Law v. Siegel: The End of Equitable Disallowance?

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The question of whether a bankruptcy court may "equitably disallow" a creditor's claim-that is, direct that a creditor shall receive no distribution out of a bankruptcy estate on account of an otherwise valid claim-has long divided the courts. Section 510(c) of the Bankruptcy Code grants the bankruptcy courts the authority to "equitably subordinate" a claim-in essence, provide that a creditor holding an otherwise valid claim, but who has engaged in wrongful conduct that has harmed the bankruptcy estate, will not be paid until other valid creditors are paid in full. But there is no express statutory provision providing for "equitable disallowance." If anything, the Bankruptcy Code says the opposite, providing that a court "shall allow" a creditor's claim unless one of a number of specified conditions-not including the creditor's inequitable conduct-are met. 11 U.S.C. § 502(b).[1] For this reason, courts have held, applying ordinary principles of statutory construction, that there is simply no such thing as "equitable disallowance" under the Bankruptcy Code.[2]

Other courts, however, have held that bankruptcy courts do have the authority to "equitably disallow" a claim.[3] Those courts have typically relied on language in the Supreme Court's decision in *Pepper v. Litton*, 308 U.S. 295 (1939), which, while using the terms "disallowance" and "subordination" interchangeably, at least suggested that the "disallowance" of a claim might be an appropriate exercise of the court's equitable authority. Because the equitable authority of the bankruptcy court is now codified in Section 105(a) of the Bankruptcy Code, these courts have generally looked to that provision as the statutory authority for the remedy of equitable disallowance.[4]

The Supreme Court decision earlier this week in *Law v. Siegel*, No. 12-5196 (U.S. Mar. 4, 2014), which concluded that Section 105(a) provides no authority to exercise a remedy that is not included in the Bankruptcy Code's enumeration of statutory remedies-and is therefore implicitly *excluded*-may well put an end to that debate.[5]

Law was an individual debtor chapter 7 case. The debtor claimed that his house, which he said was worth approximately $365,000, was subject to two liens, each of approximately $150,000, such that debt secured by the house came to approximately $300,000. In addition, Law was entitled to "exempt" from his estate up to $75,000 in value in his homestead. As a result, there appeared to be no non-exempt value in the debtor's home that would become part of the bankruptcy estate. One of the two liens, however, was entirely fictitious, an artifice of the debtor's intended to deceive the chapter 7 trustee into believing that there was no non-exempt value in the debtor's house.

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The chapter 7 trustee incurred more than $500,000 in legal fees in discovering and proving the debtor's fraud. The question the case presented is whether the $75,000 exemption could be "surcharged"-in effect, disallowed so that the estate could recover the funds-on account of the debtor's inequitable (indeed, overtly fraudulent) conduct.

The lower courts all held that the exemption was subject to this "surcharge," finding that Section 105(a) of the Bankruptcy Code supported that authority in exceptional circumstances where the debtor engages in "inequitable or fraudulent conduct." The Supreme Court unanimously reversed. In an opinion by Justice Scalia, the Court held that the Code itself sets forth the circumstances in which otherwise exempt property is available to the trustee to distribute to creditors, and that the "Code's meticulous . . . enumeration of exemptions and exceptions to those exemptions confirms that courts are not authorized to create additional exemptions." *Law v. Siegel*, slip op. at 9. Indeed, in the context of exemptions, the Code goes even farther (in language that is perhaps analogous to the command of Section 502(b) that a court shall allow a creditor's claim unless specified conditions are met), stating expressly that exempt property is "not liable for payment of any administrative expense." 11 U.S.C. § 522(k).

The Court summarily rejected the argument that Section 105(a) was the source of relevant authority to take action prohibited by the text of the Code. "Section 105(a) confers authority to carry out the provisions of the Code, but it is quite impossible to do that by taking action that the Code prohibits." *Law*, slip op. at 5.

The Court went on to observe that a number of lower courts have suggested that bankruptcy courts have a "general equitable power . . . to deny exemptions based on a debtor's bad-faith conduct." *Id*. at 9. Such a power, if it existed, would be highly analogous to the authority to disallow a creditor's otherwise valid claims on account of the creditor's bad faith conduct. But the Supreme Court made clear that there is no such power. "For the reasons we have given, the Bankruptcy Code admits no such power. . . . [F]ederal law provides no authority for bankruptcy courts to deny an exemption on a ground not specified in the Code." *Id*. at 9-10.

This reasoning is likely to sound the death knell for the remedy of "equitable disallowance." As the Court said, "whatever other sanctions a bankruptcy court may impose on a dishonest debtor, it may not contravene the express provisions of the Bankruptcy Code by ordering that the debtor's exempt property be used to pay debts and expenses for which that property is not liable under the Code." *Id*. at 12. Because essentially the same thing can be said of the power to "equitably disallow" the claim of a dishonest creditor-which claims the Code says may be equitably subordinated without any mention of equitable disallowance-the reasoning of *Law* strongly supports the conclusion that equitable disallowance simply does not exist under the Bankruptcy Code.

Moreover, while it is the unusual case in which the question of "equitable disallowance" is significant-after all, the statutory remedy of equitable subordination will typically be sufficient to leave a creditor without any economic recovery except in cases in which all other valid creditors receive payment in full-the approach taken by the unanimous Court to the statutory question is highly instructive. Many bankruptcy appeals involve circumstances in which a bankruptcy court's judgment

about sound bankruptcy policy may be difficult to square with the clear command of the Bankruptcy Code. *Law v. Siegel* makes clear that in such circumstances, where Congress has addressed the issue, the language of the Code must prevail.

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[1] *See Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 443, 450 (2007) (if a claim is valid under non-bankruptcy law, "the court 'shall allow' the claim 'except to the extent that' the claim implicates any of the nine exceptions enumerated in § 502(b)").

[2] *See, e.g., Harbinger Capital Partners LLC v. Ergen (In re LightSquared, Inc.)*, --- B.R. ---, 2013 WL 6140717 (Bankr. S.D.N.Y. Nov. 21, 2013); *In re Mobile Steel Co.*, 563 F.2d 692, 699 (5th Cir. 1977) (noting "equitable considerations can justify only the subordination of claims, not their disallowance").

[3] *See, e.g., Adelphia Recovery Trust v. Bank of America,* 390 B.R. 64 (S.D.N.Y. 2008) (affirming bankruptcy court's denial of motion to dismiss claim for equitable disallowance); *In re Adelphia Communications Corp.*, 365 B.R. 24 (Bankr. S.D.N.Y. 2007) (denying motion to dismiss and concluding that equitable disallowance is permissible); In *re Washington Mutual, Inc.*, 461 B.R. 200 (Bankr. D. Del. 2011) (denying motion to dismiss and concluding that bankruptcy court has the authority to disallow claim on equitable grounds), vacated upon settlement of parties, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

[4] *See, e.g., Adelphia Recovery Trust v. Bank of America,* 390 B.R. at 74 n.13. The district court in *Adelphia* ultimately held that the litigation trust's equitable disallowance claims were barred by the plan's payment of claims in full, and the Second Circuit affirmed. *See Adelphia Recovery Trust v. Bank of America, N.A.*, 390 B.R. 80 (S.D.N.Y. 2008), *aff'd* 379 Fed. App'x 10 (2d Cir. 2010).

[5] WilmerHale represented the National Association of Consumer Bankruptcy Attorneys as *amicus curiae* in *Law v. Siegel*, filing a brief that argued (as the Court concluded) that the general authority provided in Section 105(a) of the Bankruptcy Code could not override the clear statutory language. The firm also represented a number of financial institutions as defendants in the *Adelphia* litigation cited above, arguing that the Bankruptcy Code does not provide for the remedy of equitable disallowance.

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