

WRITTEN DECISION - FOR PUBLICATION

<p>ENTERED <u>9/26/14</u> FILED</p> <p>SEP 26 2014</p> <p>CLERK, U.S. BANKRUPTCY COURT SOUTHERN DISTRICT OF CALIFORNIA BY _____ DEPUTY</p>

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

In re:) Bk. No. 14-00720-LT7
)
 ISAIAS ARELLANO,) Chapter 7
)
 Debtor.)
)

**MEMORANDUM DECISION ON CHAPTER 7 TRUSTEE’S OBJECTIONS TO
 DEBTOR’S CLAIM OF EXEMPTIONS**

Debtor Isaias Arellano filed a chapter 7¹ bankruptcy case and concurrently filed a chapter 7 filing fee waiver application. His fee waiver request appeared meritorious given his limited income and the fact that neither his application nor his schedules evidenced an ability to pay the filing fee in installments. The Debtor’s initial schedule C was consistent with this assumption, as the Debtor claimed limited exemptions. The Court, thus, granted the fee waiver request.

At the initial section 341(a) meeting, however, new information came to light. The Debtor, in response to questioning, identified additional personal property assets not previously disclosed. As a result, the Debtor amended his schedule B to add a credit union checking account with a balance of

¹ Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1532. All “Rule” references are to the Federal Rules of Bankruptcy Procedure.

1 \$4,958.65 and an anticipated tax refund of \$2,000 based on an amended 2011 income tax return.
2 Concurrent with scheduling the omitted assets, the Debtor modified his schedule C and claimed the
3 omitted assets exempt pursuant to California Code of Civil Procedure (“CCP”) § 703.140(b). The
4 Debtor also paid the filing fee in full notwithstanding the fee waiver order.

5 Debtor’s chapter 7 Trustee objected to the Debtor’s newly claimed exemption of the omitted
6 assets. As relevant here, he based his objection on the Debtor’s alleged bad faith. Through his
7 counsel’s declaration, the Debtor opposed and contested the allegations of bad-faith.

8 DISCUSSION

9 The Bankruptcy Code authorizes a debtor to exempt certain assets. 11 U.S.C. § 522(b). The
10 debtor’s exercise of this right directly impacts creditors as exempt assets are not available for payment
11 of either pre-petition claims or administrative expenses. 11 U.S.C. § 522(c), (k). Notwithstanding, the
12 Bankruptcy Code allows a debtor significant latitude in selecting assets for exemption. The debtor also
13 has significant flexibility in the timing of an exemption claim. Under Rule 1009(a), a debtor may amend
14 his or her schedules, including to add or alter claimed exemptions, as a matter of course at any time prior
15 to the closing of the case. *See also Tyner v. Nicholson (In re Nicholson)*, 435 B.R. 622, 630 (9th Cir.
16 BAP 2010).

17 In the Ninth Circuit, however, a judicially created limit on this latitude and flexibility arose. It
18 was accepted that a bankruptcy court could deny leave to amend or disallow a claimed exemption if the
19 trustee or other party in interest timely objected and showed that either: (1) the debtor acted in bad faith;
20 or (2) the creditors were prejudiced. *Martinson v. Michael (In re Michael)*, 163 F.3d 526, 529 (9th Cir.
21 1998) (adopting the test set forth in *Doan v. Hudgins (In re Doan)*, 672 F.2d 831 (11th Cir. 1982)); *see*
22 *also In re Nicholson*, 435 B.R. at 630.

23 The United States Supreme Court’s recent decision in *Law v. Siegel*, 134 S. Ct. 1188 (2014),
24 however, requires that the Court examine the continued viability of the *In re Michael* equitably based
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1 limitations. If these two exceptions are “clearly irreconcilable” with the reasoning and analysis of
2 *Law v. Siegel*, the Court may neither deny exemption nor bar the Debtor’s amendment to add an
3 exemption based on bad faith and *In re Michael*. See *Miller v. Gammie*, 335 F.3d 889, 900 (9th Cir.
4 2003) (en banc) (where intervening Supreme Court authority is “clearly irreconcilable” with prior Ninth
5 Circuit authority, the courts “should consider themselves bound by the intervening higher authority and
6 reject the prior opinion of this court as having been effectively overruled.”); see also *Rodriguez v. AT &*
7 *T Mobility Servs. LLC*, 728 F.3d 975, 979 (9th Cir. 2013) (courts may re-examine prior precedent when
8 the reasoning or theory of that authority is “clearly irreconcilable” with the reasoning or theory of
9 intervening higher authority).

10 The Court acknowledges that tension between the Supreme Court authority and prior circuit
11 precedent is not enough to require rejection of otherwise binding circuit authority. Instead, the Supreme
12 Court must have undercut the theory or reasoning underlying the prior circuit precedent in such a way
13 that the cases are clearly irreconcilable. See *Rodriguez*, 728 F.3d at 979 (internal citation omitted).
14 Whether prior precedent is clearly irreconcilable thus focuses “on the *reasoning* and *analysis* in support
15 of a holding, rather than the holding alone.” *Id.* (internal citation omitted) (emphasis in original). And,
16 that the intervening higher authority involved a different issue is not dispositive. See *id.* (“The issues
17 presented in the two cases need not be identical in order for the intervening higher authority to be
18 controlling.”)

19 In *Law v. Siegel*, the Supreme Court held that the bankruptcy court exceeded both its statutory
20 and equitable powers when it permitted the surcharge of Mr. Law’s homestead exemption to pay
21 administrative expenses incurred as a result of Mr. Law’s misconduct. 134 S. Ct. at 1195-97. Mr. Law
22 fabricated a lien against his home in an attempt to keep equity available in the home from his creditors.
23 *Id.* at 1193. His chapter 7 trustee successfully challenged the lien and obtained a determination that
24 Mr. Law had perpetrated a fraud. *Id.* The bankruptcy court, therefore, granted his trustee’s motion to
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1 surcharge Mr. Law’s entire homestead exemption and to use those funds as recompense for the trustee’s
2 related administrative costs and attorneys’ fees. *Id.* On appeal, both the Bankruptcy Appellate Panel of
3 the Ninth Circuit and the Ninth Circuit affirmed. *Id.* at 1193-94.

4 The Supreme Court reversed. At the outset, it determined that surcharge was “unauthorized [as]
5 it contravened a specific provision of the Code.” *Id.* at 1195. The Supreme Court first observed that
6 section 522 and California law entitled Mr. Law to exempt equity in his home. *Id.* Second, it noted that
7 section 522(k) expressly prohibited the use of exempt property for the payment of administrative
8 expenses. *Id.* As the attorneys’ fees incurred by the trustee were “indubitably an administrative
9 expense,” the Supreme Court concluded that the bankruptcy court violated section 522 by ordering the
10 surcharge to pay such fees. *Id.*

11 The Supreme Court also rejected the argument that a bankruptcy court’s exemption denial when
12 based on its equitable powers, whether arising under section 105(a) or its inherent authority, could
13 “comfortably coexist” with the Bankruptcy Code. *See id.* at 1195-97. Observing first that nothing in
14 section 522 gave the bankruptcy court “discretion to grant or *withhold exemptions* based on whatever
15 considerations [it] deem[s] appropriate,” the Supreme Court emphasized that section 522 vested
16 discretion solely in the debtor to decide whether or not to claim an exemption. *Id.* at 1196 (emphasis
17 added). Insofar as the debtor claimed to be entitled to a statutorily available exemption, “the
18 [bankruptcy] court [could] not refuse to honor the exemption absent a valid *statutory* basis for doing so.”
19 *Id.* (emphasis added).

20 The Supreme Court further determined that section 522’s thorough enumeration of exemptions –
21 and exceptions to exemptions – “confirm[ed] that courts are *not authorized to create additional*
22 *exceptions.*” *Id.* (emphasis added). It, thus, emphatically rebuffed the theory that the general, equitable
23 powers of the bankruptcy court somehow conferred a basis for exemption denial based on a debtor’s
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1 bad-faith conduct, resolving that the “Code admits no such power.” *Id.* In doing so, it effectively
2 abrogated three circuit court cases, including *In re Doan*. *See id.*

3 Thus, in *Law v. Siegel*, the Supreme Court made clear that where the Bankruptcy Code is silent,
4 the only basis for denial of a state law exemption must arise under state law. *See id.* at 1196-97. And,
5 the Supreme Court emphasized that “*federal law* provides no authority for bankruptcy courts to deny an
6 exemption on a ground not specified in the Code.” *Id.* at 1197 (emphasis in original).

7 Finally, the Supreme Court noted that there is no real distinction between disallowing or denying
8 an exemption and barring a debtor from amending² his or her schedules to claim an exemption. *See id.*
9 at 1196 (“[A]uthority to disallow an exemption . . . [and] bar[ring] a debtor from amending his schedules
10 to claim an exemption, . . . is much the same thing . . .”). This conclusion is logical as the result of a
11 denial of leave to amend is the same as exemption denial: the debtor is deprived of the benefit from the
12 desired exemption.

13 The Court, thus, determines that its ability to disallow the Debtor’s claimed exemptions in the
14 omitted assets – whether indirectly by denying leave to amend to include a new exemption or directly by
15 disallowing the exemption itself – when based solely on its equitable powers and the existence of bad-
16 faith or prejudice is clearly irreconcilable with *Law v. Siegel*. First, it is reasonably assumed that the
17 Trustee seeks an order denying the exemption so that the omitted assets are available for payment of
18 administrative or pre-petition unsecured claims. Thus, disallowance of the exemption in the omitted
19 assets would result in contravention of specific language of section 522(c) and (k). This is actually the
20 same result that the Supreme Court found improper in *Law v. Siegel*.

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22 ² Moreover, the term “leave to amend” is inapt; as stated under Rule 1009, a debtor may amend
23 a claimed exemption as a matter of course, without requesting leave to amend from the bankruptcy
24 court. This is in contrast to the rule in the past that required application for leave to amend a petition or
25 schedule. *See* General Order 11, General Orders and Forms in Bankruptcy of the United States Supreme
26 Court (1939) (abrogated 1973). Thus, while at one time a material difference between amending a
debtor’s claim of exemptions and denying an exemption may have existed, it long ago became a
distinction without a difference.

1 Second, the only authority for disallowing the Debtor's claimed exemption in the omitted assets
2 is the bankruptcy court's equitable powers. *See In re Nicholson*, 435 B.R. at 634 n.5 (recognizing an
3 objection to exemption based on bad-faith conduct is "a matter of federal common law pursuant to
4 [s]ection 105(a) . . . and the inherent powers of the bankruptcy court as courts of equity to protect the
5 integrity of the bankruptcy process."). Thus, although *Law v. Siegel* involved a facially distinct issue,
6 that of surcharge allowing payment of administrative expenses, the Court cannot ignore the Supreme
7 Court's clear mandate in the area of debtor exemptions: when a debtor properly asserts an exemption
8 under section 522, it must be allowed unless the controlling law provides for disallowance. And this is
9 true whether the debtor asserts the exemption at case initiation or at a later point before case closure.
10 There is nothing in section 522 that provides for the denial or disallowance of an exemption based on a
11 debtor's bad-faith conduct or prejudice to third parties. In short, the bankruptcy court's equitable
12 powers are now an insufficient basis for exemption denial even if bad faith or prejudice exists.

13 The Court's conclusion is strengthened by *Law v. Siegel's* effective abrogation of *In re Doan*.
14 The Ninth Circuit in *In re Michael* adopted the bad-faith or prejudice exception to debtor exemptions
15 from *Doan*. *See* 163 F.3d at 529. Given *Doan's* abrogation, it follows that *In re Michael*, at least as to
16 the bad-faith and prejudice exceptions, likewise effectively is abrogated. *See Rodriguez*, 728 F.3d at
17 979; *Miller*, 335 F.3d at 893.

18 To be clear, *Law v. Siegel* did not deprive this Court of the essential authority to respond to the
19 Debtor's misconduct, if and when established, with meaningful sanctions. The Trustee's present
20 objections to the claimed exemptions, however, cannot stand as a form of sanction when based on the
21 Court's equitable powers. Such a sanction would enlarge the source of payment for administrative or
22 unsecured claims in a manner directly contrary to section 522(c) and (k).

23 Further, as *Law v. Siegel* explained, the Code provides for no such grounds for exemption denial.
24 Thus, any objection to these CCP § 703.140(b) exemptions must arise under California law. *See Law v.*

1 *Siegel*, 134 S. Ct. at 1196-97. The Trustee, however, supplied no basis for disallowance under
2 California law, and expressly declined the invitation to further brief the issue.

3 **CONCLUSION**

4 For the foregoing reasons, the Trustee's objections to the Debtor's claimed exemptions are
5 OVERRULED.

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7 DATED: September 26, 2014

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LAURA S. TAYLOR, Chief Judge
United States Bankruptcy Court

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA
325 West "F" Street, San Diego, California 92101-6991

In re Isaias Arellano, Bk. No. 14-00720-LT7

CERTIFICATE OF MAILING

The undersigned, a regularly appointed and qualified employee in the office of the United States Bankruptcy Court for the Southern District of California, at San Diego, hereby certifies that a true copy of the attached document, to wit:

MEMORANDUM DECISION

was enclosed in a sealed envelope bearing the lawful frank of the bankruptcy judges and mailed via first class mail to the party at their respective address listed below:

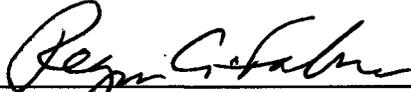
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Said envelope(s) containing such document was deposited by me in the City of San Diego, in said District on September 26, 2014.


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