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EXEMPT PROPERTY AND BANKRUPTCY: SECURED AND WAIVER CLAIMS

*Hector Currie**

Allowance of secured claims in bankruptcy is governed by section 57h of the Bankruptcy Act:

“The value of securities held by secured creditors shall be determined by converting the same into money according to the terms of the agreement pursuant to which such securities were delivered to such creditors, or by such creditors and the trustee by agreement, arbitration, compromise, or litigation, as the court may direct, and the amount of such value shall be credited upon such claims, and a dividend shall be paid only on the unpaid balance. Such determination shall be under the supervision and control of the court.”¹

This statement of the so-called bankruptcy rule for secured claims, which differs from the equity or chancery rule applied in some sorts of non-bankruptcy liquidation where the secured creditor receives dividends on the full amount of his claim without deducting the value of his security,² does not exhaust the possibilities open in bankruptcy to the secured creditor. He may prove his claim as unsecured and surrender his security or, if the security is exclusively in his possession, he may choose not to prove a claim and, instead, rely on the security.³ Unless the security has become valueless, the creditor should not waive it by proving an unsecured claim;⁴ and unless he is certain that the value of the security is ample to protect him fully, he should not fail to prove a claim. In most circumstances it is advisable for the secured creditor to prove his claim as a secured claim subject to section 57h.

CLAIMS SECURED BY EXEMPT PROPERTY

If, however, the property to which the security relates was

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1. 11 U.S.C. § 93h (1964).

2. See *United States Nat'l Bank in Johnstown v. Chase Nat'l Bank*, 331 U.S. 28 (1947).

3. 3 W. COLLIER, *BANKRUPTCY* § 57.07[3] (1969).

4. *Cf.* 11 U.S.C. § 93a (1964).

exempt from the claims of creditors generally but was not exempt from the claims of a defined class of creditors including the claimant,⁵ or if the debtor now bankrupt created a security right in exempt property for the claimant's benefit where he was permitted to do so by the local exemption law,⁶ the question arises: is the claimant a secured creditor governed by section 57h or is he not rather, in the bankruptcy meaning, unsecured—that is, may he not prove, and draw dividends on, the full amount of his claim, then enforce his security outside bankruptcy for the unpaid balance? Before this question can be considered, it is necessary to notice section 70a, section 6, and section 1 (28) of the Bankruptcy Act.

Section 70a begins:

"The trustee of the estate of a bankrupt . . . shall . . . be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this Act, except insofar as it is to property which is held to be exempt . . ."

Section 6 provides in part:

"This Act shall not affect the allowance to bankrupts of the exemptions which are prescribed by the laws of the United States or by the State laws in force at the time of the filing of the petition in the State wherein they have had their domicile . . ."

And section 1 (28) provides:

" 'Secured creditor' shall include a creditor who has security for his debt upon the property of the bankrupt of a nature to be assignable under this Act or who owns such a debt for which some endorser, surety, or other person secondarily liable for the bankrupt has such security upon the bankrupt's assets."

The bankrupt must claim his exemptions in the schedules he is required to file in the bankruptcy proceeding.¹⁰ Failure to make the claim, if not corrected by amendment, amounts to a

5. See LA. CONST. art. XI, § 2(1-5).

6. See *id.* § 2(6-7); LA. R.S. 22:647E (1950), *as amended* (1958).

7. 11 U.S.C. § 110a (1964).

8. *Id.* § 24.

9. *Id.* § 1(28).

10. *Id.* § 25a(8).

waiver of the bankrupt's right of exemption¹¹ and it necessarily destroys the creditor's security in the property supposedly exempt.¹² But if the exemption properly claimed by the bankrupt¹³ is set apart by the trustee in bankruptcy¹⁴ and this action is approved by the court,¹⁵ title to the exempt property does not pass to the trustee and the exempt property constitutes no part of the bankrupt estate.¹⁶ Does it follow, where a creditor has security in property determined to be exempt, that his security is not "upon the property of the bankrupt of a nature to be assignable under this Act"?

Remington criticizes the phrasing of section 1(28) as inept, but adds that " 'assignable under the Act' is construed to mean 'of such nature as to pass to the trustee' under the Act, and exempt property does not so pass."¹⁷ This construction has been the basis of decision in several cases.

In re Anderson,¹⁸ considering the words "of a nature to be assignable under this Act," concluded that: "They are to be understood in a broad sense as equivalent to the expression 'of a nature such that it will pass to the trustee under this act.' The word 'assignable,' as here used, is probably a heritage from the Bankruptcy Act of 1867, where at section 14 . . . provision is made for assigning and conveying the estate of the bankrupt to the assignee provided by the act. Under the present statute, exempt property does not pass to the trustee. Section 6 It is not assignable under the act. See, also, section 70. . . ."¹⁹

The same meaning was given the statutory language by *In re Bailey*,²⁰ which held that the mortgagee of an exempt homestead might prove the entire claim as an unsecured creditor. And in *In re Guilliot*²¹ a pledgee of life insurance policies of which the proceeds were exempt by local law was likewise held entitled to allowance of his entire claim. Finally, in *Feder v. John Engelhorn & Sons*,²² Judge Augustus Hand said

11. 1 W. COLLIER, BANKRUPTCY § 6.19 (1969).

12. *Id.* § 6.10.

13. 11 U.S.C. § 25a(8) (1964).

14. *Id.* § 75a(6).

15. *Id.* § 11a(11).

16. 1 W. COLLIER, BANKRUPTCY § 6.05 (1969).

17. 2 H. REMINGTON, BANKRUPTCY § 910 (1956).

18. 11 F.2d 380 (D. Minn. 1926).

19. *Id.* at 381.

20. 176 Fed. 990 (D. Utah 1910).

21. 47 F. Supp. 929 (W.D. La. 1942).

22. 202 F.2d 411 (2d Cir. 1953).

by way of dictum: "After some conflict it now seems clear that a creditor who has exempt property of the bankrupt for security is not a secured creditor and may prove his claim in full."²³

Other cases have decided that where a creditor with security on exempt property proved his entire claim in his debtor's bankruptcy as unsecured, he did not thereby waive his security and could resort to the exempt property outside bankruptcy²⁴—in effect recognizing his status as an unsecured creditor. One who is a secured creditor within the definition of section 1 (28) ordinarily is held to waive the security by filing his claim as unsecured.²⁵

Apart from reliance on the statutory language to support its conclusion that the mortgagee of an exempt homestead is not a secured creditor and may have a claim allowed in the full amount without deduction for the mortgage, *In re Anderson*²⁶ also argued that any other result would be unfair to the bankrupt. A requirement that the mortgagee reduce his claim by the value of the homestead would increase the dividend each general creditor received and would thus be tantamount to using the homestead in part for the payment of general claims.²⁷ This argument was adopted by the court that decided *In re Guilliot*.²⁸

Three cases²⁹ that applied section 57h to a creditor with a lien on exempt property of the bankrupt were decided without reference to the definition of "secured creditor" in section 1 (28), an omission that weakens the force of those decisions.³⁰ The creditor of *In re Cale*,³¹ with a valid judgment lien on the bankrupt's exempt homestead, obtained an order of special execution on the homestead from a state court after its bankruptcy claim was reduced by the value of the homestead. The debtor then took an appeal to the highest court in the state and the creditor,

23. *Id.* at 412.

24. *Robinson v. Exchange Nat'l Bank*, 28 F. Supp. 244 (N.D. Okla. 1939), modified on other grounds and *aff'd on rehearing*, 31 F. Supp. 350 (N.D. Okla. 1940); *Watters v. Hedgpeth*, 172 N.C. 310, 90 S.E. 314 (1916).

25. 3 W. COLLIER, BANKRUPTCY § 57.07[3.1] (1969).

26. 11 F.2d 380 (D. Minn. 1926).

27. *Id.* at 381.

28. 47 F. Supp. 929 (W.D. La. 1942).

29. *In re Cale*, 182 Fed. 439 (D. Minn. 1910), *aff'd*, 191 Fed. 31 (8th Cir. 1911); *In re Lantzenheimer*, 124 Fed. 716 (N.D. Iowa 1903); *In re Little*, 110 Fed. 621 (N.D. Iowa 1901).

30. *Cf.* Note, 17 MINN. L. REV. 47, 53 (1932).

31. 182 Fed. 439 (D. Minn. 1910), *aff'd*, 191 Fed. 31 (8th Cir. 1911).

as protection against the consequence of a possible reversal of the order of special execution, appealed the order of the bankruptcy court that had reduced the amount of the claim. The district court and the court of appeals affirmed, the latter stating that the question whether one who holds security on exempt property of a bankrupt is a secured creditor within the meaning of section 1(28) had not been argued in the case and would not be determined.³² *In re Lantzenheimer* asserts: "The rule contended for by the creditor would result, in the great majority of the cases, in giving to the creditor a greater share in the estate of the debtor, without really benefitting the bankrupt; and I see no good reason why the court should interpolate into clause h of section 57 an exception not named therein, to wit, that if the security held by the creditor is upon exempt property, the creditor can prove his claim for the whole amount due."³³ To the extent to which the creditor is paid from the estate, however, he will not have to resort to the exempt property after bankruptcy, with resultant benefit to the bankrupt, and good reason against the use of section 57h might have been found in section 1(28).

Of cases applying section 57h to the creditor with a lien on exempt property, only *Fenley v. Poor*³⁴ has attempted to analyze the language of section 1(28). The definition of secured creditor, said the court, "refers to the nature of the property, and, if it is such as to be assignable under the act, the fact that it includes exemptions under the state laws . . . could not affect its nature and make it nonassignable. The act provides that the bankrupt shall make claim under oath to his exemptions . . . and also makes it the duty of the trustee to set apart the bankrupt's exemptions . . . and makes it the duty of the judge to determine all claims of bankrupts to their exemptions. These provisions clearly indicate that the whole estate of the bankrupt is assigned, under the law, to the trustee, and that then the claim of the bankrupt is to be made for his exemptions, which are to be set apart by the trustee and determined by the court. The fact that the debtor has a homestead right in a tract of land does not change the nature of the property and make it nonassignable. *In re Sisler* (D.C.) 96 Fed. 402. The homestead right may be abandoned, or, if there be no objection or application

32. 191 Fed. 31, 33 (8th Cir. 1911).

33. 124 Fed. 716, 717 (N.D. Iowa 1903).

34. 121 Fed. 739 (6th Cir. 1903).

on the part of the bankrupt to have the homestead set apart to him, the property may be sold, and the proceeds distributed among his creditors. *Collier on Bankruptcy* . . . The property is of a nature to pass to the trustee. . . ."³⁵ But if the homestead is not abandoned and the bankrupt claims his exemption, the property does not pass to the trustee.³⁶ And the only case cited for the conclusion that exempt property is assignable under the Act, *In re Sisler*,³⁷ held that where the debtor had waived his homestead right in favor of a creditor, the homestead would pass to the trustee in bankruptcy so as to enable him to enforce the creditor's right against the property—a procedure that the Supreme Court was shortly to condemn.³⁸ *Collier on Bankruptcy* speaks of "a rather free interpretation of the words 'of a nature to be assignable,' contained in the statutory definition"³⁹—a reference apparently to *In re Anderson*.⁴⁰ It appears that *In re Anderson* made better sense of section 1(28) than did *Fenley v. Poor*.⁴¹

The latest case to deal with the problem, *In re Cain*,⁴² held that a creditor to which exempt life insurance policies had been assigned was a secured creditor and must reduce its claim by the value of the security. The court cited *Collier's Bankruptcy Manual* section 57.04 and said that it was disposed to follow what "Collier states to be the majority view."⁴³

Collier in fact has made conflicting statements. The first is found in Volume One of the treatise: "The decisions are sharply divided on the question of whether a creditor is deemed to be secured if his security interest encumbers *exempt* property, but the view which reaches the negative result is currently favored by the courts." Citation follows to *In re Anderson* and similar

35. *Id.* at 740.

36. 11 U.S.C. § 110a (1964).

37. 96 Fed. 402 (W.D. Va 1899).

38. *Lockwood v. Exchange Bank*, 190 U.S. 294 (1903).

39. 1 W. COLLIER, BANKRUPTCY § 1.28 (1969).

40. 11 F.2d 380 (D. Minn. 1926).

41. *Cf.* J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 167 (1956): "The Bankruptcy Act says that a secured creditor shall include a creditor who has security for his debt upon the property of the bankrupt of a nature 'to be assignable under this Act.' This definition, taken in connection with the provision of section 70a that the trustee is vested with the title of the bankrupt, except to property held to be exempt, by clear implication excludes exempt property, as such property is not 'of a nature to be assignable under this Act' to the trustee."

42. 291 F. Supp. 1 (N.D. Texas 1968).

43. *Id.* at 2.

cases.⁴⁴ And this language comes from Volume Three: "A minority view even refuses to consider a creditor as 'secured' if he holds exempt property of the bankrupt. The better and majority view, however, is to the contrary."⁴⁵

Remington says without self-contradiction: "The weight of authority is to the effect that security on exempt property of the bankrupt is not on property of the bankrupt 'of a nature to be assignable under the Act,' and that a creditor holding only such security is not a 'secured creditor' of the bankrupt and is entitled to allowance of his claim in full without regard to his security."⁴⁶ It is perhaps inexact to speak of the weight of authority where cases few in number are almost evenly balanced, but Remington expresses what seems the preferable view.⁴⁷

CLAIMS WITH WAIVER OF EXEMPTION

Instead of security on exempt property of the bankrupt, the creditor may have merely a waiver of exemption.⁴⁸ For a time it was thought that the bankruptcy court might administer exempt property for the benefit of such a creditor⁴⁹ or of one excepted by statute from the exemption,⁵⁰ but this idea died

44. 1 W. COLLIER, BANKRUPTCY § 1.28 (1969).

45. 3 *id.* § 57.07.

46. 2 H. REMINGTON, BANKRUPTCY § 910 (1956).

47. See Note, 17 MINN. L. REV. 47, 52-54 (1932): "The status as against the estate in bankruptcy of a creditor whose debt is secured by a claim against property of the bankrupt which is exempt under the Act has been a troublesome problem and has given rise to an irreconcilable conflict among the few cases that have passed on the question. A minority number of cases have held that such a creditor is not secured within the meaning of the definition in the Act and allow him to share in the general estate of the bankrupt as unsecured. . . . In view of the fact that the result reached by this construction accords with the express policy of the bankruptcy law, which is to preserve the bankrupt's rights to exemptions and make such property unavailable to the general creditors of the estate, the rule adopted in the minority group of cases seems to be the more justifiable." Collier cites this Note as "supporting the current trend," then adds: "But it would seem that the inequality thus created is contrary to the policy of the Bankruptcy Act, while the bankrupt himself is not benefitted." 1 W. COLLIER, BANKRUPTCY § 1.28 n.15 (1969).

48. See LA. CONST. art XI, § 3; LA. R.S. 22:647E (1950), *as amended* (1958). Some states permit contractual waiver of exemption in favor of a particular creditor, but many states hold that such an executory waiver is against public policy. Comment, 68 YALE L.J. 1459, 1494-97 (1959). See also Succession of Onorato, 219 La. 1, 50 So.2d 804 (1951).

49. In re Sisler, 96 Fed. 402 (W.D. Va. 1899); In re Woodruff, 96 Fed. 317 (S.D. Ga. 1899); In re Garden, 93 Fed. 423 (N.D. Ala. 1899).

50. In re Boyd, 120 Fed. 999 (N.D. Iowa 1903).

with *Lockwood v. Exchange Bank*.⁵¹ In the *Lockwood* case, the Supreme Court held that, as exempt property did not pass to the trustee, the bankruptcy court had no jurisdiction over exempt property other than to set it aside, but that discharge of the bankrupt should be postponed long enough to enable the waiver creditor to take whatever action was necessary, in state court, to make good his right.⁵² The Supreme Court added: "As, in the case at bar, the entire property which the bankrupt owned is within the exemption of the state law, it becomes unnecessary to consider what, if any, remedy might be available in the court of bankruptcy for the benefit of general creditors, in order to prevent the creditor holding the waiver as to exempt property from taking a dividend on his whole claim from the general assets, and thereafter availing himself of the right resulting from the waiver to proceed against exempt property."⁵³ The issue reserved in *Lockwood* has been considered by several courts.

*In re Meredith*⁵⁴ held that as the waiver of homestead was in the nature of a security,⁵⁵ the claim of the waiver creditor was subject to section 57h and it could be allowed only after deducting the value to be received from the homestead. No mention was made of section 1(28). In a later case, *In re Loden*,⁵⁶ the same court said: "It is not at all clear to me that, because a creditor has proven his claim as unsecured in the bankruptcy court, he may not, notwithstanding this, assert whatever peculiar right he may have against the homestead exemption."⁵⁷ Though the court seemed to find no incongruity, this language necessarily casts doubt on the decision in the *Meredith* case.

*Schloss v. Unsell*⁵⁸ permitted partners who were creditors with a valid waiver of homestead and who had proved their entire claim in bankruptcy as unsecured and had received substantial dividends, to enforce their right to the unpaid balance

51. 190 U.S. 294 (1903).

52. For criticism of *Lockwood v. Exchange Bank*, see Kennedy, *Limitation of Exemptions in Bankruptcy*, 45 IOWA L. REV. 445, 462-9 (1960); Comment, 68 YALE L.J. 1459, 1476-78 (1959). The rule of the case is "firmly established." 1 W. COLLIER, BANKRUPTCY § 6.05 (1969).

53. 190 U.S. 294, 300-01 (1903).

54. 144 Fed. 230 (N.D. Ga. 1906).

55. *Bell v. Dawson Grocery Co.*, 120 Ga. 628, 48 S.E. 150 (1904).

56. 184 Fed. 965 (N.D. Ga. 1910).

57. *Id.* at 966.

58. 114 Kan. 69, 216 P. 1091 (1923).

against the homestead in a state court. Similar in effect is *Johnson v. Turnholt*.⁵⁹

The court in *Schloss v. Unsell* distinguished the consequences for a lien creditor of proof of his claim as unsecured according to whether the property subject to the lien was or was not exempt. Where it was not exempt, the creditor would lose the benefit of his lien. Where it was exempt, his lien would not be affected. "In such a case, the exempt property might be taken by the lien creditor and applied to the payment of his claim without reference to the bankruptcy proceeding. If the lien creditor proved his claim in the bankruptcy proceeding and received part payment out of the assets, the debtor's exempt property would to that extent be relieved from the payment of the claim. The creditors would have no cause of complaint, because they cannot look to the exempt property for the payment of their claim, nor compel other creditors to resort to that property and thereby leave a greater amount in the assets of the bankrupt estate. The debtor would have no cause for complaint, because the claim against the exempt property would be reduced by the amount received."⁶⁰

If a creditor with a lien on exempt property may prove his claim in full, the same should be true *a fortiori* of a creditor with only a waiver of exemption. This has been denied, however, by Professor Kennedy: "It is true that some courts allow a creditor holding security against property otherwise exempt to prove in full, i.e., without reducing the amount of his claim by the value of such security. Whatever may be said as to the soundness of that rule, however, it constitutes no embarrassment to the argument that an unsecured creditor with a mere waiver is assisted in achieving a preferential position *vis-à-vis* the other unsecured creditors in the debtor's property when the bankruptcy court allows such a creditor to prove in full and simultaneously to pursue the exempt property. Moreover, the rule respecting treatment of holders of security in exempt property affords no support whatever for saying that exempt property which is subject to the claims of one or more unsecured creditors nevertheless does not belong to the bankrupt estate. Certainly the trustee's position in respect to the portion of exempt property vulnerable to unsecured creditors' claims is quite different

59. 199 Iowa 1331, 203 N.W. 715 (1925).

60. 114 Kan. 69, 71-72, 216 P. 1091, 1092 (1923).

from that which he holds in relation to exempt property subject to a valid security interest. It may be argued of course that a waiver holder has a right which he has bargained for and which he ought to be able to assert as against the trustee in bankruptcy in the same manner as a secured creditor's rights are respected. The objectives of bankruptcy administration are not served, however, by extension of the rights of secured and priority claimants at the expense of the general creditors and the debtor."⁶¹ One cannot agree that allowing a waiver creditor to prove his claim in full and to pursue the exempt property impairs the rights either of the debtor or of the general creditors,⁶² or that the objectives of bankruptcy administration can be defined without reference to the recognition of state exemption policies in section 6.

Collier criticizes the holding of *Schloss v. Unsell* as "inequitable and contrary to the philosophy of bankruptcy distribution."⁶³ The criticism fails to take adequate account of section 6, section 70a, and particularly section 1(28). "Creditors holding waivers of exemptions are not secured creditors within the definition of . . . the Bankruptcy Act. . . ." ⁶⁴

61. Kennedy, *Limitation of Exemptions in Bankruptcy*, 45 IOWA L. REV. 445, 464 (1960).

62. "A waiver in favor of a particular creditor cannot be asserted for the benefit of other creditors. Likewise, a waiver of homestead rights in favor of all creditors cannot be accomplished through a waiver made to one creditor only, nor can the latter form of waiver entitle all creditors to marshal securities or funds." 1 W. COLLIER, *BANKRUPTCY* § 6.10 (1969).

63. *Id.* at 840.

64. J. MACLACHLAN, *HANDBOOK OF THE LAW OF BANKRUPTCY* § 167 (1956).