Hughes Hubbard & Reed

Law v. Siegel: Oral Argument Suggests Unusual Alignment of Stars

Client Advisories

Hughes Hubbard & Reed LLP • A New York Limited Liability Partnership
One Battery Park Plaza • New York, New York 10004-1482 • +1 (212) 837-6000

January 15, 2014 - On January 13, 2014, oral argument before the Supreme Court produced a spirited session, as seven Justices took an active role in questioning, with only Justices Thomas and Scalia remaining on the sidelines. As counsel for the petitioner/debtor, respondent/trustee and the Solicitor General ("SGO") as amicus (supporting affirmance) were peppered with questions, the express language of the Bankruptcy Code collided repeatedly with the unpleasant prospect that a lying debtor could walk away with his $75,000 homestead exemption, even as the trustee's administrative cost in exposing the debtor's fraud went unpaid. Could the venerable Section 105(a) save the day? Could this catch-all provision provide hand- or foot-holds on the seemingly sheer precipice of Section 522(k)'s express pronouncement that exempt property "is not liable for any administrative expense"?

Liberal Justices as Strict Constructionists?

The dilemma was neatly captured by Justice Kagan's challenge to the SGO, which was advocating affirmance of the Ninth Circuit's "surcharge" of the debtor's homestead exemption, thus permitting the $75,000 to be applied to the legal cost of uncovering the fraud:

JUSTICE KAGAN: Ms. Harrington, you clearly have the facts on your side. The question is whether you have the law. 522(k) says, as Justice Breyer said, "Property that the debtor exempts under this section is not liable for payment of any administrative expense."

Now, as I read your brief, you're essentially asking us to put the word "usually" in that provision. Is not usually liable. When is it – when is it liable? It's – it's liable when there are special circumstances dealing with debtor dishonesty. And where does that come from? (Tr. at 43.)

Similar reservations had been expressed not only by Justice Breyer, but also by Justices Ginsburg and Sotomayor, who inquired as to the extent and limits on a Bankruptcy Court's power to modify the statutory expression "not liable." Here was the liberal wing of the Court asking how the plain meaning of the statute could be tinkered with, even if the tinkering might achieve a result both more just and more in keeping with bankruptcy policy.

This Debtor Can Just Walk Away?

At the other end of the bench, Justice Alito was having none of this. Pro bono counsel for the miscreant debtor had begun by stating that surcharge of exempt property was not permitted under the Code (with two inapplicable exceptions), and that exemptions serve the legislative goal that debtors not become "*wards of the state*." These words had just been spoken (for the first and only time) when Justice Alito broke in:

JUSTICE ALITO: I am somewhat taken aback by your constant reference –your repeated references to "wards of the state." What we're talking about is whether your client gets $75,000. Do you think everybody who doesn't have $75,000 is a ward of the State?

MR. HELLMAN: This is his last $75,000, Your Honor.

JUSTICE ALITO: Yes. Well, do you know what the median net worth of a household in the United States is?

MR. HELLMAN: It's –it's about –I'm not sure what the median net worth is.

JUSTICE ALITO: It's less than $70,000. So the question here is not whether he's going to be a ward of the State. The question is whether he's going to be above the median in his assets. (Tr. at 4-5.)

It would serve no purpose to speculate on how many petitioners' counsel would have been prepared at that moment to discuss the median net worth of US households. In any case, this exchange suggests that respect for statutory language is not the only issue for Justice Alito. Justices Sotomayor, Breyer and Ginsburg also questioned whether the lying debtor was getting off scot-free if he kept the $75,000, a prospect that no Justice liked.

What was the Trustee Supposed to do?

Justice Alito also asked a practical question that will be of keen interest to the bankruptcy bar:

JUSTICE ALITO: What was the trustee supposed to do? Suppose the trustee has a meter running on his desk, and he's hot in pursuit of this phantom Lily Lin of China, but we get to the point where he's down to the –he says, well, if I do any more work, the only way I'm going to get paid is out of the $75,000. I better stop, because otherwise, I'm going to be working free. (Tr. at 6-7.)

The petitioner's response, with citation to the US Trustee's Handbook for Trustees, was that, yes, the trustee must take account of benefit to the estate when incurring administrative cost to pursue claims.

Like Justice Alito, Justice Kennedy seemed troubled that the "trustee can take no action to make the estate whole" where a debtor's misconduct leads to administrative expense that cannot be paid with non-exempt assets. At the same time, Justice Roberts (whose mild questions at several points no doubt give comfort to both sides as they await the decision), wondered whether the trustee really "had to investigate to the tune of half a million dollars" when a "much smaller amount" was at issue. (Tr. at 29.)

Disallow the Exemption Nunc Pro Tunc?

The lower courts had viewed the issue as whether Section 105(a) includes the power to "surcharge" property that is exempt under state law, proceeding on the basis that $75,000 in homestead value was clearly exempt, and that such a surcharge could be levied after misconduct was established. However, it was Justice Kagan who first floated the idea that the Bankruptcy Code's provision for Bankruptcy Court adjudication of objections to exemption claims suggested that "the court gets to decide" what property is exempt. (Tr. at 22.) Justice Alito also took up this theme (Tr. at 23), while Justice Breyer took up the contra side, and seemed to persuade the SGO to drop the idea. (Tr. at 48.)

Inherent Power?

There was also much discussion of a court's "inherent power" to punish misconduct and award attorneys' fees, a centerpiece of the argument of the respondent trustee and the SGO. Justice Sotomayor described the court's "sanctioning power" as among "the most longstanding and respected powers." (Tr. at 8.) Again, the frequency and limits on use of this power, seemingly difficult to harmonize with a statutory provision, was an important question. Justice Roberts suggested that use of the power would become "not very unusual," as misconduct affecting a debtor's non-exempt assets is "fairly common." (Tr. at 45-46.)

Reading the Tea Leaves

Going way out on a limb here, the argument would suggest that at least six Justices (Kagan, Breyer, Ginsburg, Sotomayor, Roberts and Kennedy) will potentially vote to reverse. Justice Alito will write a dissent, and may get either Justice Scalia or Justice Thomas (but not both) to join. Final vote: 7-2 to reverse.

Related People

David Wiltenburg

Related Areas of Focus

Corporate Reorganization & Bankruptcy