

## **The Trustee's New Weapon**

**By  
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At times, bankruptcy trustees seem to wield almost super-human powers in their administration of bankruptcy estates. Clothed with a variety of special rights conferred by the Bankruptcy Code, they can dodge liens on estate property, recover otherwise lawful payments to creditors, undo transactions occurring years prior to bankruptcy, and ignore statutes of limitation. So what other powers could trustees need? Well, according to the Ninth Circuit, trustees apparently have yet another weapon in their arsenal to maximize distributions to creditors: the power to surcharge a debtor's exemptions.

The Latmans were debtors who, as it turned out, failed to account in their bankruptcy schedules for the proceeds of the sale of a boat and vehicle made shortly before they filed for Chapter 7 relief, or for the funds they held in an out-of-state bank account. As a sanction for their conduct, at the trustee's request, the bankruptcy court denied the Latmans a discharge. End of story? Not exactly.

The trustee realized denying the Latmans a bankruptcy discharge didn't get the creditors paid, and the debtors were unwilling to account for the missing money. So the trustee made an unusual request to the bankruptcy court: she asked the bankruptcy judge to allow her to recover the value of the undisclosed assets from the Latmans' exempt property, in this case, a car and an engagement ring. When the judge agreed with the trustee's novel request, the Latmans appealed.

The Ninth Circuit affirmed the bankruptcy court's decision to allow the trustee to "surcharge" the debtors' exempt property. *Latman v. Burdette*, 366 F.3d 774 (9th Cir. 2004). The court acknowledged that the Bankruptcy Code does not explicitly provide for such a remedy where the debtors have "under-reported" their assets. However, the court explained, a surcharge against exempt property under these facts should be seen as an appropriate equitable tool to prevent the debtors from, in effect, exceeding the value of assets that may be exempted under the Code. In other words, if the debtors were able to retain the previously undisclosed assets and the full amount of exempt property authorized by the statutes, the debtors would get more than the "fresh start" that Congress intended and their creditors would be prejudiced. In this case, the court concluded the surcharge was a necessary to prevent the debtors from enjoying the benefit of their fraudulent conduct.

The Ninth Circuit viewed a surcharge against the debtors' exempt property under the "exceptional circumstances" in *Latman* as "reasonably necessary both to protect the integrity of the bankruptcy process and to ensure that a debtor exempts an amount no greater than what is permitted by the exemption scheme of the Bankruptcy Code." 366 F.3d at 786. But could *Latman's* reasoning be extended or other common bankruptcy scenarios?

Consider this: Trustees frequently ask the bankruptcy court to deny a discharge to debtors who willfully fail to turn over tax refunds they receive that constitute property of the bankruptcy estate. But most trustees recognize that denial of discharge is but one of their concerns. Since a tax refund can amount to thousands of dollars, these trustees would also prefer to recover the refund for distribution to creditors, and so they frequently also seek a money judgment against the debtors. Keeping in mind that most of these debtors are probably “judgment proof” (they are “bankrupt”, after all), it surely must be a challenge for the trustee to collect many of these judgments. Ah, but don’t most all debtors have some amount of exempt property? Under Latman, a surcharge against exempt property could now give the trustee another avenue for recovering the refund amounts.

There are other situations where, arguably, the Latman decision may play out. Without suggesting they are doing so inappropriately, frequently debtors place relatively low values on their items of property in their bankruptcy schedules. Depending upon the true value of these assets, some debtors may perhaps be able to exempt more assets, or a greater share of a particular asset, by using this tactic. While this strategy may serve a debtor’s interests at the outset, if the trustee “gets wise” and later seeks to surcharge the debtor’s exempt property on the basis of the “erroneous” valuation, the strategy may backfire.

And how will the trustee decide which of the debtor’s exempt assets should be surcharged? While Grampa’s old fishing gear may be worth only a hundred dollars to a collector, it may be invaluable to the debtor (for whom it represents all those “good ‘ole days down by the creek.”) Recall, in Latman, the trustee went after the debtors’ engagement ring – pretty cagey, right? Surely, if these sorts of exempt property are targeted, the debtor may be very motivated to “settle up.” The point is, the trustee’s right to surcharge a debtor’s exempt property may generate some intriguing strategies by trustees for maximizing amounts available for creditors.

Of course, bankruptcy judges will play a role making sure “equity” is being done in any given case, so that neither debtors nor trustees act unfairly. But given the creativity and determination of most trustees, the implications of the Latman approach could be interesting, indeed.