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Law v. Siegel: From Tiny Acorns

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December 12, 2013 - The scope of Bankruptcy Court powers is again before the Supreme Court this term, although no former Playmates or wealthy octogenarians are involved this time around. The Court granted certiorari to review the Ninth Circuit's decision, *Law v. Siegel*, which affirmed use of Bankruptcy Code Section 105 to "surcharge" the exempt homestead property of an individual debtor – in effect eliminating the statutory exemption — because the debtor had concocted a fictitious lien on the property, thereby causing the estate to incur overwhelming litigation costs in exposing the fraud. No. 12-5196 (*to be argued* Jan. 13, 2014).

There is arguably a circuit split on the use of Section 105 to negate statutory exemptions, with the First and Ninth Circuits holding (with qualifications) that a Bankruptcy Court has power to surcharge exempt property in appropriate circumstances, while the Tenth Circuit holds that it does not. *Compare Latman v. Burdette*, 366 F.3d 774, 785 (9th Cir. 2004), and *In re Malley v. Agin*, 693 F.3d 28 (1st Cir. 2012) (Souter, J.) with *Scrivner v. Mashburn (In re Scrivner)*, 535 F.3d 1258 (10th Cir. 2008), *cert. denied*, 129 S. Ct. 1613 (2009).

Still, the Court's decision to review the Ninth Circuit's decision—which was unpublished—came as a surprise. The petition was filed pro se by the individual debtor whose efforts to frustrate creditors included invention of a non-existent lender in China and fabrication of physical evidence of the purported lien on the homestead. The petition did not mention the circuit split, but mainly sought to assert the debtor's innocence in the face of massive evidence of wrongdoing, and to point out that the excess value of the debtor's homestead, which was ultimately sold for more than enough to pay even the fictitious lien, would now go to the Chapter 7 trustee's legal fees, while still leaving the estate administratively insolvent. Litigation over the validity of a $157,000 lien has now cost over $450,000 in administrative costs, with fees still mounting.

The Court solicited the input of the Solicitor General's Office ("SGO"), which took the position that the case was not appropriate for review, for reasons that, in hindsight, may not have been well-chosen. Relying on a decision by Justice Souter sitting by designation on an appeal to the First Circuit, the SGO first argued that the Ninth Circuit was correct that imposition of an "equitable surcharge" was within the Section 105 power of the Bankruptcy Court, even though it is not among the remedies for debtor misconduct enumerated in the Bankruptcy Code. Second, it argued that there was not a true circuit split on the precise issue presented, as the prior cases dealt with sanctions for non-disclosure of assets rather than litigation fraud. Finally, the SGO argued that the Supreme Court's decision in *Marrama v. Citizens Bank*, 549 U.S. 365 (2007), which upheld use of the Section 105 power to limit

debtor-initiated conversion of Chapter 7 cases, supports the broad reading of Section 105 adopted by the Ninth Circuit.

The Court's decision to hear the case despite the seemingly egregious nature of the debtor's misconduct and the contrary recommendation of the SGO invites the question of what exactly the Court wants to address in taking this case.

Section 105: Age Cannot Wither nor Custom Stale its Infinite Variety

Bankruptcy Courts have traditionally been described as courts of equity, and Bankruptcy Code Section 105(a) is said to codify their equitable powers:

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.

Still, the bankruptcy practitioner is seldom sorry to see invocation of Section 105 in the Bankruptcy Court applications of adversaries, as it probably means that there is no statutory authority for the relief sought. Indeed, the permissible uses and limits of this section (and its predecessor statutes and principles) have been fruitful sources of dispute and litigation.[1] The modern view, as stated by the Supreme Court in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988), is that is that the equitable powers of Bankruptcy Courts "must and can only be exercised within the confines of the Bankruptcy Code." This means that equitable principles may not be used to negate express terms of the Bankruptcy Code, or to create rights and remedies beyond those created by the statute.

Against this background, the SGO may have been waving the proverbial red flag before the bull when it argued in its amicus brief that the Court's 2007 decision in *Marrama* should be read to justify the Ninth Circuit's use of equitable principles to extinguish property rights that are seemingly guaranteed by Section 522 of the Bankruptcy Code. *Marrama* itself is not so broad – the use of Section 105 in that case did not negate a property right, but merely affirmed denial of an attempted conversion to Chapter 7 as a bad faith tactic. The Supreme Court may wish to use this occasion to explain the limits of *Marrama*.

The Arithmetic: $450,000 to Expunge a $157,000 Lien?

It may be questioned whether the bankruptcy forum creates incentives to engage in litigation that would be deemed uneconomic in an ordinary two-party dispute. In this case, the homestead sold for more than enough to satisfy the undisputed first lien, to pay actual creditors, satisfy the $75,000 homestead exemption, *pay the fictitious second lien*, pay administrative costs—and then return a surplus to the miscreant debtor. In other words, if the fraudulent character of the fictitious lien had simply been ignored, no creditor injury would have occurred.

Adding $450,000 in administrative cost to this equation, however, changes everything. The estate may be administratively insolvent, with or without use of the $75,000 homestead exemption to defray administrative cost. The Supreme Court may question whether intervention at some point in the proceedings, whether by the Bankruptcy Judge, the Bankruptcy Appellate Panel (which saw the case many times) or the United States Trustee's office could have avoided administrative cost that appears out of proportion to the true economic interests at stake.

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Merits briefing is now complete, with arguments focusing on Section 105, the inherent powers of the Bankruptcy Court to punish fraudulent litigation tactics, and deference owed to statutory text where it falls short of producing a result that the Bankruptcy Court views as just. From the seemingly humdrum, small-time debtor fraud that provided the factual record in this case, a significant Supreme Court precedent may yet emerge.

Footnotes

[1] *See, e.g., Caldwell v. Unified Capital Corp. (In re Rainbow Magazine, Inc.)*, 77 F.3d 278, 284 (9th Cir. 1996) (Section 105(a) provides bankruptcy courts inherent power to sanction vexatious conduct); *Jamo v. Katahdin Fed. Credit Union (In re Jamo)*, 283 F.3d 392, 403 (1st Cir. 2002) (Section 105(a) not a "roving writ"); *GAF Corp. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 26 B.R. 405, 409-10 (Bankr. S.D.N.Y. 1983) Section 105 "does not permit the court to ignore, supersede, suspend or even misconstrue the statute itself or the rules."); *Walls v. Wells Fargo Bank*, 276 F.3d 502, 506-07 (9th Cir. 2002) (Section 105 does not provide an implied private right of action); *Bair v. United States (In re Bair)*, 240 B.R. 247, 254 (Bankr. W.D. Tex. 1999) (exercising authority under Section 105(a) to equitably toll a statute of limitations period).

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