

## BY-LINED ARTICLE

### Two Bankruptcy Cases Set to Come Before the U.S. Supreme Court

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November 6, 2009

*The Legal Intelligencer*

During its current term, the U.S. Supreme Court will hear argument in two critical bankruptcy cases. The first, *Milavetz v. United States*, includes a challenge to the constitutionality of the debt relief agency provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, or BAPCPA. This Supreme Court decision may finally resolve whether attorneys are included within the definition of a "debt relief agency" and, if so, whether the requirements imposed upon debt relief agencies are constitutional as applied to attorneys.

The second, *Schwab v. Reilly*, calls on the court to decide whether a trustee waives any objection to a debtor's exemption if the trustee fails to object within the 30-day limitation provided by Federal Rule of Bankruptcy Procedure 4003. This case should clarify the holding of an earlier U.S. Supreme Court case on a related issue.

#### **Background of Milavetz**

In drafting the BAPCPA, Congress added the term "debt relief agency" to the Bankruptcy Code. The term is defined in Section 101(12A) as "any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer. . . ." There are various restrictions and requirements for debt relief agencies, such as those found in Section 526(a)(4), which prohibits debt relief agencies from advising a client to "incur more debt in contemplation" of a bankruptcy filing, and Sections 528(a)(4) and (b)(2), which require debt relief agencies to include a statement in all bankruptcy-related advertisements disclosing their debt relief agency status.

These provisions came under fire in *Milavetz*, which challenged both the inclusion of attorneys within the definition of "debt relief agency" and the constitutionality of Sections 526(a)(4) and 528(a)(4) and (b)(2). The U.S. Supreme Court granted certiorari in *Milavetz* June 8.

#### **Milavetz in The District Court**

In *Milavetz*, two of the attorneys in the Milavetz Gallop & Milavetz law firm and two clients of the law firm brought suit against the United States seeking a declaratory judgment that Sections 526(a)(4) and 528(a)(4) and (b)(2) of BAPCPA either don't apply to attorneys or are unconstitutional as applied to attorneys. The plaintiffs argued that Section 526(a)(4) has a chilling effect on attorneys' speech in violation of the First Amendment; Sections 528(a)(4) and (b)(2) unconstitutionally mandate speech in violation of the First Amendment and attorneys are not "debt relief agencies." The district court agreed with all three arguments.

First, in reviewing Section 526(a)(4), the court applied a "strict scrutiny" standard, requiring that the government's asserted interest was

narrowly tailored to achieve a compelling state interest. The court held that even if the government's asserted interests of protecting debtors, creditors and the bankruptcy system were compelling, the provision was not sufficiently narrowly drafted to achieve those interests. The court held that Section 526(a)(4) is an unconstitutional, content-based regulation of attorney speech that forbids advice that may be helpful to clients.

Second, the court applied an "intermediate scrutiny" standard in its review of Sections 528(a)(4) and (b)(2), requiring that the provisions directly advance a substantial government interest and are narrowly drawn. The court disagreed with the government's argument that Section 528 advances the government's interest in protecting consumers from deceptive advertising; instead, it found that both the term "debt relief agency" and the requirement that attorneys use the same disclosure as non-attorneys are likely to confuse consumers. The court concluded that Section 528 is not sufficiently tailored to the government's asserted interest because it regulates both truthful and deceptive advertisements. Consequently, it held Sections 528(a)(4) and (b)(2) to be unconstitutional.

Finally, the court held that attorneys are excluded from the definition of "debt relief agency." It relied upon Section 526(d)(2)(A), which provides that nothing in Sections 526, 527, or 528 shall be deemed to limit the authority of a state to regulate the practice of law. The court found that including attorneys within the definition of "debt relief agency" would result in a conflict with Section 526(d)(2)(A) by allowing Congress to legislate in an area traditionally left to the states.

### ***The 8th U.S. Circuit Court of Appeals on Milavetz***

The 8th Circuit affirmed the district court in part and reversed it in part in *Milavetz*. It agreed that Section 526(a)(4) is unconstitutionally overbroad as applied to attorneys. However, it found no constitutional problem with Sections 528(a)(4) and (b)(2), and held that attorneys are validly considered to be "debt relief agencies" for purposes of BAPCPA.

The court focused on the plain meaning of "debt relief agencies," stating that the broad statutory language clearly includes attorneys providing bankruptcy assistance unless they are excluded by another section. Finding no such exclusion, it concluded that attorneys are debt relief agencies under BAPCPA.

Next, the appellate court affirmed the district court's conclusion that Section 526(a)(4) is unconstitutionally overbroad as applied to attorneys. It found that this outcome would be the same regardless of the standard of review applied, because Section 526(a)(4) prevents attorneys from fulfilling their duty to provide appropriate and beneficial advice to clients.

Finally, the court of appeals reversed the district court's finding that Sections 528(a)(4) and (b)(2) were unconstitutional. It rejected the district court's use of "intermediate scrutiny" in favor of "rational basis" review, finding the less stringent standard of review appropriate because the challenged provisions were intended to avoid potentially deceptive advertising. The court concluded that Section 528's disclosure requirements are reasonably related to the government's interest in protecting consumers from deceptive advertising. Judge Steven Colloton dissented only

with regard to the court's finding that Section 526(a)(4) was unconstitutional. The court has adopted a limited construction of the code, which would require an interpretation of Section 526(a)(4) that would prohibit advising a client to incur more debt in contemplation of bankruptcy only where it is for the purpose of manipulating the system.

### ***Milavetz and The High Court***

The Supreme Court is expected to hear argument on *Milavetz* this term. The government's brief is due by Nov. 20. The petitioners' brief, filed Aug. 25, argues that attorneys are not "debt relief agencies" based on the district court's separation of powers argument and emphasizes the First Amendment values implicated by the requirements and restrictions placed on attorneys by BAPCPA. This case should finally end the long debate over the meaning of "debt relief agency" and clarify attorneys' responsibilities under the code.

### ***Schwab Background***

When a debtor files for bankruptcy, Section 541(a)(1) provides that "all legal or equitable interests of the debtor in property" become part of the bankruptcy estate. Debtors may exempt property from the estate: that falls within the categories listed in Section 522; and in amounts not to exceed the specific limits set forth in Section 522. Thus, with its bankruptcy petition, a debtor files one schedule that lists the value of all personal property and another that lists the property the debtor intends to exempt. Under Federal Rule of Bankruptcy Procedure 4003, the trustee or any party in interest has 30 days to object to the exemptions. Unless an objection is filed, Section 522(l) provides that the property listed on the debtor's exemption list is exempt.

In *Taylor v. Freeland & Kronz*, the Supreme Court addressed whether a trustee could contest an exemption after the 30-day period where the debtor listed a pending lawsuit of "unknown" value and the trustee failed to object within the timeline. The lawsuit later proved to be valuable, but the court held that under a strict construction of the bankruptcy rules, the trustee's failure to timely object resulted in the property being exempt. The *Taylor* opinion has been subject to a wide array of contradicting interpretations. For example, the 8th Circuit noted that the amount of an allowed exemption is limited by the code, and therefore, it held that *Taylor* cannot mean that a debtor can overcome the statutory limit simply by listing the property's value as unknown. In contrast, the 6th and 11th Circuits have held that *Taylor* stands for the broader proposition that whenever a debtor shows intent to fully exempt property and the trustee does not object within the 30-day window, the property is exempt. In an apparent attempt to address this confusion, the court granted certiorari in *Schwab* April 27.

### ***Schwab in The District Court***

On April 21, 2005, Nadejda Reilly filed a petition for relief under Chapter 7 of the Bankruptcy Code. She included "business equipment" in her list of property, which she valued at \$10,718, and claimed an exemption for \$10,718 of business equipment. She claimed \$1,850 of the \$10,718 under Section 522(d)(6), which allows a debtor to exempt tools of the debtor's trade, and the remaining \$8,868 under Section 522(d)(5), the

was \$10,225. Thus, her claimed exemption was within the limits set forth in Section 522.

The trustee did not object to the exemption within the prescribed 30-day period, but the trustee later asserted that the equipment had been undervalued and wished to sell it for the benefit of Reilly's bankruptcy estate. The bankruptcy court held that the trustee had waived the right to challenge the valuation when he failed to timely object to the scheduled exemption. The trustee appealed to the district court, arguing that his failure to challenge the exemption within the 30-day period contained in Rule 4003 was irrelevant as he was not challenging the validity of the exemption, but rather the value of the exemption.

In *Schwab*, the district court disagreed with the trustee's distinction. Relying on *Taylor*, it determined that the Rule 4003 deadline must be strictly construed.

### *The 3rd Circuit's Opinion in Schwab*

The 3rd Circuit affirmed the district court in *Schwab*. It found *Taylor* controlling, stating that Reilly's listing of an identical value for the asset and the exemption put the trustee on notice that she intended to fully exempt the property. The court dismissed the trustee's argument that its holding could lead debtors to undervalue their assets in hopes that no one would object, reasoning that there are various protections against such behavior built into the Bankruptcy Code. Moreover, the court noted that its holding was in accord with the policy of providing debtors a fresh start. The court explained that Rule 4003's deadline provides debtors with the assurance that upon expiration of the deadline, the debtor may use the property without fear that it will later be subject to the claims of the trustee or other creditors.

### *Schwab and The Supreme Court*

The Supreme Court heard arguments in *Schwab* on Tuesday. In his brief to the court, the petitioner argues that when there are no objections to claimed exemptions, the property is exempt only up to the amount of the statutory dollar limits provided in Section 522. In her brief, the respondent argues that she clearly conveyed her intent to exempt the entire value of the business equipment and, consequently, the trustee's failure to object is fatal to his case. Reilly suggests that by failing to require timely objection to a valuation of exempt property, the trustee's approach would result in a cloud on the title of property claimed as exempt even beyond the 30-day objection period. The Supreme Court's resolution of this case will hopefully resolve the conflict over the meaning of *Taylor* and further clarify the exemptions process.

### *Conclusion*

The Supreme Court's decisions in both *Milavetz* and *Schwab* should resolve unsettled issues in the world of bankruptcy. The outcome of these cases will further elucidate the role attorneys play in a bankruptcy filing and the advice they may give to their clients, as well as the responsibilities of Chapter 7 trustees to ensure that debtors exempt only appropriate property.

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