

Exemption Elasticity? The Ongoing Debate Over Unlimited or In-Kind Exemptions

by

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A debtor's right to exempt property from the bankruptcy estate is fundamental to the concept of a fresh start. Generally, 11 U.S.C. § 541 defines what type of property becomes property of the bankruptcy estate upon the filing of a petition, while 11 U.S.C. § 522¹ defines what specific property the debtor may exempt. Many exemptions are subject to dollar limits.²

Courts have reached different conclusions about what is actually exempted when a debtor claims a property exemption in the same amount as she values the property. The split in authority may be attributed to the courts' interpretation of the ruling of the United States Supreme Court in *Taylor v. Freeland & Kronz*, 503 U.S. 638, 112 S. Ct. 1644, 118 L. Ed. 280 (1992). This article highlights some of the decisions issued subsequent to *Taylor* in light of a petition for *certiorari* that was recently granted by the Supreme Court in *Schwab v. Reilly (In re Reilly)*, 534 F.3d 173 (3d Cir. 2008).

In *Taylor*, the debtor, Emily Davis, filed a chapter 7 petition while her employment discrimination suit was pending in state court. On her bankruptcy schedules, she claimed as exempt the proceeds from the lawsuit and her claim for lost wages, and she listed the value of both as unknown. At the § 341 meeting of creditors, she told the trustee that she might recover \$90,000 in damages from the lawsuit.³ The trustee informed the debtor that he considered any such proceeds to be property of the estate, but he did not object to the claimed exemption. The lawsuit settled for \$110,000 and the debtor paid her attorneys \$71,000. The trustee sued the attorneys, seeking turnover of the legal fees paid as property of the estate. The attorneys argued that the proceeds were exempt because the trustee did not object to the debtor's exemptions.⁴

The bankruptcy court found for the trustee and ruled that the debtor had no statutory basis for the claimed exemption. The district court affirmed. The Third Circuit Court of Appeals reversed, holding that the proceeds were exempt because the trustee failed to object to

¹ In the states that have opted out of the federal exemption scheme, debtors may only exempt property under state law. In the states that have not opted out, debtors may choose between state-permitted exemptions and those listed in section 522(d). 11 U.S.C. § 522(b).

² See, e.g., 11 U.S.C. § 522(d) (setting out maximum values in subparagraphs (1) through (6), (8) and (11)(D)). Similarly, state exemptions are often limited in amount.

³ *Taylor v. Freeland & Kronz*, 112 S. Ct. at 1646. Her employer had already been found liable in the state court suit (although that determination was on appeal), but damages had not yet been awarded. *Id.*

⁴ *Id.* at 1647.

the exemption within the deadline imposed by Bankruptcy Rule 4003.⁵ Fed.R.B.P. 4003. The Supreme Court granted *certiorari* and framed the issue as follows: “[W]e must decide in this case whether the trustee may contest the validity of an exemption after the 30-day period if the debtor had no colorable basis for claiming the exemption.”⁶ The Court held that the trustee’s failure to object prevented him from challenging the validity of the exemption.⁷ The Court’s decision also put trustees on notice to inquire further:

“If [the trustee] did not know the value of the potential proceeds of the lawsuit, he could have sought a hearing on the issue, see Rule 4003(c), or he could have asked the bankruptcy court for an extension of time to object, see Rule 4003(b). Having done neither, Taylor cannot now seek to deprive Davis and respondents of the exemption.”⁸

For some courts, *Taylor* stands for the proposition that, when a debtor exempts an interest in property in an amount equal to the value placed on the property, she has expressed a clear intent to assert a complete “in-kind” exemption in that property. For example, in *Olson v. Anderson (In re Anderson)*, 377 B.R. 865 (B.A.P. 6th Cir. 2007), the court upheld the bankruptcy court’s order denying the trustee’s motion to settle a proceeding brought under 11 U.S.C. § 363(h) because the estate no longer had an interest in the property. The debtors described their interest in property on their Schedule of Exemptions (Schedule C) as “1/2 interest in old cabin. The debtors own a 1/2 interest in an old cabin that may have a total value of about \$30,000. The debtors interest would be \$15,000.”⁹ The debtors also scheduled the value of this property at \$15,000. The trustee did not object to the exemption, and she later obtained an appraisal that valued the property at \$60,000. When she sought approval to settle the section 363(h) proceeding against the co-owners, the debtors objected and argued that the estate no longer had an interest in the property because the trustee did not object to their exemption. The bankruptcy court agreed.

On appeal, the Sixth Circuit BAP found that the “*Taylor* decision is clear that when a debtor makes an unambiguous manifestation of intent to seek an unlimited exemption in property, then, absent a timely objection, that property is exempt in its entirety, even if its actual

⁵ *Id.* Rule 4003(b) provides that any party in interest may object to the debtor’s list of property claimed as exempt within 30 days after the 341 meeting is concluded or within 30 days after any amendment to claimed exemptions, whichever is later. Fed. R. Bankr. P. 4003(b).

⁶ 112 S. Ct. At 1647.

⁷ *Id.* at 1648.

⁸ *Id.*

⁹ *Olson v. Anderson*, 377 B.R. at 869.

value exceeds statutory limits, and it is no longer property of the estate.”¹⁰ The court then considered what constitutes a debtor’s “manifestation of intent.”¹¹ The debtors argued that when the property value and exemption amount are the same, an intent to exempt the property in full, regardless of its actual value, is clearly expressed. The trustee argued that if debtors want to exempt the property in its entirety, they must list the market value as unknown and the exemption as 100 percent, or they must make a similar notation on their schedules to express their intent.¹² The Sixth Circuit BAP agreed with the debtors. It held that when a debtor lists an exemption in an amount sufficient to exempt all of the unencumbered value in the property, she intends to exempt the property in full, whatever that amount turns out to be.³¹

Other courts hold that, when a debtor lists an exemption in a certain amount, the debtor indicates an intent to exempt from the estate only that amount. In *Barroso-Herrans v. Lugo-Mender (In re Barroso-Herrans)*, 524 F.3d 341 (1st Cir. 2008), the debtors claimed as exempt two pending state court lawsuits, each in the amount of \$4,000. On the Schedule of Personal Property (Schedule B), they listed the value of each lawsuit at \$4,000 and related accounts receivable at \$170,452. The trustee did not object to the debtors’ claimed exemptions. He later settled both lawsuits for a total of \$100,000 and the debtors objected to the settlement. The bankruptcy court found that the debtors were entitled to an exemption in the amount of \$4,000 for each lawsuit.¹⁴ The debtors appealed, and the district court affirmed. On appeal, the Court of Appeals for the First Circuit was not persuaded by the debtors’ argument that they intended to exempt the proceeds in full, because the damages sought in the state court were \$4,000,000 and because they valued the related accounts receivable at \$170,000.¹⁵ The court held that the debtors were entitled only to the amount they scheduled as exempt.

The debtors in *Lewandowski v. Lim (In re Lewandowski)*, 386 B.R. 643 (E.D. Mich. 2008), scheduled an undeveloped parcel of land on Schedule B with a value of \$7,500 and claimed the property exempt in the same amount. The trustee did not object to the claimed exemption. Thereafter, the bankruptcy court authorized the trustee to sell the land at auction, over the debtors’ objection, for \$58,000.¹⁶ The debtors appealed. The district court affirmed, ruling that other provisions of section 522(d) without a monetary limit might provide for “in-

¹⁰ *Id.* at 875.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* at 876, citing *Allen v. Green (In re Green)*, 31 F.3d 1098, 1100 (11th Cir. 1994). *See also In re Jones*, 357 B.R. 888 (Bankr. M.D. Ga. 2005), another case on this side of the split.

¹⁴ *Barroso-Herrans*, 524 F.3d at 343.

¹⁵ *Id.* at 344-45.

¹⁶ *In re Lewandowski*, 386 B.R. at 644.

kind” exemptions, but section 522(d)(5) did not.¹⁷ It declined to follow *Anderson*, and suggested that the court in that case was wrong.¹⁸ It also ruled that *Taylor* only stands for the proposition that, once the 30-day window of Rule 4003(b) passes, the trustee can no longer object to exemptions, even if the exemption was improperly claimed. *Taylor* did not address “when an objection to the valuation of underlying property rather than to the exemption itself was subject to the rule.”¹⁹

The question was posed again recently in *Schwab v. Reilly (In re Reilly)*, 534 F.3d 173 (3d Cir. 2008). The debtor in *Reilly* owned a one-person catering business. When she filed a chapter 7 petition, she claimed her business equipment exempt under 11 U.S.C. §§ 522(d)(5) and (d)(6) in the total amount of \$10,718.²⁰ On Schedule B, she listed the same equipment with a value of \$10,718. The trustee did not object to her exemptions. He later obtained an appraisal and determined that the equipment was worth approximately \$17,200. When he filed a motion to sell the equipment, the debtor objected and argued that the property had become fully exempt when the trustee failed to timely object to her exemption. The bankruptcy court agreed with the debtor and denied the trustee’s motion. The trustee appealed, and the district court affirmed. It found that the debtor had demonstrated her intent to exempt the entire value of the property when she listed the same figure for the value of the property as she claimed exempt. Because the trustee did not object to the debtor’s exemption, the debtor was entitled to the entire value, even if it was higher than she disclosed on her schedules.²¹

On appeal to the Court of Appeals for the Third Circuit, the trustee argued that he had no grounds for objecting to the exemption as improperly claimed, he intended to pay the debtor her exemption in the amount of \$10,718 from proceeds of the sale, and *Taylor* did not apply to the question whether the value placed on property by the debtor in her schedules was conclusive on the issue of value in the absence of objections under Rule 4003(b).²² The Third Circuit rejected the trustee’s arguments. It quoted the Supreme Court’s cautionary language: “If *Taylor* did not know the value of the potential proceeds of the lawsuit, he could have sought a hearing on the issue, or he could have asked the Bankruptcy Court for an extension of time to object. Having

¹⁷ Section 522(d)(5) allows an exemption for the debtor’s “interest in any property, not to exceed in value \$1,075 plus up to \$10,125 of any unused amount of the exemption provided under” 522(d)(1).

¹⁸ *Id.* at 647.

¹⁹ *Id.* at 648.

²⁰ *Schwab v. Reilly*, 534 F.3d at 174. She claimed \$8,868 as exempt under section (d)(5) and \$1,850 as exempt under section (d)(6).

²¹ *Id.*

²² *Id.* at 177-78. The National Association of Bankruptcy Trustees (NABT) filed an amicus brief in support of the trustee on March 26, 2007. See Docket, Third Circuit Court of Appeals, *Schwab v. Reilly*, No. 06-4290.

done neither, Taylor cannot now seek to deprive [the debtor] of the exemption.”²³ Affirming the district court, the appellate court held that, once the Rule 4003 deadline passed without objection, the property became fully exempt from the estate regardless of its value.⁴²

The trustee in *Reilly* filed a Petition for Writ of Certiorari with the United States Supreme Court on October 20, 2008.²⁵ The trustee in the *Reilly* case, as well as others on the Third Circuit’s side of the split, argue that the holding in *Taylor* is limited to objection deadlines. Over the last 17 years, courts have used *Taylor* to answer the question of what the debtor intended to exempt: the property itself or some monetary amount representing her estimated interest in that property. On April 27, 2009, the Supreme Court granted the trustee’s request for review.²⁶ The issue regarding whether exemptions can expand with the value of the property may be finally settled. Until then, panel trustees should be aware of any controlling precedent in their jurisdiction and should continue to heed the *Taylor* Court’s advice and seek a valuation hearing or an extension of time to object under Bankruptcy Rule 4003.

²³ 534 F.3d at 177, citing *Taylor*, 112 S. Ct. at 1644.

²⁴ 534 F.3d at 178. The court recognized the split of authority on this issue and described some of the cases discussed in this article. *See Id.*

²⁵ *See* Docket, United States Supreme Court, *Schwab v. Reilly*, No. 08-538. On November 24, 2008, the NABT filed a Brief of Amicus Curiae in Support of Petitioner. The Debtor filed her Brief in Opposition on March 23, 2009.

²⁶ *See Id.*