No. 12-5196

In The
Supreme Court of the United States

STEPHEN LAW,

Petitioner,

v.

ALFRED SIEGEL, TRUSTEE,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF NATIONAL ASSOCIATION OF BANKRUPTCY TRUSTEES AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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TABLE OF CONTENTS

TABLE OF CONTENTS – Continued

TABLE OF AUTHORITIES

Page

CASES

TABLE OF AUTHORITIES – Continued

Page

TABLE OF AUTHORITIES – Continued

TABLE OF AUTHORITIES – Continued

Page

OTHER AUTHORITIES

STATEMENT OF INTEREST OF NABT AS *AMICUS CURIAE*

The National Association of Bankruptcy Trustees ("NABT") is a non-profit association formed in 1982 to address the needs of chapter 7 bankruptcy trustees throughout the country, and to promote the effectiveness of the bankruptcy system as a whole.[1] NABT is a premier national professional association of bankruptcy trustees. Of the approximately 1,100 bankruptcy trustees currently receiving new cases, 835 are NABT members. As a result, NABT is intimately familiar with the application of the Bankruptcy Code in the practical context of administration of trustee cases. NABT is also active in shaping legislation and has a strong interest in ensuring proper interpretation of the Bankruptcy Code[2] as it affects trustees.

The issue presented in this appeal is of critical importance to NABT and its trustee members. The Court's decision in this case will affect the ability of trustees to effectively and expeditiously administer

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[1] All parties have consented to the filing of this *amicus* brief. No counsel for a party authored this brief in whole or in part, and no such counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amicus curiae* has made a monetary contribution intended to fund its preparation or submission.

[2] United States Bankruptcy Code, 11 U.S.C. § 101 *et seq*. (hereinafter "Bankruptcy Code" or "Code"). Unless otherwise noted, all statutory citations in text are to provisions of the Code. Likewise, any references to "Rules" or "Bankruptcy Rules" are references to the Federal Rules of Bankruptcy Procedure.

chapter 7 cases in accordance with their statutory and fiduciary mandates. Trustees are duty-bound to investigate the financial affairs of the debtor, collect and reduce to money the property of the estate, and distribute such proceeds to creditors according to the Code's distribution scheme. When debtors fraudulently conceal or undervalue assets, and thwart the trustee's efforts in the chapter 7 liquidation process, they should not be entitled to retain all of their exempt property while the estate's creditors suffer the full financial consequences of the debtor's abuse.

In the exercise of trustee duties, the "surcharge" or "forfeiture" remedy is needed to sanction atypical debtors who commit fraud and abuse while seeking the privileges and protections of bankruptcy. In this case, the magnitude of the debtor's misconduct constitutes extraordinary circumstances warranting surcharge of exempt property. The debtor committed fraud on the court and deployed highly abusive litigation tactics which caused the trustee and the estate to incur over $400,000 in unnecessary litigation costs, significantly delaying the trustee's administration of the case and diminishing estate assets. Debtors must be held accountable for such extraordinary circumstances of fraud and abuse of the bankruptcy system.

SUMMARY OF ARGUMENT

The Bankruptcy Code provides for the appointment of a trustee in chapter 7 cases to administer

estate property. 11 U.S.C. §§ 701, 704. Chapter 7 trustees are charged with numerous statutory and other duties intended to promote the efficient administration of bankruptcy cases and to preserve the integrity of the bankruptcy system. Among other things, chapter 7 trustees are charged with investigating the financial affairs of the debtor, investigating fraud and misconduct, collecting and reducing to money property of the estate, making distributions to creditors, and closing the estate as expeditiously as is compatible with the best interests of parties in interest. 11 U.S.C. § 704.

In order for the statutory scheme to properly function, the Code requires full and accurate disclosures by debtors. Under § 521(a)(1), a debtor is obligated to file verified schedules of assets and liabilities, schedules of income and expenses, and a statement of financial affairs. 11 U.S.C. § 521(a)(1). Good faith disclosure is essential to the administration of chapter 7 cases, and is vital to maintaining the integrity of the bankruptcy system. Debtors are required, by statute, to cooperate with trustees in order to enable them to efficiently execute their duties under the Code. 11 U.S.C. § 521(a)(3).

In an asset case, once a debtor has disclosed all of his assets and liabilities and has cooperated with the trustee so that the trustee can reduce to money property of the estate, the Code provides for the division and distribution of such funds according to a carefully designed statutory scheme. *See* 11 U.S.C. §§ 507, 726. This scheme implements a balanced and

equitable allocation of property between the debtor and his creditors. *See id*. In exchange for performing these statutory duties and good faith obligations under the Code, the debtor receives a discharge of debts and is entitled to exempt and thereby retain certain interests in property. *See* 11 U.S.C. §§ 522, 727. Only through this mandated submission to the bankruptcy process does the "honest but unfortunate debtor" obtain a "fresh start" – one of the primary aims of bankruptcy. *See Grogan v. Garner*, 498 U.S. 279, 286, 287 (1991). Thus, fresh start policy is premised on the debtor's truthful disclosures and cooperation with the trustee in the bankruptcy process.

The overwhelming majority of chapter 7 debtors provide candid and complete disclosures and cooperate in the liquidation process. Occasionally, however, debtors abuse the system by omitting or undervaluing assets in their disclosures in an attempt to keep this value hidden from the court, the trustee and creditors. Other times, debtors present false claims in an effort to manipulate the bankruptcy process and hinder the trustee's administration of estate assets.

In this case, the debtor's abuse of the bankruptcy process was so extensive and pervasive that it presented truly exceptional circumstances, compelling the bankruptcy court to fashion appropriate equitable relief. Specifically, the debtor misrepresented value and concocted false lien claims in an effort to mislead the trustee and creditors and conceal the true value of property of the estate. The debtor lied to the bankruptcy court about the nature and content of public

records and case filings in support of his false claims. As part of this fraudulent scheme, the debtor foisted needless, baseless, exhaustive, and expensive litigation and appeals on the trustee in an endless effort to exert financial pressure on the estate and prevent the trustee from fulfilling his duties under the Code.

Where exceptional circumstances like this exist, bankruptcy courts must be authorized to enter orders providing for the surcharge or limited forfeiture of certain rights by debtors.[3] This power is consistent with the scope of authority granted by § 105(a) and the inherent power of federal courts to remedy abuse. Thus, the rare debtor who abuses the bankruptcy process forfeits his ability to benefit from rights that are available to the "honest but unfortunate debtors" bankruptcy laws are designed to protect. *See Local Loan Co. v. Hunt*, 292 U.S. 234, 244-45 (1934). This authority, appropriately circumscribed, is likewise consistent with this Court's opinions, including *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007), and *Chambers v. NASCO, Inc.*, 501 U.S. 32 (1991).

[3] The trustee notes in his merits brief at p. 2, n. 1, that the "surcharge" nomenclature is an awkward fit in that the remedy imposed in surcharge cases does not impose charges or levies against the debtor or his property. The remedy imposed is more in the nature of an equitable forfeiture, but the vast majority of courts speak in terms of surcharge, and the terms are used interchangeably herein.

ARGUMENT

I. The Bankruptcy Code's Statutory Framework

A. The Estate and the Trustee

The Code provides for the appointment of a trustee in chapter 7 cases to administer estate property. 11 U.S.C. §§ 701, 704. Chapter 7 trustees are charged with a broad array of statutory and other duties intended to promote the efficient administration of bankruptcy cases, and to preserve the integrity of the bankruptcy system. *See generally*, Vol. 6, ALAN N. RESNICK AND HENRY J. SOMMER, COLLIER ON BANKRUPTCY ¶ 704.01 (16th ed. 2013) (hereinafter "COLLIER ON BANKRUPTCY"); *see also* U.S. Department of Justice, Executive Office for United States Trustees, Handbook for Chapter 7 Trustees (Effective October 1, 2012) (the "TRUSTEE HANDBOOK"), available at http://www.justice.gov/ust/eo/private_trustee/library/chapter07/ (last visited October 25, 2013), at pp. 1-2.

Chapter 7 trustees are charged with investigating the financial affairs of the debtor. 11 U.S.C. § 704(a)(4); 6 COLLIER ON BANKRUPTCY ¶ 704.07. Chapter 7 trustees must "undertake an immediate examination and investigation of the debtor's liabilities and property. . . . [to] ensure that the court and the parties to the case are supplied with the facts essential to proper administration of the debtor's estate." 6 COLLIER ON BANKRUPTCY ¶ 704.07. A chapter 7 trustee's investigation includes questioning the debtor under oath at the meeting of creditors to verify information

and investigate the scope and value of assets, claims of creditors, liens against property, and other matters impacting the bankruptcy estate. *See* 11 U.S.C. § 341; 6 COLLIER ON BANKRUPTCY ¶ 704.07; TRUSTEE HANDBOOK, pp. 3-7, pp. 4-2. In this gatekeeping capacity, chapter 7 trustees are duty-bound to investigate fraud, misconduct, fraudulent transfers, and the validity of claims. *See id.*

Chapter 7 trustees are also charged with collecting and reducing to money property of the estate, and making distributions to creditors. 11 U.S.C. § 704(a)(1); 4 COLLIER ON BANKRUPTCY ¶ 521.15[1] (discussing trustee's duties in relation to debtor's duty to cooperate); 6 COLLIER ON BANKRUPTCY ¶ 704.02. Indeed, the TRUSTEE HANDBOOK calls this the "principal duty of the trustee." TRUSTEE HANDBOOK, p. 4-1. The statutory directive in § 704(a)(1) "gives the trustee the authority to exercise wide-ranging authority over the debtor's assets[.]" 6 COLLIER ON BANKRUPTCY ¶ 704.02; *see* TRUSTEE HANDBOOK, p. 4-6 (noting obligation to obtain control over estate property), p. 4-11 (discussing turnover demands). In order to implement this obligation, trustees may demand turnover of estate assets, and debtors are obligated to cooperate. 11 U.S.C. §§ 521(a)(3), 542.

In assessing whether to take control of and liquidate property of the estate, a chapter 7 trustee must assess the value of assets, claims of exemptions, and whether the property is encumbered by liens, in order to determine whether there is sufficient value to warrant liquidation. *See* 6 COLLIER ON BANKRUPTCY

¶ 704.02[1]; TRUSTEE HANDBOOK, p. 4-1 (trustee must administer cases so as to "maximize and expedite dividends to creditors."). In doing so, the trustee must review the debtor's sworn schedules and statements, examine the debtor under oath, and conduct an independent investigation to determine whether sufficient value exists such that assets should be administered. 11 U.S.C. § 704; TRUSTEE HANDBOOK, pp. 4-3 – 4-4 (noting obligation of chapter 7 trustee to inventory debtor's property), p. 4-5 (noting obligation of chapter 7 trustee to analyze, *inter alia*: (i) fair market value, (ii) the amount, validity and perfection of purported security interests, and (iii) the costs to be borne by the estate in recovering property), pp. 4-14 – 4-15 (same).[4]

Finally, chapter 7 trustees are charged with closing the estate "as expeditiously as is compatible with the best interests of parties in interest." 11 U.S.C. §§ 704(a)(1), (4); *see* 6 COLLIER ON BANKRUPTCY ¶ 704.02[3] (describing this duty as "the main object

[4] Chapter 7 trustees must also: (i) object to a debtor's discharge where appropriate, (ii) provide information to creditors, the court, and the United States Trustee, (iii) prepare and file periodic and final reports, (iv) provide notices in cases involving claims arising out of domestic relationships, (v) review a debtor's claim of exemptions, (vi) refer cases of bad faith, abuse, and bankruptcy crimes to the United States Trustee, (vii) review the timeliness and sufficiency of documents filed by the debtor and assess whether abuse is present that may provide a basis for dismissal under 11 U.S.C. § 707(b), and (viii) examine proofs of claim. *See generally* 11 U.S.C. § 704; 6 COLLIER ON BANKRUPTCY ¶ 704; TRUSTEE HANDBOOK, pp. 4-1 – 4-36.

and purpose of the [trustee's] appointment"). In undertaking this duty, and others outlined above, trustees often: (i) collect accounts, (ii) institute legal actions, (iii) seek orders compelling debtors or third parties to turn over estate property, (iv) sell property of the estate, (v) deal with contracts to which the estate is a party, (vi) challenge fraudulent and preferential transfers, and (vii) compromise and resolve claims. *See* 6 COLLIER ON BANKRUPTCY ¶ 704.02[3]; TRUSTEE HANDBOOK, pp. 4-1 – 4-2, pp. 4-12.

B. Debtor's Sworn Disclosures and Cooperation with the Trustee

In order for the statutory scheme to work in chapter 7 cases, debtors must provide full and accurate disclosures in their sworn schedules and statements. Under § 521(a)(1) of the Code, the debtor is obligated to file verified schedules of assets and liabilities, schedules of income and expenses, and a statement of financial affairs. 11 U.S.C. § 521(a)(1); FED. R. BANKR. P. 1008.[5] The debtor's duties also include cooperation with the trustee to enable the trustee to perform the trustee's duties under the Code. 11 U.S.C. § 521(a)(3).

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[5] Rule 1008, which references 28 U.S.C. § 1746, requires all debtors to verify under oath or subscribe under pains and penalties of perjury to the truthfulness of "all petitions, lists, schedules, statements and amendments" filed in their bankruptcy cases.

A chapter 7 trustee's ability to properly administer a case in an efficient and cost-effective manner is dependent upon a debtor's cooperation and candid disclosures. TRUSTEE HANDBOOK, p. 4-3; 4 COLLIER ON BANKRUPTCY ¶ 521.15[5] ("'Cooperate' is a broad term. . . . whenever the trustee calls upon the debtor for assistance in the performance of his duties, the debtor is required to respond. . . ."); 6 COLLIER ON BANKRUPTCY ¶ 704.08[1] (noting duty to cooperate in connection with discussion of trustee's duties). Indeed, fresh start policy is premised on the debtor's truthful disclosures and cooperation in the bankruptcy process. *See In re Rolland*, 317 B.R. 402, 413-14 (Bankr. C.D. Cal. 2004); *In re Robinson*, 292 B.R. 599, 607-08 (Bankr. S.D. Ohio 2003); *In re Colvin*, 288 B.R. 477, 479-81 (Bankr. E.D. Mich. 2003); *Job v. Calder (In re Calder)*, 93 B.R. 734, 738 (Bankr. D. Utah 1988), *aff'd*, 907 F.2d 953 (10th Cir. 1990) (citing *Chalik v. Moorland (In re Chalik)*, 748 F.2d 616, 618 (11th Cir. 1984)).

Thus, a debtor's good faith reporting and cooperation are essential to administration of chapter 7 cases. Moreover, enforcement of these debtor mandates is vital to maintaining the integrity of the entire bankruptcy system. *In re Rolland*, 317 B.R. at 413; *Cusano v. Klein*, 264 F.3d 936, 946 (9th Cir. 2001).

C. Division of Estate Property, Exemptions, and Discharge

Once the debtor has disclosed all assets, and cooperated with the trustee so that the trustee can reduce to money all property of the estate, the Code provides for the balanced and equitable allocation and distribution of property between the debtor and his creditors. *See* 11 U.S.C. §§ 507, 522, 726. After the debtor's exemptions are properly claimed and allowed, non-exempt assets are distributed to creditors according to a predetermined distribution scheme. *See id.* In furtherance of fresh start policy, the honest debtor who cooperates and complies with the foregoing statutory requirements receives a discharge of debts, and is also entitled to exempt certain interests in property. *See* 11 U.S.C. §§ 522, 727.

II. Bankruptcy Courts May Order Surcharge or Forfeiture of Exempt Property to Remedy a Debtor's Abusive Conduct

When debtors conspire to retain more assets or value than they are entitled to by failing or refusing to comply with the disclosure, cooperation, and turnover requirements of §§ 521, 542 and 704, the Code's distribution scheme goes awry. Sidestepping the foregoing provisions, the dishonest debtor may not then turn to § 522 as a shield to the consequences of his own abuse.

Here, the debtor concealed the true value of property of the estate by concocting a false lien claim

and substantially misrepresenting its value, and then fought turnover of this estate asset to the trustee for its ultimate sale. Without the diligence of the trustee and the bankruptcy court's forfeiture order, the debtor would have retained substantially more asset value than permitted by the Code's exemption scheme and would have foisted upon the estate the full extent of the exorbitant costs to the estate of his abusive conduct.

A. The Bankruptcy Code Must be Construed to Benefit Honest But Unfortunate Debtors and to Discourage Abuse

A fundamental purpose of the Code is to provide the "honest but unfortunate debtor" with a "fresh start." *See Grogan v. Garner*, 498 U.S. 279, 286, 287 (1991). As the Court articulated in *Local Loan Co. v. Hunt*, bankruptcy protection is designed to provide:

> . . . . *the honest but unfortunate debtor* who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt. The various provisions of the Bankruptcy Act were adopted in the light of that view and are to be construed when reasonably possible in harmony with it so as to effect the general purpose and policy of the act.

292 U.S. 244-45 (emphasis supplied) (internal citations and quotations omitted).

These same principles were articulated in *Pepper v. Litton*, 308 U.S. 295 (1939). *Pepper* involved the prepetition manipulation of claims and bogus liens by Litton, who "had no intention of trying to satisfy his confessed judgment" and was using the judgment lien "as a shield against the Pepper debt." 308 U.S. at 297 (internal quotations omitted). The trustee in bankruptcy later challenged the judgment lien and debt, contending that it was part of a "deliberate and carefully planned attempt to avoid the payment of a just debt[,]" that Litton and the judgment lien creditor "were in reality the same[,]" and that the alleged underlying claims giving rise to the bogus judgment "did not represent an honest debt of the bankrupt corporation." *Id*. at 301 (internal quotations omitted).

The *Pepper* court recognized the powers and duties of the trustee and the equitable nature of bankruptcy proceedings. *Id.* The Court observed that "for many purposes, 'courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity[.]'" *Id.* at 304 (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934)). Considering the exercise of trustee duties and powers in seeking the bankruptcy court's equitable intervention, the Court stated:

> The bankruptcy courts have exercised these equitable powers in passing on a wide range of problems arising out of the administration of bankrupt estates. They have been invoked to the end that fraud will not prevail, that substance will not give way to form, that

> technical considerations will not prevent substantial justice from being done.

Id. at 304. The Court further instructed that bankruptcy courts have "the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." *Id.* at 308.

1. This Court's Decision in *Marrama* Supports Equitable Surcharge or Forfeiture to Prevent Abuse

These fundamental principles of bankruptcy law articulated in *Local Loan Co.* and *Pepper* provide the foundation for this Court's decision eight decades later in *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007). *Marrama* held that, as here, a debtor found guilty of serious misconduct will forfeit an otherwise absolute statutory right under the Bankruptcy Code in order to prevent injustice and unfairness, and to uphold the integrity of the bankruptcy process. *Id.*

In *Marrama*, the bankruptcy court determined that the debtor made a number of "misleading or inaccurate" statements of fact about his residence. *Id*. at 368. The debtor misrepresented the value of this property, and made further misrepresentations about pre-bankruptcy transfers of the property. *Id*. Similar to this case, and contrary to the debtor's sworn disclosures, the property at issue "had substantial value" to the estate. *Id*.

The issue in *Marrama* was whether the debtor had an "absolute" right to convert his chapter 7 case to a case under chapter 13, despite his fraudulent conduct. The debtor argued that § 706(a) must be read to grant debtors an "absolute" or unqualified right to convert. *See* 11 U.S.C. § 706(a). The Court disagreed, observing that the debtor was "not a member of the class of honest but unfortunate debtors that the bankruptcy laws were designed to protect." *Id*. at 373 (internal quotations omitted) (citing *Grogan v. Garner*, 498 U.S. 279 (1991)). Underscoring that the debtor's conduct was "atypical," *id*. at 375, n. 11, the *Marrama* court opined:

> The class of honest but unfortunate debtors who *do* possess an absolute right to convert their cases from Chapter 7 to Chapter 13 includes the vast majority of the hundreds of thousands of individuals who file Chapter 7 petitions each year. Congress sought to give *these* individuals the chance to repay their debts should they acquire the means to do so
>
> . . . .
>
> Nothing in the text of either § 706 or § 1307(c) (or the legislative history of either provision) limits the authority of the court to take appropriate action in response to fraudulent conduct by the atypical litigant who has demonstrated that he *is not entitled to the relief available to the typical debtor*.

Id. at 374-75 (emphasis supplied). The Court also recognized the bankruptcy court's authority under

§ 105(a), and the "inherent power of every federal court to sanction 'abusive litigation practices,'" as consistent with its determination that the debtor had forfeited his right to convert his case from one chapter to another. *See id*. at 375-76.

These principles of bankruptcy law are fully consistent with the Court's decision in *Chambers v. NASCO, Inc*., 501 U.S. 32 (1991), which was cited in *Marrama* (along with § 105(a) of the Code). *See Marrama*, 549 U.S. at 375-76 (discussing the "inherent power of every federal court to sanction 'abusive litigation practices'") (citing *Roadway Express, Inc. v. Piper*, 447 U.S. 752, 765 (1980)); *Chambers*, 501 U.S. at 45-46 (discussing the inherent power of federal courts to sanction litigation abuse). Indeed, in *Chambers*, the Court stated:

> We discern no basis for holding that the sanctioning scheme of the statute and the rules displaces the inherent power to impose sanctions for the bad-faith conduct described above. These other mechanisms, taken alone or together, are not substitutes for the inherent power, for that power is both broader and narrower than other means of imposing sanctions.

Chambers, 501 U.S. at 45-46.

The *Marrama* decision thus embodies the fundamental principle that bankruptcy courts have meaningful authority to sanction a debtor's bad-faith

litigation abuse, and can order the forfeiture of otherwise available bankruptcy relief in furtherance thereof.

B. Surcharge is a Valid Remedy Pursuant to the Scope of Authority Granted to Bankruptcy Courts Through § 105(a) of the Bankruptcy Code

Section 105(a) of the Code grants bankruptcy courts broad powers, consistent with the fundamental nature of bankruptcy courts as courts of equity. Section 105(a), entitled "Power of court," provides:

> (a) 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.

11 U.S.C. § 105(a).

Section 105(a) represents an expansion of the power granted to bankruptcy courts as compared with its predecessor statute, section 2a(15) of the Bankruptcy Act. Whereas section 2a(15) allowed courts to "make such orders, issue such process, and

enter such judgments in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this Act," the Code broadened bankruptcy courts' powers through § 105(a), which allows not only orders that are "necessary," but also orders that are "appropriate" to carry out the provisions of the Code. *See* 2 COLLIER ON BANKRUPTCY ¶ 105.LH (discussing historical development of statute and similarity of § 105(a) to the All Writs Statute).

Where a debtor acts dishonestly and frustrates the Code's purposes, § 105(a) grants bankruptcy courts meaningful equitable power to prevent the debtor from profiting from his misdeeds while benefiting from the Code's protections. These powers, implemented through the statute, are consistent with the guiding principles in *Local Loan Co.*, *Pepper*, *Grogan*, *Marrama,* and *Chambers*, discussed above.

In practice, § 105(a) has been used with success to stem abuse and restore to the estate the value of non-exempt property wrongfully retained by the debtor. In cases where non-exempt assets are dissipated or concealed, and debtors otherwise engage in egregious misconduct seeking to withhold property of the estate from the trustee, courts have turned to § 105(a) and the court's inherent equitable powers to fashion effective remedies. *See*, *e.g.*, *Malley v. Agin*, 693 F.3d 28 (1st Cir. 2012); *Latman v. Burdette*, 366 F. 3d 774 (9th Cir. 2004); *In re Onubah*, 375 B.R. 549 (9th Cir. BAP 2007); *In re Nolan*, Case No. 09-31456, 2013 WL 3153849 (Bankr. W.D. N.C. June 19, 2013);

In re Spiers, Case No. 11-32345, 2013 WL 319785 (Bankr. W.D. N.C. Jan. 28, 2013); *In re Price*, 384 B.R. 407 (Bankr. E.D. Va. 2008); *In re Koss*, 319 B.R. 317 (Bankr. D. Mass. 2005); *In re Karl*, 313 B.R. 827 (Bankr. W.D. Mo. 2004). *See also Scrivner v. Mashburn (In re Scrivner)*, 370 B.R. 346 (10th Cir. BAP 2007), *rev'd*, *In re Scrivner*, 535 F.3d 1258 (2008), *cert. denied*, *Mashburn v. Scrivner*, 556 U.S. 1126 (2009).

The First Circuit's recent decision in *Malley v. Agin* is consistent with the principles outlined above and with the historical development of the statute, and exemplifies an appropriate use of § 105(a) to stem fraud and abuse through surcharge. *See* 693 F.3d 28 (1st Cir. 2012). In *Malley*, the debtor misrepresented a prepetition sale involving his residence. *Id*. at 28. The debtor "repeatedly declared and swore under oath" that his wife obtained the entire sale proceeds and that he received nothing. *Id*. In reality, however, the debtor received $25,000 in proceeds, which he dissipated by the time the trustee discovered the debtor's fraud. *Id.* at 29. The First Circuit observed that "[the debtor's] willful concealment of the funds . . . was, of course, a violation of his disclosure obligation under 11 U.S.C. § 521, compounded by continuing misrepresentation, all of which amounted to a fraud on the court, the trustee, and the general creditors." *Id*.

Responding to the debtor's argument that exemptions in bankruptcy are inviolate, the First Circuit disagreed:

> Should [the debtor's] interest in [the residence] be recognized as "exempted under this section" when its exemption would consummate a fraud on creditors by giving the debtor a greater exemption in fact than the code entitles him to claim in law? We naturally suppose that Congress intended bankruptcy courts to be able to enforce the "provisions" requiring honest disclosure on the part of the debtor, *see* § 521, and placing limits on exemption claims, *see* § 522.

Id.

Next, the First Circuit addressed the debtor's contention that § 105(a) relief was strictly limited and improperly pursued by the trustee. The court repudiated the debtor's narrow interpretation, astutely analyzing the statutory construct of § 105(a):

> To start with, the limitation to carrying out "provisions" must be read within the entire section in which it occurs, which in its second sentence authorizes the court *sua sponte* to take "any action necessary or appropriate . . . to prevent an abuse of process." We have been given no reason to think that Congress would have intended the spaciousness of this authority to be confined only to *sua sponte* action as distinct from rulings at a trustee's behest, and it makes sense to read the second sentence's authority to prevent abuse of process as an example of what the first sentence speaks of as action "necessary or appropriate to carry out the provisions by this title."

Id. at 30.

Thus, determining that the bankruptcy court could act at the trustee's behest, the First Circuit applied its construction of § 105(a) to the abuse at hand:

> There could not be a clearer example of foiling abuse of process than a surcharge order mitigating the effect of fraud in retaining non-exempt assets and thus enhancing the set-aside for a fresh start beyond the amount Congress provided for the honest debtor. Nor can one easily imagine an order more necessary, for although the enumerated remedies of dismissal or denial of discharge penalize the dishonest debtor, they add nothing to the pot for listed creditors, who would otherwise bear the brunt of the fraud.

Id.

In this case, the matter to be vindicated was intentional undervaluation, the bogus lien claim and the need for the trustee to prosecute and invalidate the lien so that non-exempt value could be liquidated to fund a distribution to creditors. In pursuing this corrective action for the benefit of the estate, the trustee's efforts were met with bad faith litigation tactics and the debtor's refusal to cooperate and turn over estate property for sale. In light of the debtor's fraud and litigation abuses, the courts below properly determined that exceptional circumstances existed and the bankruptcy court rightfully invoked the surcharge remedy to place at least some of the economic burden of the debtor's abuse where it belonged – on the debtor. *See* JA52a ("The BAP properly

affirmed the bankruptcy court's order granting the trustee's surcharge motion because the surcharge was calculated to compensate the estate for the actual monetary costs imposed by the debtor's misconduct, and was warranted to protect the integrity of the bankruptcy process."); JA74a-75a ("[B]ankruptcy court did not abuse its discretion in deciding to impose an equitable surcharge on Debtor's homestead exemption."); JA93a (noting costs).

C. Surcharge Orders to Remedy Fraud are Thoroughly Grounded in the Provisions of the Code

When invoking § 105(a), courts must remain within the confines of the Bankruptcy Code. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988). Application of § 105(a) must be consistent with the Code's other provisions and the substantive rights granted by the Code. *In re Nosek*, 544 F.3d 34, 44 (1st Cir. 2008). Nonetheless, § 105(a) confers "broad authority" on bankruptcy courts, thus enabling them to "facilitate the implementation of other Bankruptcy Code provisions." *Cuevas-Segarra v. Contreras*, 134 F.3d 458, 459-60 (1st Cir. 1998) (quoting *Noonan v. Sec'y of Health & Human Servs. (In re Ludlow Hosp. Soc., Inc.)*, 124 F.3d 22, 27 (1st Cir. 1997)); *see also In re Hannigan*, 409 F.3d 480, 481 (1st Cir. 2005).

With this interpretive framework in mind, the *Malley* court concluded its analysis by tying invocation of § 105(a) to enforcement of §§ 521 and 522 of the Code:

> Finally, it should be recalled, this line of reasoning does not enlarge the court's authority beyond "carry[ing] out the provisions" of the code. When the concealed assets have disappeared, as the $25,000 seems to have done, surcharge is an appropriate and necessary way to vindicate § 521, requiring honest disclosure of non-exempt assets, and § 522, regulating the determination of legitimate exemptions for the debtor's benefit. If § 105(a) was not meant to empower a court to issue an order like the one before us, it is hard to see what use Congress had in mind for it.

Malley, 693 F.3d at 30.

As in *Malley*, in this case the bankruptcy court's exercise of equitable power was consistent with § 105(a)'s mandate, inasmuch as the surcharge order was necessary and appropriate to vindicate the Code's provisions regarding a debtor's duty of honest disclosure and regulation of legitimate exemption rights under §§ 521 and 522 of the Code.

Moreover, surcharge orders under § 105(a) are thoroughly grounded in the implementation of various other Code provisions, including §§ 507, 541, 542, 704, and 726. These provisions, together with §§ 521 and 522, implement the most fundamental purposes of the Code, and § 105(a), as well as the court's inherent equitable powers, provides the authority for bankruptcy courts to ensure that they are adhered to and enforced.

1. Surcharge Enforces the Debtor's Obligation to Make Truthful Disclosures and Turnover Property of the Estate

When a debtor is dishonest in his disclosures in an effort to hide and retain for his own benefit property of the estate, and then refuses to turnover such property to the trustee, he defies the directives of §§ 521, 541, 542 and 704 – which together establish the debtor's duty to make accurate disclosures, cooperate with the trustee, and turnover property of the estate. Surcharge is an effective way to remedy these failures.

The Code's other remedies, such as denial of discharge, do not provide effective redress: while denial of the debtor's discharge punishes the debtor, surcharge orders are often necessary to replenish the value of the stolen or concealed property to the estate. *See Malley*, 693 F.3d at 30 ("[A]lthough the enumerated remedies of dismissal or denial of discharge penalize the dishonest debtor, they add nothing to the pot for listed creditors, who would otherwise bear the brunt of the fraud."). Likewise, turnover orders, alone, are often an insufficient remedy. As was observed by the Ninth Circuit in *Latman*, a turnover order "would not be effective if the assets withheld from the trustee were subsequently lost or otherwise converted by the debtor for personal benefit." 366 F.3d at 785 n. 8.

2. Surcharge Implements the Code's Division of Exempt and Non-Exempt Assets and Equitable Distribution Scheme

Surcharge implements the Code's equitable division of property, as set forth in §§ 507, 522, and 726. The Code divides property between debtor and creditors according to the Code's overarching policies: a fresh start for the debtor and equitable distribution among his creditors. Section 522 allows the debtor to retain certain interests in property that Congress has determined are necessary for the debtor's fresh start. Sections 507 and 726 then provide for the equitable distribution of any non-exempt property among the debtor's creditors, while affording priority treatment to certain classes of creditors, such as wage claimants, taxing authorities, and domestic support creditors. *See* 11 U.S.C. §§ 507, 704.

When a debtor conceals value in an effort to retain for himself more property than is permitted by § 522, and in doing so imposes substantial costs on the bankruptcy estate, the Code's carefully balanced distribution scheme is disrupted. Surcharging exempt assets to the extent necessary to offset costs incurred as a result of a debtor's bad faith litigation abuse is appropriate. Indeed, concealing and retaining non-exempt assets is "tantamount to claiming an additional and unauthorized exemption." *Latman*, 366 F.3d at 352; *see also In re Onubah*, 375 B.R. at 553 (surcharge is appropriate in "exceptional circumstances, [which] are present when a debtor engages

in inequitable conduct that, when left unchallenged, denies creditors access to property in excess of that which is properly exempted under the Bankruptcy Code").

The debtor's misconduct would thereby subvert the Code's directives that the debtor retain only a set amount of property to further his fresh start and that any non-exempt property be available to satisfy creditor claims. Thus, a surcharge order is a necessary and appropriate vehicle to implement the Code's carefully balanced division of assets and distribution scheme.

3. The Surcharge Remedy Plays an Important Role in Stemming Debtor Abuse

A survey of representative cases employing the surcharge remedy reveals the important role surcharge orders play in stemming debtor abuse and preserving the integrity of the bankruptcy system.

In *Latman v. Burdette*, the seminal case on surcharge, the Ninth Circuit Court of Appeals issued a surcharge order to stem contemptuous conduct by the debtor during the pendency of the bankruptcy case. 366 F.3d 774. Seeking to remedy a fraud on the bankruptcy court, the Ninth Circuit upheld surcharge of the debtors' wild card exemption to compensate the estate for the debtors' willful failure to account for undisclosed proceeds of non-exempt assets. *Id*. As the court stated, "the surcharge remedy protected the

[debtors'] creditors by preventing the [debtors] from sheltering more assets than permitted by 11 U.S.C. § 522." *Id*. at 785.

In *In re Koss*, the debtor argued that using § 105(a) to surcharge exempt assets overextends a bankruptcy court's equitable powers. 319 B.R. 317. Following the loss of property during the pendency of his chapter 11 case, the debtor received $1.4 million in insurance proceeds, including $440,000 attributable to an amount in excess of the value scheduled for this property. None of the debtor's chapter 11 operating reports disclosed receipt of these proceeds or where they went. *Id*. at 319.

The *Koss* court defined surcharge in context of a debtor who converts estate property as "recharacterizing the property converted as an advance on the amount that can be exempted." *Id*. at 323. The court observed that surcharge cases have a "common nexus: The debtors engaged in wrongful conduct that detrimentally impacted the bankruptcy estate, all while seeking the benefits and protections of the Bankruptcy Code." *Id*. at 322-23. The *Koss* debtor contended that he was entitled to his homestead exemption, and that § 522(c) precluded the trustee's action seeking surcharge of this exempt property. The bankruptcy court disagreed: "The Debtor would ascribe to Congress the intention to permit debtors who have converted nonexempt assets to exempt the rest. Not likely . . . the Debtor may not employ § 522 (c) as a shield." *Id*. at 323.

In *In re Price*, the debtors withheld from the trustee in excess of $400,000 in non-exempt assets. 384 B.R. 407, 411. In imposing its surcharge order, the bankruptcy court reasoned that surcharge for the estate's administrative fees was permitted to make up the shortfall caused by the debtors' concealment and conversion of non-exempt property. *Id.* The court allowed the trustee to set-off exempt funds that came into her possession so as to "preserve the integrity of the bankruptcy process, to make the estate whole, and to prevent the debtors from, in essence, receiving their [exemption] a second time." *Id.* at 410.

In *In re Spiers*, the bankruptcy court outlined the debtor's "rampant" bad faith conduct warranting surcharge, including: falsely attesting to prepetition sales of a vintage vehicle, a Harley motorcycle, and Panthers season tickets, claiming, in some instances, that he used the fictitious sale proceeds "to live on"; failing to disclose interests in bank accounts, business entities, guns, jewelry, and a receivable from his ex-wife that he procured post-petition and dissipated; and failing to provide the trustee with documentation needed to ascertain the existence and status of the foregoing assets and transfers. 2013 WL 319785 at *2-5. Citing *Latman* and *Malley*, the bankruptcy court surcharged the debtor's exemptions to the extent necessary to compensate the estate for $70,000 in fees and expenses incurred in combating the debtor's fraud. *Id.* at *7. The court reasoned that the debtor "must be held accountable financially to his creditors and the bankruptcy estate should be put in

[*sic*] back into the position it would have been had [the debtor] filed accurate and truthful schedules." *Id.*

Finally, in *In re Nolan*, the bankruptcy court addressed whether surcharge for the trustee's legal expenses incurred in combating the debtors' abuse was available in light of § 522(k)'s restriction on seeking administrative expenses from property a debtor exempts. 2013 WL 3153849 at *4. The court determined that § 522(k) could not be employed as a shield where "exceptional circumstances may justify charging exempt property with the cost to the estate of a debtor's wrongful post-petition conduct in order to protect the integrity of the bankruptcy process." *Id.* The court observed that "as a matter of statutory construction, expenses are not 'necessary' within the meaning of § 503(b)(1)(A) when they would not have been incurred if the debtors has cooperated with the trustee and, therefore are not prevented from being charged against exempt property by § 522(k)." *Id.* (citing *In re Swanson*, 207 B.R. 76, 81 (Bankr. D. N.J. 1997)).

As these cases demonstrate, trustees have been pursuing and bankruptcy courts utilizing surcharge orders in those exceptional circumstances where debtors engage in egregious misconduct while seeking the privileges and protections of bankruptcy. The principles of law embodied in the Code do not permit a debtor to force upon a trustee the type of abusive litigation conduct deployed by the debtor in this case, without consequence. The bankruptcy court ordered the debtor's homestead exemption forfeited in

order to partially offset the litigation costs incurred by the estate in combating the debtor's fraud on the court, the trustee, and creditors. The relief implemented was narrowly circumscribed, and necessary and appropriate to stem the debtor's abuse and preserve the integrity of the bankruptcy system.

CONCLUSION

Based on the foregoing, NABT, as *amicus curiae*, respectfully requests that the Court affirm the decision of the Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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