Business Law Section

Insolvency Law Committee

June 12, 2018

Dear constituency list members of the Insolvency Law Committee, the following is a case update analyzing a recent case of interest, *In re Lee*, 889 F. 3d 639 (9th Cir. 2018):

SUMMARY

The U.S. Court of Appeals for the Ninth Circuit held that a chapter 7 trustee's complaint to avoid a debtor's fraudulent transfers of real property to the debtor and his wife as tenants by the entirety met the procedural requirements of an objection to the debtor's claims of exemption in those properties under Federal Rule of Bankruptcy Procedure ("FRBP") 4003(b).

FACTS

In 2010, the debtor transferred a majority of his interests in two Hawaiian properties, Palua Place #1 and Palua Place #2, to himself and his spouse in a tenancy by the entirety ("TBE"). Under Hawaiian law, tenancy by the entirety is a form of ownership in which both spouses are jointly seized of property such that neither spouse alone can convey an interest in the property, nor can the creditors of only one spouse reach either spouses' interest in the property.

On August 12, 2013 (almost three years after the transfers) the debtor filed a chapter 7 bankruptcy petition. In his Schedule A, he included his tenancy by the entirety interests in the Palua Place properties. He elected to claim state law exemptions under 11 U.S.C. § 522(b)(3) and utilized Hawaii law to exempt his tenancy by the entirety interest in the Palua Place properties (the "TBE Exemption"). At the meeting of creditors, debtor testified that the prepetition transfers were for "exemption planning" purposes resulting from his meeting with his attorney in 2010 to discuss a possible bankruptcy. Debtor further testified that he did not receive any consideration from his spouse for the interests she received by virtue of the transfers.

Within thirty days after conclusion of the meeting of creditors, the trustee filed a complaint against the debtor and his spouse seeking to set aside the transfers of the Palua Place properties ("Fraudulent Transfer Action"). The Fraudulent Transfer Action did not contain an explicit objection to the debtor's claimed exemptions in Schedule C, nor did the complaint rely upon 11 U.S.C. § 522(b)(3) as grounds for relief.

After a three-day trial in the Fraudulent Transfer Action, the bankruptcy court found that the trustee had "proved, by clear and convincing evidence, that [debtor] transferred his interest in the Palua Place properties to himself and his wife with the actual intent to hinder, delay or defraud existing or future creditors." Accordingly, the bankruptcy court issued a final judgment avoiding the transfers, but did not expressly deny the TBE Exemption. Debtor appealed to the district court, which affirmed the judgment. Debtor further appealed to the Ninth Circuit, but that appeal was dismissed based on debtor's failure to prosecute.

While the debtor's appeal of the judgment in the Fraudulent Transfer Action was pending, the trustee moved the bankruptcy court for an order requiring debtor to turnover the Palua Place properties on the grounds that the debtor had been interfering with the trustee's efforts to liquidate the properties. In his opposition thereto, debtor disputed his obligation to turn over the Palua Place properties because the trustee did not object to the TBE Exemption within 30 days of the conclusion of the meeting of creditors, as required by FRBP 4003(b)(1).

The bankruptcy court granted the trustee's turnover motion on the grounds that that the Fraudulent Transfer Action satisfied the procedural requirements of FRBP 4003(b)(1). Debtor appealed that order to the district court, which affirmed. Debtor then timely appealed to the Ninth Circuit.

<u>REASONING</u>

While conceding that the Fraudulent Transfer Action was filed within 30 days after the conclusion of the meeting of creditors, debtor argued that it did not constitute an objection to the TBE Exemption for purposes of FRBP 4003(b)(1) because it did not expressly state that the trustee objected to the exemptions. The Ninth Circuit therefore considered whether the Fraudulent Transfer Action met the procedural requirements for objections to claims of exemptions set forth in FRBP 4003(b)(1).

After analyzing the Fraudulent Transfer Action, the Ninth Circuit concluded that it satisfied the purpose of FRBP 4003. The Ninth Circuit reasoned that, while FRBP 4003 "sets forth the procedure for objecting to claim of exemptions," FRBP 4003(b) does not prescribe any particular form for such an objection. The form just needs to satisfy the purpose of the objection, which is to provide the debtor with timely notice that a party objects to the claim of exemption. The Ninth Circuit held that the complaint in the Fraudulent Transfer Action provided debtor with more than adequate notice of the trustee's objections to the TBE Exemption because the Fraudulent Transfer Action and the debtor's claimed exemptions were "inextricably intertwined." The Ninth Circuit found that the debtor could only claim an exemption in the Palua Place properties because he conveyed them to himself and his spouse as tenants by the entirety. Therefore the trustee had no legal basis for objecting to the TBE Exemption unless he could avoid the underlying transfers. Thus, by pursuing the Fraudulent Transfer Action, the trustee had necessarily attacked the basis for the TBE Exemption. Proceeding with the Fraudulent Transfer Action would have been pointless otherwise because the debtor could retain his fraudulently transferred property interests by claiming them as exempt.

It was apparent to the Ninth Circuit that the sole function of the Fraudulent Transfer Action was to prevent the debtor from retaining the properties he claimed as exempt. Thus, the Ninth Circuit concluded that the Fraudulent Transfer Action provided the debtor with adequate notice that the trustee was objecting to his TBE Exemption. The Ninth Circuit did note, however, that it would have been "better practice" for the trustee to include an express objection to the TBE Exemption in the Fraudulent Transfer Action. The Ninth Circuit also ruled that the Fraudulent Transfer Action met the procedural requirements of FRBP 4003 in that it (1) was timely filed, (2) was served on the debtor and his attorney, (3) provided for a hearing after notice, and (4) required the trustee to prove his allegations (Under Hawaiian law, objections to exemptions must be proven "by clear and convincing evidence").

The Ninth Circuit rejected the debtor's arguments that (a) the exemption law should be construed liberally in favor of a debtor and, (b) pursuant to the Supreme Court's decisions in *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), and *Law v. Siegel*, 571 U.S. 415 (2014), that a trustee's failure to timely object to a claim of exemption prevents him or her from later challenging that objection. The Ninth Circuit distinguished both of those cases as inapplicable on the facts, finding that the trustees in those cases "took no action that could qualify as a Rule 4003(b) objection…" The Ninth Circuit also distinguished another case relied upon by debtor, *In re Canino*, 185 B.R. 584 (9th Cir. BAP 1995), because the trustee in that case had simply ignored a claim of exemption and attempted to liquidate the exempt property, arguing that his liquidation efforts constituted an "informal" or "de facto" objection to the claim of exemption. Here, the Ninth Circuit found that the trustee took affirmative steps with respect to the claims of objection: "the trustee did not simply disregard [debtor's] claimed exemptions and seek to take possession of [the Palua Place properties]. Instead, the trustee brought an adversary proceeding, expressly seeking to invalidate the basis for the exemptions and formally recover the interests for the bankruptcy estate."

AUTHOR'S COMMENTARY

From a debtor's perspective this author can understand disagreement with the opinion. However, judicial economy is an underpinning of this decision. Once the bankruptcy court avoided the transfer of the Palua Place properties to the tenancy by the entirety estate, there was nothing more to litigate with respect to the TBE Exemption. It would have been a waste of judicial resources and time and expense of the parties to require the trustee, after the conclusion of the Fraudulent Transfer Action, to then file an objection to the TBE Exemption.

Uncommon in the Western U.S. (Alaska, Hawaii, and Oregon are the only Ninth Circuit states with TBE), this situation creates a unique circumstance where the debtor held a legal interest in the Palua Place properties, but the trustee needed to avoid the prepetition transfer to the TBE "estate" to recover the properties for the bankruptcy estate. It is interesting that, had an unwary trustee missed the 30-day period of FRBP 4003 and treated this as an ordinary fraudulent transfer with a two-year limitations period of Section 546, this holding suggests that the trustee would have avoided the transfers only to have the recovered property exempted from the estate due to the failure to timely object to the TBE Exemption.

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Best regards,
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