus moved to surcharge Law's \$75,000 homestead exemption in an attempt to recover a portion of his fees. Courts have allowed trustees to surcharge a debtor's exemptions in "extraordinary circumstances." Law thus argued that the bankruptcy court should use its power under Section 105(a) of the Bankruptcy Code to do so.

The bankruptcy court, relying on the Ninth Circuit's opinion in *Latman v. Burdette*, 366 F.3d 774 (9th Cir. 2004), allowed the surcharge. The court in *Latman* had held that Section 105(a) allows a court to "equitably surcharge a debtor's exemptions when reasonably necessary both to protect the integrity of the bankruptcy process and to ensure that a debtor exempts an amount that is no greater than what is permitted by the exemption scheme of the Bankruptcy Code." Both the Bankruptcy Appellate Panel and the Ninth Circuit affirmed, finding that the bankruptcy court had not abused its discretion in surcharging the exemption.

Not all courts read Section 105(a) as broadly as the court in *Latman* did, setting the stage for the Supreme Court's entry into the dispute. In a unanimous opinion that focused on statutory interpretation, the Court held that the surcharge was improper because in approving the surcharge, the bankruptcy court contravened a specific statutory provision. The Court found that, by doing so, the bankruptcy court stretched Section 105(a) beyond the boundaries of its intended purpose.

Although all of the lower courts had held in his favor, Siegel had a tough argument.

The Code specifically prohibits the use of a debtor's exempt property to pay administrative expenses, a category of expenses that includes the trustee's legal fees. (11 U.S.C. § 522(k).) Rather than carrying out the provisions of the Bankruptcy Code, the surcharge directly contradicted one of its provisions. Moreover, Section 522, the Code section that provides for exemptions, does not give a court the discretion to deny an exemption because of a debtor's bad behavior except in a handful of enumerated circumstances (for example, the court may limit a debtor's homestead exemption if the debtor owes a debt as a result of the violation of federal or state securities laws). The Court recognized that Congress, in its "mind-numbingly detailed enumeration of exemptions and exceptions to those exemptions . . .," demonstrated that it knows how and when to limit exemptions. Therefore, the Court held that a court cannot use Section 105(a) to impose additional exceptions to a debtor's ability to exempt property from his or her bankruptcy estate.

Does this holding favor cheats and liars? The Court stressed that it does not. As noted at the beginning of this article, the court can withhold the discharge from the debtor, leaving that debtor liable for all of his or her pre-bankruptcy debts. If the debtor's behavior in the bankruptcy case is bad enough, he or she can face criminal prosecution. The Court additionally noted that some state laws limit or deny an exemption if the debtor engaged in certain types of wrongful behavior in acquiring the exempt asset. These limitations tend to apply when the debtor fraudulently transferred non-exempt property in order to acquire exempt property. (*See, e.g. Tex. Prop. Code* § 42.004 (disallowing an exemption in personal property if the debtor fraudulently transferred non-exempt property to obtain that property).) The Code, however, contains no such provisions.

So where do the bankruptcy court's equitable powers granted by Section 105(a) stand today? According to the Court in *Law*, those powers cannot be used to contravene a specific Code section, even if doing so would prevent an abuse of process, because

such a use does not "carry out the provisions" of the Code. On the other hand, there are several orders by a court that the Code neither permits nor specifically prohibits. An example is the non-debtor stay. The Code states that the filing of a bankruptcy petition automatically stays all debt collection actions against a debtor. (11 U.S.C. § 362(a).) It says nothing, however, about actions against corporate insiders. Courts have used Section 105 to enjoin actions against those parties in the interest of promoting the reorganization of the debtor. (*See Lyondell Chem. Co. v. CenterPoint Energy Gas. Servs. (In re Lyondell Chem. Co.)*, 402 B.R. 571 (Bankr. S.D. N.Y. 2009).) *Law v. Siegel* will not end those injunctions. In an opinion that gives no comfort to unpaid bankruptcy trustees, however, the Supreme Court has made it clear that using Section 105 to do something that the Code clearly prohibits will no longer be allowed.

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