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Objections to Exemptions and Dischargeability

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EXEMPTIONS

DETERMINATION OF APPLICABLE EXEMPTION

The first issue that arises in claiming exemptions is the determination of the exemption laws applicable to the debtor. Usually, it will be either the exemptions provided in § 522(d) of the Bankruptcy Code or, if the state in which the case is filed has opted-out of the Bankruptcy Code exemptions, the exemption laws of that state. However, the debtor's attorney should not assume that because venue is proper in a particular state, the laws of that state automatically control the selection of exemptions.

Section 522(b)(2)(A) provides that the appropriate law is the law applicable

> on the date of the filing of the petition at the place in which the debtor's domicile has been located for the 180 days immediately preceding the date of the filing of the petition, or for a longer portion of such 180-day period than any other place. (emphasis added).

Pursuant to 28 U.S.C. § 1408 proper venue of a bankruptcy case is established not only in the location of the debtor's domicile, but also the location of the debtor's residence, principal place of business or principal assets. Since the domiciliary state's law controls for exemption purposes, there are cases in which venue is proper in a particular state on the basis of the location of the debtor's residence or assets, but the debtor's domicile is in another state. See In Re Stockburger, 192 B.R. 908 (E.D.Tenn. 1996), aff'd, 106 F.3d 402 (6th Cir. 1997) (unpublished opinion). For example, suppose the debtor is a marine domiciled in California and stationed at Camp LeJeune, NC. If he files a bankruptcy in the Eastern District of North Carolina, California law will apply, and the debtor must claim his exemptions under California law. See In Re Wellberg, 12 B.R. 48 (Bankr. E.D.Va. 1981). Furthermore, venue is not jurisdictional, and cases are sometimes filed in a state in which venue is not proper[1]. In such a case, the law of the state of the debtor's domicile determines the applicable exemptions.

Interestingly, even when §522(b)(2)(A) dictates that the applicable law is that of an opt-out state, the Bankruptcy Code exemptions may be available in some circumstances. This unexpected occurrence is the result of the language employed by some states in their opt-out statutes. The case of In Re Deboer, Case No. 99-01686-5-ATS (Bankr. E.D.N.C., Judge A. Thomas Small, November 12, 1999), illustrates the point.

When Bruce Deboer consulted a bankruptcy attorney in North Carolina, the initial interview revealed two important facts: 1) He could not exempt all his photographic equipment under North Carolina law; and 2) He was planning to move to Chicago. North Carolina's opt-out statute, N.C. Gen. Stat. §1C-1601(f), provides, "The exemptions

[1] In such instances, if a party objects to the improper venue, the case either must be dismissed or transferred to a proper venue. 28 U.S.C. Sections 1406 and 1412 and Bankruptcy Rule 1014.

provided in the Bankruptcy Act, 11 U.S.C. § 522(d), are not applicable to residents of this state." Mr. Deboer in fact moved to Chicago, obtained an Illinois driver's license, and registered to vote. He filed a chapter 7 bankruptcy in North Carolina 30 days after he moved to Chicago. He claimed the exemptions codified in §522(d), and the trustee objected. The court denied the trustee's objection on the grounds that North Carolina denied the Bankruptcy Code exemptions only to North Carolina residents, and that Mr. Deboer was not a resident of North Carolina[2]. Other courts have come to the same result construing similar opt-out statutes. In Re Schultz, 101 B.R. 301 (Bankr. N.D.Fla. 1989) (Florida law); In Re Volk, (Bankr. D.S.D. 1983) (South Dakota law); In Re Hawkins, 15 B. R. 618 (Bankr. E.D.Va. 1981) (Virginia law).

Since some of the states have opted-out only for their residents, an understanding of the difference between domicile and residency is crucial. Neither term is defined in the Bankruptcy Code. The issues concerning domicile and residency are determined according to the law of the forum. In Re Gurley, 215 B.R. 703 (Bankr. W.D. Tenn. 1997). In simple terms, domicile denotes one's permanent home. Residency denotes the person's current home. One may be away from his domicile temporarily or even for an extended period of time, but it is the place to which he intends to return. A fairly typical statement of the distinction between a domicile and a residence is the following statement contained in In Re Vaughan, 188 B.R. 234, 237 (Bankr. E.D. Ky. 1995), applying Florida law and quoting the Florida Supreme Court:

> [Domicile] is of or more extensive signification and includes, beyond mere physical presence at the particular locality, positive or presumptive proof of an intention to constitute it a permanent abiding place. 'Residence' simply indicates the place of abode, whether permanent or temporary; 'domicile' denotes a fixed, permanent residence, to which, when absent, one has the intention of returning. (citations omitted)

A more poetic statement is the following from the Bankruptcy Court from the Western District of Tennessee:

> In Tennessee, "domicile" is defined as the place "where a person has his principal home and enjoyment of his fortunes; which he does not expect to leave, except for a purpose; from which when absent, he seems to himself a wayfarer; to which when he returns, he ceases to travel." A person may have two or more residences but only one domicile. For bankruptcy purposes, "the term 'residence' has been construed to include places where the debtor has a semi-permanent residence, even if that place is not the debtor's domicile."

In Re Gurley, 215 B.R. 703, 708 (citations omitted).

Every attorney who practices in an opt-out state must examine the language of the opt-out statute to determine whether the state has completely "opted-out" or only partially done so. Attached as Appendix B is a compilation of the opt-out statutes in the 30 states who

[2] A copy of the Deboer opinion is set out in Appendix A.

have opted-out of the Bankruptcy Code exemptions. Of those states at least 17 [3] have provisions that leave the door open to circumstances in which the Bankruptcy Code exemptions will apply.[4] Some of these states[5] have opted-out of the Bankruptcy Code exemptions just for persons domiciled in the state. In these states, the availability of the Code exemptions are limited to those circumstances in which the debtor has moved his domicile to another state within 90 days prior to the filing of the petition. The opportunities to utilize the Bankruptcy Code exemptions are greater with respect to the remaining states listed in footnote 3. All these states, except Tennessee[6], have opted out for their residents.

An analysis of the law in Virginia illustrates the point that opportunities to utilize Bankruptcy Code exemptions may exist in opt-out states not listed in footnote 3. In Virginia, the opt-out statute provides, "No individual may exempt from the property of the estate in any bankruptcy proceeding the property specified in subsection (d) of § 522 of the Bankruptcy Reform Act, except as may otherwise be expressly permitted under this title." Va. Code § 34-3.1. It first appears that Virginia is an absolute opt-out state. However, § 34-4 of the Virginia Code provides that the Virginia exemptions are available for Virginia residents only, and § 34-24 of the Virginia Code provides that the exemptions are lost when the resident removes himself from the state. Consequently, on facts almost identical to the Deboer case, the Bankruptcy Court for the Eastern District of Virginia held that the debtor was entitled to the Bankruptcy Code exemptions. In Re Hawkins, 15 B.R. 618 (Bankr. E.D.Va. 1981).

Even in states that have absolutely opted out, attorneys should be mindful to "think outside the box" to claim the maximum exemption available. The attorney who represented Robert J. Arrol did so. Mr. Arrol purchased a home in Michigan in 1982. He moved to California in 1994 and established his domicile there. He moved back to the former home in Michigan in November 1996, and filed a chapter 7 bankruptcy in the Northern District of California on January 9, 1997. The home had a value of $75,000. California has a $75,000 homestead exemption; Michigan, $3,500. The debtor claimed a $75,000 exemption in the residence under California law. The trustee objected to the exemption contending that a California debtor couldn't claim a homestead in Michigan. Upon careful analysis of § 522(b)(2)(A) and the California homestead exemption the

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[3] Arizona, Colorado, Delaware, Florida, Illinois, Indiana, Kentucky, Nevada, New York, North Carolina, North Dakota, Ohio, Oklahoma, South Dakota, Tennessee, Virginia and West Virginia.

[4] Section 307 of HB 975 would amend §522(b)(2)(A) to provide that the applicable exemptions are determined by the laws of the state in which the debtor was domiciled 730 days preceding the filing of the petition "or if the debtor's domicile has not been located in a single state for such 730-day period, the place in which the debtor's domicile was located for 180 days immediately preceding the 730-day period, or for a longer portion of such 180-day period than in any other place." The effect of this amendment is to require the debtor to choose exemptions as if he had filed the bankruptcy 2 years prior to the actual filing date.

[5] Delaware, Indiana, Kentucky, New York and West Virginia

[6] Tennessee Code Annotated, §26-2-112, provides that its "citizens" are not entitled to use the Bankruptcy Code exemptions.

Ninth Circuit held that the debtor was entitled to the California exemption. In Re Arrol, 170 F.3d 934 (9th Cir. 1999).[7]

PROCEDURAL ISSUES IN CLAIMING EXEMPTIONS AND OBJECTION TO CLAIM OF EXEMPTIONS

A discussion of the procedural issues in claiming and objection to exemptions begin with §522(l) which provides:

> The debtor shall file a list of property that the debtor claims as exempt under subsection (b) of this section. If the debtor does not file such a list, a dependant of the debtor may file such a list, or may claim property as exempt from property of the estate on behalf of the debtor. Unless a party in interest objects, the property claimed as exempt on such list is exempt.

The Rule that implement this section is Bankruptcy Rule 4003, which provides as follows:

> **EXEMPTIONS Rule 4003**
>
> (a) Claim of Exemptions. A debtor shall list the property claimed as exempt under §522 of the Code on the schedules of assets required to be filed by Rule 1007. If the debtor fails to claim exemptions or file the schedule within the time specified in Rule 1007, a dependant of the debtor may file the list within 30 days thereafter.
>
> (b) Objection to a Claim of Exemptions. A party in interest may file an objection to the list of property claimed as exempt only within 30 days after the meeting of creditors held under §341(a) is concluded or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later. The court may, for cause, extend the time for filing objections if, before the time to object expires, a party in interest files a request for an extension. Copies of the objections shall be delivered or mailed to the trustee, the person filing the list, and the attorney for that person.
>
> (c) Burden of Proof. In any hearing under this rule, the objecting party has the burden of proving that the exemptions are not property claimed. After hearing on notice, the court shall determine the issues presented by the objections.

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[7] Consider the impact of the holding in Arrol in combination with HB 975's exemption choice provision set out at footnote. A Californian would be able to carry the $75,000.00 homestead exemption with her to and from their state for a period of a year after she leaves the state. Perhaps, persons domiciled in Florida, Iowa, Kansas, South Dakota, and Texas would be able to take unlimited homestead exemptions with them as well.

(d) Avoidance by Debtor of Transfers of Exempt Property. A proceeding by the debtor to avoid a lien or other transfer of property exempt under §522(f) of the Code shall be by motion in accordance with Rule 9014.

Pursuant to Bankruptcy Rule 1007 (b)(1), the exemptions are claimed on Official Form 6, Schedule C. Many jurisdictions have a local rule and local form to be utilized in claiming exemptions, customized to accommodate the jurisdiction's exemptions scheme. Pursuant to Bankruptcy Rule 1009 the schedule of exemptions "may be amended as a matter of course of any time before the case is closed." A dispute over exemptions is a contested matter governed by Bankruptcy Rule 9014.

Discussed below are four important questions that arise out of the claim of exemptions. They are: 1) What is the effect of the failure of the trustee or a creditor to object to the claim of exemptions? 2) Under what circumstances have the courts limited the debtor's right to amend his exemptions? 3) If a creditor fails to object to the claim of exemptions, does the creditor forfeit the right to object to the exemptions in defending a motion pursuant to §522(f) to void the creditor's lien on the alleged exempt property? 4) When a case is converted from chapter 13 to chapter 7, does the chapter 7 trustee obtain a second chance to object to the claim of exemptions?

Objection to Exemptions

As every bankruptcy attorney knows, the leading case on the consequences of the failure to object to the claim of exemptions is Taylor v. Freeland & Kronz, 503 U.S. 638, 112 S. Ct. 1644, 118 L.Ed.2d 280 (1992). The Supreme Court held that after the 30-day bar date had expired the chapter 7 trustee could not contest the validity of an exemption which was claimed in good faith, even though the debtor had no colorable basis for claiming the exemption. The Court refused to consider the trustee's argument that the validity of claim of exemptions could be challenged on principals of equity pursuant to 11 U.S.C.§105(a). The court's refusal was based upon the trustee's failure to raise the issue in the lower courts.

Since Taylor, many courts have denied objections to objection on the basis of a tardy objection. In Re Bell, 225 F.3d 203 (2nd Cir. 2000); In Re Sadkin, 36 F.3d 473 (5th Cir. 1994); In Re Green, 31 F.3d 1098 (11th Cir. 1994); In Re Kazi, 985 F.2d 318 (7th Cir. 1993). Other courts have limited the impact of Taylor by closely scrutinizing and narrowly construing the debtor's claim of exemptions. See Williams v. Peyton, 104 F.3d 688 (4th Cir. 1997) (debtor's claim of tenants by entirety exemption not effective against joint creditors since by definition entireties property is not exempt against joint creditors); In Re Mercer, 31 F.3d 1098 (1st Cir. 1995) (debtor exemption of "100% of potential personal injury settlement" pursuant to §522(d)(10)(c) not effective to claim exemption in that portion of the actual settlement not entitled to exemption). To take full advantage of the Taylor's holding the debtor's attorney can be bold, but must be clear and precise in claiming exemptions. Some guidelines follow:

1. On assets with uncertain or contingent values rather than list the value as a nominal sum, such as $1.00, list the value as "unknown" on the schedules and specifically state on schedule C, "The debtor exempts her entire interest in this asset." See In Re Soost, 262 B.R. 68 (8th Cir. BAP 2001) (Debtor's claim of value of "$1.00" in property limited him to avoiding only 1.00 in 522(f) lien avoidance action).[8]

2. In claiming an exemption in an interest in a corporation and the like, be specific about the debtor's interest.

   Example:

   > Bad: ABC Corporation
   > Good: 132 Shares of ABC Corporation
   > Better: 100% of the debtor's interest in ABC corporation, in whatever form and however owned

3. Treat your claim of exemptions like a pleading in which you are requesting relief, to wit: the debtor wants to keep every asset listed on the schedule. Even if you are restricted by the use of the standard schedule C or a local form, attach an addendum to the form if necessary to make it clear what you are claiming as exempt. Attached hereto as Appendix C are some provisions to consider for inclusion in the schedule of claim of exemptions.

The irony in these cases is that as the invalidity of the exemption claim becomes more obvious the more likely the courts are to sustain the "exemption by declaration." The reasoning of the courts in such cases is that the trustee was put on notice and should have timely objected. This situation may lead to the temptation to claim meritless exemptions. The case of In Re Slentz, 157 B.R. 418 (Bankr. N.D.Ind. 1993), provides reason to avoid the temptation. In Slentz, the debtors claimed as exempt their interest in common stock worth $1192 as tangible personal property. Indiana law allowed a debtor to exempt $4,000 in tangible personal property and $100 in intangible personal property. The court sustained the trustee's objection to exemption and sanctioned the debtors by disallowing the $200 exemption to which they were entitled and requiring them to pay the attorney's fees of the trustee. [9] The court reasoned as follows:

> If our only response to an improper claim of exemptions is to limit the claim to what it should have been, there will be absolutely no disincentive to discourage debtors from making improper and excessive claims.

[8] The court ignored the formula provided in §522(f)(2)(A) and the holding appears to be erroneous. See discussion of §522(f) at pp.8-11.

[9] The court sanctioned just the debtors because under Rule 9011, in effect at that time, it could not sanction the attorney who did not sign the claim of exemption form. Today the court can sanction the debtor's attorney under Rule 9011 under proper circumstances in connection with the claim of exemptions.

> Attempts at exemption by declaration would become a riskless endeavor. If the improper claim passed without objection, the attempt would succeed and debtors would be able to keep for themselves property in which they otherwise would not been entitled; while, if an objection was filed, the only consequence would be that debtors would be deprived of something they had no right to. Debtors would have everything to gain and nothing to lose by making the attempt. Since the proper operation of the bankruptcy system depends, to a large extent, upon debtors honestly and forthrightly completing the schedules and statements which are filed with the court, attempts at cheating cannot be made to appear too attractive.

Id. at 420.

Limitations on Amendments

The courts are in complete agreement that despite Bankruptcy Rule's authorization to amend a schedule "as a matter of course at any time before the case is closed," the right to amend the claim of exemptions is limited. The courts have the discretion to deny the amendment of exemptions if the amendment is proposed in bad faith or would prejudice creditors. In Re Kaelin, 308 F.3d 885 (8th Cir. 2002); In Re Michael, 163 F.3d 526 (9th Cir. 1998); In Re Yonikus, 996 F.2d 866 (7th Cir. 1993); In Re Calder, 973 F.2d 862 (10th Cir. 1992); In Re Doan, 672 F.2d 831 (11th Cir. 1982); Ward v. Turner, 176 B.R. 424 (E.D. La 1994). The courts also have discretion to deny an amendment to exempt a previously concealed asset. In Re Yonikus, 996 F.2d . at 882.

Whether there is sufficient bad faith, prejudice to creditors, or concealment of an asset to deny an amendment to exemptions obviously depends upon the facts of the case and the views of the particular judge. the following guidelines are derived from studying the cases:

1. Don't litigate with a trustee concerning whether particular asset is property of the estate, and then after you lose attempt to claim an exemption in the asset. In Re Calder, 973 F.2d at 867 (amendment denied). It is wise to inform the trustee at the outset that in addition to contending that the asset is not property of the estate that the debtor contends it is exempt, in whole or in part.

2. Don't allow the trustee to spend time, effort and money in bringing an asset into the estate, and then claim it as exempt. In Re Szymanski, 189 B.R. 5 (N.D. Ill. 1995) (amendment denied).

3. If an asset of which your client was previously unaware surfaces, schedule it and claim the exemption immediately. In Re Kaelin, 308 F.3d at 888. (amendment allowed).

4. If there is a technical error or oversight with the claim of exemptions, let the trustee know you intend to claim an exemption at the earliest possible moment. In Re Michael, 163 F.3d at 530 (amendment allowed).

Some courts have wisely resolved issues of prejudice to creditors by allowing the amendment to exemptions conditioned upon the payment of costs incurred by the trustee in connection with bringing the particular asset into the estate. See In Re Blaise, 116 B.R. 398 (Bankr. D. Vt. 1990).

Finally, Bankruptcy Rule 1009(a) allows the debtor to amend "as a matter of course at any time before the case is closed." In Re Clear, 1992 WL 135970 (N.D. Ind. 1992), held this rule prevents the debtor from amending his exemptions after the case has been closed, and then reopened. First National Bank of Park Falls v. Maley, 126 B.R. 563 (W.D. Wis. 1991), held that a case can be opened and exemptions amended.

Lien Avoidance

It is not unusual for a debtor not to receive an objection to his claim of exemptions, but when he moves to avoid a creditor's judicial lien or a nonpossessory, nonpurchase-money lien from the exempted property for the creditor to file an objection to the exemption at that time. The courts are split on whether the creditor obtains a second chance to object to the exemption in opposing the motion to avoid the lien. The leading case in granting the creditors the right to raise the validity of the exemption is In Re Morgan, 149 B.R. 147 (9th Cir. BAP 1993). The court based its holding on the requirement in §522(f) that the exemption must be one "to which the debtor would have been entitled under subsection (b) of this section." The court reasoned that the fact that the debtor exempted the property by default by application of §522(l) does not mean he was entitled to it under §522(b). See also In Re Mohring, 142 B.R. 389, 394 (Bankr. E.D. Cal. 1992), aff'd mem. 153 B.R. 601 (9th Cir. BAP 1993), aff'd mem. 24 F.3d 247 (9th Cir. 1994); In Re Streeper, 158 B.R. 7836 (Bankr. N.D. Iowa 1993); In Re Maylin, 155 B.R. 605 (Bankr. Me. 1993).

Some courts have rejected the Morgan rationale and held that the creditor cannot contest the validity of the exemption in a lien avoidance action if it failed to timely object to the claim of exemption pursuant to §522(l). In Re Chinosorn, 248 B.R 324 (N.D. Ill. 2000); In Re Youngblood, 212 B.R. 593 (Bankr. N.D. Ill. 1997). They have based their rulings on the finality of the claim of exemptions pursuant to Taylor.

Conversion from Chapter 13 to Chapter 7

Prior to the enactment of the Bankruptcy Act of 1994 most courts held that exemption rights in cases converted from chapter 13 to 7 are fixed as of the date the original petition was filed. In Re Sandoval, 103 F.2d 20 (5th Cir. 1997); In Re Walter, 45 F.3d 1023 (6th Cir. 1995); In Re Heater, 189 B.R. 629 (Bankr. E.D. Va. 1995). Section 348(f)(1), which provides that unless the case is converted in bad faith property of the estate in the chapter 7 consists of property of the estate as of the filing date, has reinforced these rulings.

Therefore, if the chapter 13 trustee does not timely object to the debtor's claim of exemptions, the chapter 7 trustee does not get a second chance to object to the exemptions upon conversion. In Re Slack, 290 B.R. 282 (Bankr. D.N.J. 2003); In Re Rogers, 278 B.R. 201 (Bankr. D.Nev. 2002); In Re Wegner, 243 B.R. 731 (Bankr. D.Neb. 2000); In Re Ferretti, 230 B.R. 883 (Bankr. S.D. Fla. 1999), aff'd 268 F.3d 1065 (11^{th} Cir. 2001).

Judicial Lien Avoidance

The avoidance of liens, especially judicial liens, is indispensable to providing the debtor's fresh start. Sections 522(f)(1)(A) and 522(f)(2)(A) and (B), the lien avoidance statutes, provide as follows:

> (f) (1) Notwithstanding any waiver of exemptions but subject to paragraph (3), the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is—
>
> (A) a judicial lien …
>
> (2)(A) For the purposes of this subsection, a lien shall be considered to impair an exemption to the extent that the sum of—
>
> (i) the lien,
> (ii) all other liens on the property; and
> (iii) the amount of the exemption that the debtor could claim if there were no liens on the property;
>
> exceeds the value that the debtor's interest in the property would have in the absence of any liens.
>
> (B) In the case of a property subject to more than one lien, a lien that has been avoided shall not be considered in making the calculation under subparagraph (A) with respect to other liens.

Prior to the enactment of the Bankruptcy Reform Act of 1994 conflicting decisions construing §522(f) were rendered by the courts throughout the country. The formula set out in §522(f)(2)(A) was enacted as part of the Act to clarify the intent of Congress with respect to lien avoidance. As is often the case with bankruptcy legislation, new ambiguities accompanied the clarification. In two factual situations the literal application of §522(f)(2)(A) provides very interesting results. In both instances these results are very beneficial to the debtor, and in one aspect, unexpected.

The first circumstance arises when the judicial lien avoided is superior to another lien not avoided. Because the formula provides for including "all other liens on the property,"[10] not just liens superior to the judicial lien, the junior liens displace the judicial lien and allow its avoidance. This result upsets the priority position of a judicial lien in most, if not in all, states. The second circumstance arises when the debtor owns a partial interest in the property upon which the lien is being avoided. Because the formula provides for comparing the total amount of the liens and the exemption to "the value of the debtor's interest in the property," it results in the avoidance of a lien in its entirety in some circumstances in which the debtor has non-exempt equity in the property.

In the first circumstance most courts apply the formula literally. The case of In Re Kolich, 273 B.R. 199(8th Cir. BAP 2002) provides an example of the application of the formula. The debtor's residence was worth $275,000.00. It was encumbered by a first mortgage of $219,000.00, followed by the judgment lien of $134,000.00. After the attachment of the judgment lien the debtors borrowed $80,000.00 from Norbank and gave it a second deed of trust. The Missouri homestead exemption is $8,000.00. Under Missouri law had the judgment creditor executed on the property and received $275,000.00, the proceeds remaining after paying the first mortgage would have been $56,000.00. After paying the debtors their exemptions, the creditor would have been entitled to retain the balance of $48,000.00. However application of the formula as set out below, results in the avoidance of the judicial lien in its entirety.

		AMOUNT
(i)	Lien:	$134,000.00
(ii)	other liens:	
	First Mortgage	$219,000.00
	Second Mortgage	$ 80,000.00
(iii)	exemption:	$ 8,000.00
	Subtotal	$441,000.00
	Less	
	Value of Property:	$275,000.00
	Extent of Impairment:	$166,000.00

The extent of impairment exceeds the amount of the lien, so the lien is avoided in its entirety. See also In Re Brinley, 2003 WL 1825521 (W.D. Ky. 2003); In Re Radcliffe, 2003 WL 1825451. But see In Re Dolan, 230 B.R. 642 (Bankr. D. Conn. 1999).

This construction of §522(f)(2)(A) provides opportunities for proper pre-bankruptcy planning. Consider the following example:

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[10] The application of §522(f)(2)(B) prevents the debtor from including "a lien that has been avoided" in the calculation. A literal application allows the debtor to choose which judicial liens to avoid.

> The debtor is entitled to a homestead exemption of $17,425. He owns a residence worth $200,000 which is encumbered by a $150,000 deed of trust. A creditor has obtained a judgment against him for $30,000. He owes $35,000 of nondischargeable income taxes. His father has indicated he will lend him the money with which to pay the taxes.

Under the fact situation set out above, if the debtor borrows $35,000 from his father and gives him a deed of trust on his residence for that amount, when he files bankruptcy he will be able to avoid the judgment lien in its entirety.

On the second issue most courts are refusing to apply the formula literally. The issue is illustrated by the following example:

> The debtor and his partner own in equal shares their residence with a value of $260,000.00. It is subject to a first deed of trust with a balance of $120,000.00 and a judicial lien against just the debtor in the amount of $25,000.00. The debtor claims a homestead exemption under §522(d)(1) in the amount of $17,425.00. The literal application of the §522(f)(2)(A) formula is as follows:

		AMOUNT
(i)	lien:	$ 25,000.00
(ii)	other liens: mortgage	$120,000.00
(iii)	exemptions	$ 17,425.00
		$162,425.00
Value debtors intends to pay		$130,000.00
Extent of Lien Impairment		$ 27,425.00

Since the amount of the lien is less than the amount of the impairment, the lien is fully avoided. In the absence of the lien, the amount of the debtor's equity in the property is $70,000.00. To allow the entire lien to be not only avoided, but entirely avoided, in this circumstance, in the words of at least one court, provides a "windfall" to the debtor and is "absurd." In Re Lehman, 223 B.R. 32, 34-35 (Bankr. N.D. Ga. 1998), aff'd 205 F.3d 1255 (11th Cir. 2000). Other courts based on similar reasoning also have refused to apply §522(f)(2)(A) literally.[11] In Re Miller, 299 F.3d 183 (3rd Cir. 2002);[12] Nelson vs. Scala, 192 F.3d 32 (1st Cir. 1999); In Re Jeffries, 2002 WL 202108 (Bankr. M.D.N.C. 2002).

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[11] In Re Nielson, 197 B.R. 665 (9th Cir. BAP 1996), is cited by courts rejecting the literal application of §522(f)(2)(A), but in Nielson the petition was filed in 1992 and does not entail the interpretation of the §522(f)(2)(A) formula.

EXEMPTIONS VS. SET-OFFS

Suppose the debtor has claimed her interest in a bank account or in an unpaid tax refund as exempt, but the IRS or the bank, claim rights of setoff against these assets respectively. Which claim will prevail – the exemption or the setoff? The resolution of this issue requires the application of four provisions of the Bankruptcy Code: §§ 506(a), 522(c), 524(a)(2), and 553(a).

Section 523(c) provides, in part, as follows:

> "(c) Unless the case is dismissed, property exempted under this section is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case, except –
>
> (1) a debt of a kind specified in section 523(a)(1) or 523(a)(5) of this title;
> (2) a debt secured by a lien that is –
>
> (A)(i) not avoided under subsection (f) or (g) of this section or under section 544, 545, 547, 548, 549, or 724(a) of this title; and
>
> (ii) not void under section 506(d) of this title; or
>
> (B) a tax lien, notice of which is properly filed ..."

Section 506(a) provides, in part, as follows:

> "(a) An allowed claim of a creditor secured by a lien on property in which the estate has as interest, or that is subject to setoff under section 553 of this title, is a secured claim to the interest in such property, or to the extent of the amount subject to setoff, as the case may be..."

Section 553(a) provides, in part, as follows:

> "(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case ..."

Finally, § 524(a)(2) provides as follows:

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[12] Miller effectively overrules In Re Piersol, 244 B.R. 309 (Bankr. E.D.Pa. 2000).

"(a) A discharge in a case under this title –
(2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived;"

Pursuant to §523(c) (1) and (2), debts that are superior to the properly claimed exemptions are non-dischargeable tax and support debts, debts secured by unavoided liens, and debts secured by properly filed tax liens.[13] Section 506(a) grants the holder of a right setoff the status of a holder of a secured claim, but it is not make it a lienholder. Section 524(a)(2) reinforces §522(c) by enjoining the setoff of a discharged debt. Section 553(a), however, provides that the Bankruptcy Code does not effect the right of setoff of mutual prepetition debts. The courts have struggled with reconciling §§ 522(c) and 524(a)(2) with §553(a).

This issue arises most often when the IRS offsets a pre-petition tax refund against a pre-petition, discharged tax debt.[14] The only circuit court case on this issue is In Re Luongo, 259 F.3d 323 (5th Cir. 2001). In Luongo, the debtor filed bankruptcy on May 19, 1998. She owed the IRS $3,800.00 in 1993 taxes. On August 15, the debtor filed her 1997 tax return on August 15, 1998 showing an overpayment of $1,400.00. The debtor was granted her discharge on September 10, 1998. In November 1998, the IRS offset the 1997 tax refund against the discharge 1993 tax liability. The Fifth Circuit held for the IRS, concluding that the specific, clear language of §553 prevails over §524(a)(2). It avoided resolving the conflict between §553 and §522(c) through the dubious holding[15] that the debtor's refund was not property of the estate, and therefore not exempted from the estate. It reasoned that since 26 U.S.C. § 6402 authorizes the IRS to credit any overpayment due the debtor against any liability owed to the IRS by her, she was not entitled to a refund, and the tax refund did not become property of the estate. The court expressly left "open the question of whether §522(c) immunizes exempt property from setoff." Id. at p. 336.

The majority of the courts that have addressed the issue of whether a creditor can exercise a right of setoff against exempt property have held that §522(c) prohibits the creditor from doing so. A well reasoned case adopting this view is In Re Alexander, 225

[13] Sections 523(c)(3) and (4) exclude from exemptions: (3) debts nondischargeable pursuant to §523(a)(4) and (6) related to an institution-affiliated party of a F.D.I.C. insured bank, (4) and fraud debts in connection with obtaining or providing loans, grants, and the like to finance an education at an institution of higher education.

[14] Note that the tax to which the refund is setoff must be a dischargeable tax in order for the debtor to prevail. Section 522(c) explicitly excludes from its protection non-dischargeable tax and support debts. Likewise, the refund must be for a pre-petition tax year for the IRS to prevail. Section 553(a) only applies when the mutual debt arose before the commencement of the case.

[15] The Supreme Court held in United States v. Whiting Pools, Inc., 462 U.S. 198, 103 S. Ct. 2309, 76 L.Ed.2d. 515 (1983), that property seized pre-petition for unpaid taxes of the debtor is property of the estate. It seems that a claim for a tax refund is also property of the estate.

B.R. 145 (Bankr. W.D.Ky. 1998), aff'd 224 B.R. 280 (W.D.Ky. 1999). See also In Re Jones, 230 B.R. 875 (M.D.Ala. 1999) (IRS cannot assert setoff against exempted refund); In Re Cole, 104 B.R. 736 (Bankr. D.Md. 1989) (utility company cannot exercise right of setoff against exempted security deposit); In Re Laues, 90 B.R. 158 (Bankr. E.D.N.C. 1988) (credit union cannot setoff exempted funds on deposit against dischargeable loan); In Re Wilde, 85 B.R. 147 (Bankr. D.N.M. 1988) (bank cannot setoff exempted funds on deposit against dischargeable loan despite express contractual agreement permitting setoff); In Re Haffner, 12 B.R. 371 (Bankr. M.D. Tenn 1981) (bank cannot setoff against certificate of deposit against discharged loan).[16]

In Re Laues, supra, is interesting because the court approaches the resolution of the conflict between §522(c) and §553(a) from the opposite direction, as did the Fifth Circuit in Luongo. Whereas the Fifth Circuit preempts the conflict by asserting that the right of setoff prevents the tax refund from becoming property of the estate and therefore exempt, Judge Small held that the right of setoff does not exist against exempt property. In Re Laues, 190 B.R. at 161.

One case that is often cited as holding that a creditor can exercise a right of setoff against exempt property is In Re Pieri, 86 B.R. 208 (9th Cir. BAP 1988). In that case the debtor exempted a $5,000.00 claim he had against his landlord arising out of a commercial lease dispute. The landlord sought to setoff her claim against the debtor arising out of the same lease. Applying California law, the Ninth Circuit BAP held that some types of exemptions, such as wages, unemployment, and disability benefits, are immune from setoff, but that the claim for damages arising out of the lease dispute was not immune from setoff. In resolving the "appellate nightmare" resulting from the conflict between §§ 522(c) and 553(a), the court held that §553(a) prevails because it comes after §522(c) in the Code.

DEBTS TO WHICH EXEMPTIONS DO NOT APPLY

Pursuant to §522(c) exempt property is "not liable during or after the case" for any non-lien, pre-petition debt, except nondischargeable tax and support debts. Two major issues arise from this provision. The first issue arises out of the negative implication that exempt property is liable for the nondischargeable tax and support debts during the case. Does this provision empower the holder of such a debt to demand that the chapter 7 trustee liquidate exempt assets to pay the claim? May a trustee in an asset case, through principles of marshalling, decline to pay the holders of such claims from estate distributions since they can pursue non-exempt assets for payment? The second is the effect of §522(c) on nondischargeable debts other than tax and support debts.

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[16] The bank setoff cases often involve the action of the bank to "freeze" the account prior to obtaining relief from the automatic stay to offset the account against the debt to the bank. The bank will cite In Re Strumpf, 506 U.S.16, 116 S.Ct. 286, 133 L.Ed.2d 358 (1995), as its authority to do so. However, in that case the debtor had not claimed the bank account as exempt. Therefore, Strumpf does not address the issue of whether exempt property is or is not subject to setoff.

Liability of Exempt Property for Tax and Support Debts

I have found no case in which the trustee was authorized to liquidate a totally exempt asset to pay a tax or support claim. However, there are two fairly old cases from the Southern District of New York in which the chapter 7 trustee, after having liquidated assets, a portion of which was exempt, was given a "reasonable time" to ascertain whether an allowed exemption must be paid to a creditor holding a non-dischargeable tax or support claim. In Re Greene, 76 B. R. 940 (S.D.N.Y. 1987) and In Re Kaufman, 68 B.R. 391 (Bankr. S.D.N.Y. 1986).

Exempt property was used to pay a tax debt in the case of In Re Clate, 69 B.R. 506 (Bankr. W.D. Pa. 1987). The trustee liquidated the debtor's residence and immediately paid him $2,500.00 of his $7,500.00 exemption with the permission of the court from the proceeds of $34,349.11. The trustee's subsequent motion for distribution proposed to pay the debtor $5,000.00 as the remainder of his exemption. The IRS objected, contending that it held a non-dischargeable debt of $6,236.37 for withholding tax liability. The court upheld the IRS objection and ordered the trustee to pay the debtor's remaining exemption of $5,000.00 to the IRS. The opinion does not disclose sufficient facts to ascertain whether the IRS could have been paid in full as the holder of a priority tax claim from the non-exempt property of the estate pursuant to §726(a)(1). Assuming that there were sufficient non-exempt funds to pay the IRS claim, the court's ruling does effectuate a marshalling of assets.

The only circuit court case on this issue is In Re Davis, 170 F.3d 475 (5th Cir. 1999). In that case, the debtor claimed his unlimited Texas homestead in his $500,000 lien-free residence. His ex-wife, citing §522(c)(1) as authority, requested that the court sell the homestead to pay her $300,000 alimony and child support claim. Under Texas law the homestead was exempt from the claim for alimony and support. The ex-wife argued, however, that §522(c)(1) preempted Texas law or granted the court authority to sell exempt property to pay the support debt. The Fifth Circuit held that §522(c)(1) neither preempts Texas law nor authorizes the bankruptcy court to sell exempt property to pay tax debts. It held that the provision "permits creditors holding such claims to proceed against property after bankruptcy based on the rights and remedies they would have had under state law if bankruptcy had not been filed." Id. at 481.[17]

[17] Section 216 of HB 975 overrules Davis. It amends § 522(c)(1) to provide that exempt property is liable for the payment of a support debt "notwithstanding any provision of applicable non-bankruptcy law to the contrary."

Liability of Exempt Property for Other Nondischargeable Debts

With the exceptions previously noted, exempt property is not liable "during or after the case" for pre-petition debts. What then is the relationship between exempted property and other non-dischargeable debts? The fact that the exemption remains intact during the case is easy to grasp. But, what are the implications arising from the fact the property not be liable for the non-discharged debt after the case? To explore this issue consider these examples set out below. In each case, the debtor has a $50,000, nondischargeable fraud debt. He lives in a state in which he can exempt $15,000 equity in his residence.

Case One:

The creditor obtains a judgment pre-petition. When the debtor files he has $10,000.00 equity in his residence (value of $100,000 less $90,000 mortgage). He files a motion to avoid the judgment lien as impairing his exempt interest in his residence. Can the debtor avoid the judicial lien?

The courts have held that the debtor can avoid the lien. The plain language of the statute provides for this result. See Walters v. U.S. Nat. Bank of Johnstown, 879 F.2.d. 95(3rd, 1989); In Re Gartrell, 119 B.R. 405 (Bankr. W.D.N.Y. 1990); In Re Ewiak, 75 B.R. 211 (Bankr. W.D. Pa. 1987); In Re Haupt, 16 B.R. 118 (Bankr. E.D. Pa. 1981).

Case Two:

The creditor has not obtained a pre-petition judgment. When the debtor files he has $10,000 equity in his residence. He claims his interest in the property as exempt. The creditor obtains a judgment 3 years post-petition. At that time the debtor has $25,000 equity in his residence. Can the creditor execute on the debtor's residence?

In case one, we have assumed that once the judgment lien is avoided, it is avoided forever. If that is so, then the answer to the question to case number 2 should be that it cannot execute on the residence. Otherwise the creditor is treated more favorably than the creditor in case one, with the only difference being that it obtains its judgment post-petition rather than pre-petition. Section 522(c)'s protection of exempt property from pre-petition debts does not support disparate treatment of creditors based upon this difference. To support the continued protection of the exempted property, the debtor's attorney in such a case should point to the fact that is was not $10,000.00 that the debtor claimed as exempt, but it was his entire interest in his residence that he claimed as exempt. She should argue that the plain language of §522(c) ("property exempted is not liable...after the case for any debt of the debtor that arose ...before the commencement of the case...") is designed to provide a fresh start to a debtor, even when the debtor has a nondischargeable debt.[18]

[18] But see discussion of California and Ninth Circuit law on p. 16.

Case Three:

The creditor has not obtained a pre-petition judgment. When the debtor files he has \$16,500 in equity in his residence. (\$116,500 value less \$100,000 mortgage) He claims a \$15,000 exemption. The trustee doesn't administer the \$1,500 in non-exempt equity and the case is closed. The creditor obtains a judgment 3 years post-petition. The debtor then has \$25,000 equity in his residence. Can the creditor execute on the debtor's residence? If so, what portion of debtor's equity is protected?

As discussed in case one, the debtor can utilize §522(f) to avoid judicial liens securing non-dischargeable fraud debt. If the creditor had obtained a judgment pre-petition, application of the formula set out in §522(f)(2)(A) avoids all but \$1,500.00 of the judgment lien. In essence, the combination of §522(f) and §522(c) "freezes" the lien creditor's interest in the debtor's residence at \$1,500.00. As argued in connection with case two, it is incongruous to treat the creditor who did not obtain a judgment pre-petition better than the one who did. Therefore, the creditor should be limited to executing on only \$1,500.00 of the debtor's residence.

Based on the recent opinion from the Ninth Circuit Bankruptcy Appellate Panel, acceptance of the analysis proposed in the previous paragraph is unlikely in California. <u>In Re Farr</u>, 278 B.R. 171 (9th Cir. BAP 2002). In that case, on the date the petition was filed according to the schedules the debtor had a one-half interest in property with \$210,000.00 of equity. Therefore, his one-half interest had a value of \$105,000.00. He claimed a \$100,000 homestead exemption under California law. No party objected to the claim of exemptions, and the case was eventually closed without any administering of assets. While the case was pending, a creditor filed an adversary proceeding pursuant to §523(a)(2)(A) and obtained a judgment in the approximate amount of \$800,000.00. The debtor did not move to avoid the lien pursuant to §522(f), but he did successfully defend in bankruptcy court the creditor's attempt to enforce its judgment against the non-exempt equity in the property. The court held that the debtor had exempted "the property" and that §522(c)(1) protected the entire residence from the creditor. <u>In Re Farr</u>, 224 B.R. 438 (N.D. Ca. 1998). The creditor appealed the decision, but the appeal was dismissed as having been untimely filed. The bankruptcy case was closed on April 4, 2000.

Apparently Farr attempted to sell the residence after the case was closed and could not do so because the creditor's judicial lien had not been released. He reopened his case seeking to hold the creditor in contempt for not releasing its lien. The bankruptcy court ruled in Farr's favor and entered an order decreeing that the creditor has no right, title, or interest in the debtor's property as a result of its judgment in the adversary proceeding.

The creditor appealed and the BAP reversed. The BAP held that the debtor did not exempt the residence, but rather only exempted \$100,000.00 in the residence. It concluded that §522(c) protects his interest in the residence only to the extent of \$100,000.00. <u>In Re Farr</u>, 278 B.R. at 175-79. Any equity over and above the

$100,000.00 is subject to the creditor's lien. The essence of the holding is to freeze the debtor's protected interest in his residence at $100,000.00.

So the answer to the question following case three is that on one extreme, the creditor can recover only $1,500.00 upon an execution sale, and on the other extreme, following the Farr analysis, the creditor can recover $10,000.00.

Case Four:

Same as case three except that the debtor's claim of exemption form states, "I claim 91% of my equity in this residence as exempt." When the creditor attempts to execute on his post-petition judgment can debtor limit the execution to 9% of the equity?

The question posed in case four is the result of applying aggressiveness and imagination to the claiming of exemptions. The 91% is derived from the fact that the amount of the allowable exemption, $15,000.00, is 91% of the total amount of equity in the property on the petition date. If successful in utilizing this strategy, the debtor would limit the creditor's interest in the residence to 9%. Under these facts upon the execution sale, the creditor would be entitled to recover only $2,250.00.

Whether such a strategy would prevail is dependant, in part upon the language on the particular exemption statute involved. For example §522(d)(1) provides that the debtor may exempt his "aggregate interest, not to exceed $117,425.00 in value, in real property that the debtor or a dependant of the debtor uses as a residence … ." The debtor exempts his interest in the property, not $17,425.00.[19] In California, according to In Re Farr, 278 B.R. 171, 175-179, the exemption scheme authorizes exemptions only in monetary amounts. See also In Re Hyman, 967 F.2d. 1316 (9th Cir. 1992); In Re Reed, 940 F.2d. 1317 (9th Cir. 1991); and In Re Morgan-Busby, 272 B.R. 257 (9th Cir. BAP 2002). The claiming of the 91% interest as exempt is more likely to be successful in jurisdictions in which the debtor claims his "interest" exempt, rather than just a monetary amount.

[19] North Carolina's homestead exemption statute is identical to §522(d)(1) except for the amount of the exemption. In Re McQueen, 196 B.R. 31 (E.D.N.C. 1995), the debtor moved pursuant to §522(f) to avoid a judicial lien on his residence in which he had no equity. The case was filed prior to the enactment of the 1994 Bankruptcy Reform Act amending §522(f) to add the formula set out in §522(f)(2)(A). The bankruptcy court denied the debtor's motion. The district court reversed, quoting favorably from the debtor's brief that the interest exempted "represent much more a monetary interest and should be read to encompass the debtor's use and possession of their property in perpetuity."