UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

U.S. COURT OF APPEALS DOCKET NUMBER: 21-16034

United States of America,

Appellant,

v.

Lawrence J. Warfield;

Appellee.

PETITION FOR REHEARING
OR REHEARING EN BANC

Appeal from the United States District Court
District of Arizona
CV-20-08204-PCT-DWL

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INTRODUCTION AND RULE 35 STATEMENT

This appeal involves issues of exceptional importance in the practice of bankruptcy law. The precise issue before the Court is an issue that has not previously been addressed by this Court, or by any other circuit court of appeals. It is an issue that affects a growing body of lower court authority on tax lien avoidance,[1] much of which is either adverse to or cannot be reconciled with the Panel Decision in this matter. Moreover, the answer to this question has significant implications in the day-to-day practice of bankruptcy law. The question is this:

> Is a lien that secures a tax penalty avoidable according to the plain language of 11 U.S.C. §724(a), or do exemptions claimed by the debtor amend the statute to protect the lien from avoidance?

The bankruptcy court and the district court ruled that the exemption claimed by the debtor did not alter the outcome. The dissent written by Circuit Justice Bumatay agreed. The Panel Decision held that the debtor's exemption

[1] See, e.g., *In re Gill*, 574 B.R. 909 (9thCir.BAP2017); *In re Hutchinson*, 519 B.R. 860 (Bankr.E.D.Cal.2018), *affirmed*, 15 F4th 1229 (9thCir.2021); *In re Bolden*, 327 B.R. 657 (Bankr.C.D.Cal.2005); *In re Hannon*, 619 B.R. 524 (D.Mass.2020); *United States v. MacKenzie*, 2021 WL 4427069 (D.Ariz.).

prevented the avoidance of the lien, effectively amending the statute to create an exception for liens on exempt property.

The Panel Decision conflicts with or calls into question several long standing rulings of this Court on a variety of bankruptcy issues. For these reasons, the appellee requests that this Court allow this matter to be reheard or reheard *en banc*.

BACKGROUND

At the time of the bankruptcy filing, debtor Sandra Tillman ("Tillman") owned a residence in Arizona. Although Tillman asserted a homestead exemption under Arizona law, the residence was subject to both a deed of trust and a federal tax lien that were superior to the asserted exemption. **The trustee objected to the exemption and obtained an order which confirmed that the exemption was subordinate to both the deed of trust and the tax lien.** Dkt. 31.

Tillman sought and obtained bankruptcy court approval to sell the residence. Because the tax lien secured penalties, and because Tillman's homestead was subordinate to the tax lien, the bankruptcy court ordered that the penalties which were secured by the lien had to be paid to the bankruptcy trustee pending further order. ER-34.

After the sale was completed, the trustee filed an adversary proceeding against the IRS to avoid the penalty lien pursuant to 11 U.S.C. §724(a) and retain the penalties for the benefit of the unsecured creditors. The IRS opposed, arguing

among other things that the exemption claimed by Tillman prevented avoidance of the penalty lien.

The bankruptcy court entered an order avoiding the tax lien. ER-38. The district court affirmed. ER-5. The Panel Decision reversed, holding that the exemption claimed by Tillman prevented the trustee from avoiding the lien. Circuit Judge Butamay dissented.

I. The Holding Of The Panel Contradicts Or Calls Into Question Existing Authority, Including The Bankruptcy Code.

A. The Logic Is Flawed

The Panel reached its conclusion by the following logic:

1. §724(a) relies on §726(a)(4) to define which penalty liens are avoidable.

2. §726(a), in general, directs the manner in which "property of the estate" is distributed.

3. Since the debtor was allowed an exemption in the property that was subject to the lien, the property was "removed from the estate" and was no longer "property of the estate".

4. Since the exempt property was "removed from the estate" and was no longer "property of the estate", the tax lien was not within §726(a)(4) and, therefore, was not avoidable.

In short, the Panel judicially amended §724(a) to say:

The trustee may avoid a lien that secures a claim of a kind specified in section §726(a)(4) of this title, EXCEPT FOR LIENS THAT ARE SECURED BY EXEMPT PROPERTY.

Circuit Judge Bumatay cut this logic to the quick: "[T]he Bankruptcy Code creates no exception to the trustee's avoidance power for liens on exempt property." Diss. Op. at 27.

"Property of the estate" is defined by 11 U.S.C. §541, not §726. Moreover, the phrase "property of the estate" does not appear in §724(a). The Panel simply grafted it onto §724(a) because that phrase was found elsewhere in §726.

§541(a)(3) and (4) SPECIFICALLY INCLUDE in the estate "any interest in property" which the trustee recovers under §550, or which is preserved under §551. And, both §550(a) and §551 specifically include §724(a). As a result, contrary to the ruling of the Panel, EVEN IF Tillman's exemption "removed" the entire property from the estate (another error addressed further below) the Bankruptcy Code itself provides that the tax penalty lien, once avoided (and which, according to the bankruptcy court's final and unappealed order was superior to Tillman's exemption) was estate property.

The Panel's logic also fails because the "estate property" that is available for distribution under §726 are the tax penalties that were carved out of the property that Tillman was permitted to exempt. **Tillman never enjoyed an exemption in that part of the value of her residence that was encumbered by the tax liens** because her exemption was always inferior to, and subject to, the tax lien, just like her exemption was inferior to, and subject to, the mortgage that encumbered Tillman's residence. Indeed, as noted above, **the bankruptcy court entered a final and unappealed order that confirmed that Tillman's exemption was subordinate to both the mortgage and the tax lien.** Consequently, Tillman never had a right to any money from the sale of her residence until both the tax lien and the mortgage were satisfied. Indeed, the Arizona exemption statute upon which Tillman's exemption is premised could not be more clear – **the "value" that Tillman is entitled to exempt comes only from the "equity" in the property. A.R.S. §33-1101(B) ("The value as specified in this section refers to the equity of a single person or married couple.")** That portion of the value of Tillman's property that was encumbered by the tax lien was not "equity" available to Tillman. It was never part of Tillman's exemption. The Panel Decision ignores both the bankruptcy court's order regarding the subordinated nature of Tillman's exemption and ignores the limitation on the exemption imposed by Arizona law.

Since Tillman's exemption did not reach the value that was encumbered by the tax lien, that value, i.e., the amount needed to pay the tax lien, was never "removed from the estate" and at all times remained property of the estate. Thus, to the extent that the "property of the estate" phrase from §726(a) is 'brought into' §724(a) (as the Panel concludes) the proceeds of the tax lien which were paid over to the trustee from the sale remain "property of the estate" for distribution under §726. The Panel's conclusion that those tax penalties were "removed from the estate" is erroneous.

B. The Snapshot Rule

The Panel's decision also ignores the "snap shot" rule by which bankruptcy estates are evaluated. See, *Wilson v. Rigby*, 909 F.3d 306 (9th Cir. 2018), *In re Masingale*, 2022 WL 16632954 (9thCir.). In its place, the Panel embraces a "dynamic" view of the bankruptcy estate during which "property of the estate" is redefined as exemptions are allowed and, in the process, changes the avoidance rights granted by Congress. Maj. Op. at 13. This is contrary to what the 9th Cir. BAP ruled in 1996 in *In re Heintz*, 198 B.R. 581, 585 (9thCir.BAP.1996):

> However, the fact that property is removed from the estate after a case is commenced, through exemption or some

other means, does not change the fact that it was property of the estate as of the commencement of the case.

C. DeMarah

Similarly, the Panel's decision is at odds with *In re DeMarah*, 62 F.3d 1248, 1251 (9thCir.1995), where this Court stated: "The fact that DeMarah may be able to exempt the property that is subject to the tax lien from the bankruptcy estate does not mean that he can remove the lien itself, or that portion of it which secures the penalty."

What §724(a) authorizes, by its plain language, is the avoidance of the "lien which secures" certain penalties. The fact that the debtor can "exempt the [underlying] property" has nothing to with the avoidance of the "lien" that remains attached to the property. While certain "property" of a debtor can be exempt, the lien of a creditor on that property can never be "exempted" by the debtor. The debtor does not own the creditor's lien and a debtor cannot exempt anything which he or she does not own. If the trustee avoids a purchase money lien on an automobile, the trustee holds that lien for the benefit of the estate. The debtor cannot "exempt" the lien held by the finance company, nor does the debtor's exemption remove the lien from the automobile. Under the Panel's logic, once an exemption is allowed, any lien avoidance claim that existed with respect to the automobile is terminated

since, like §726(a), §551 is limited to "property of the estate". The Panel conflates an exemption in the underlying property with an ability to "exempt the lien" which encumbers that property.

D. Noblit & Glass

It has long been the law of this Circuit that a transfer of otherwise exempt property can be avoided by the trustee and preserved for the benefit of the estate. *See, In re Noblit*, 72 F.3d 757 (9thCir.1995); *In re Glass*, 60 F.3d 565 (9thCir.1995). In particular, *Noblit* holds that a debtor's exemption CANNOT be used by a third party to defeat the avoidance rights afforded by the Code. *Noblit*, 73 F.3d at 758-759. Yet, the Panel's decision does exactly that - it allows the IRS to use Tillman's homestead exemption to defeat the avoidance rights granted by the plain language of §724(a). The Panel permits the IRS to use Tillman's exemption, which was, by a final order, determined to be subordinate to the tax penalty lien, to then protect the penalty lien from avoidance. That result cannot be reconciled with *Noblit*.

The ruling of the Panel also erodes both *Noblit* and *Glass*. For example, assume that the debtor creates a lien on her exempt residence to secure an antecedent debt during the 90 days prior to bankruptcy. Prior to this ruling, the trustee could avoid the lien as a preference (11 U.S.C. §547), and preserve it for the estate under

§551, regardless of whether the debtor's claimed exemption of the property was allowed. But, under this Panel's ruling, once the "exempt property" is "removed from the estate" by the allowance of the exemption, there can no longer be a distribution of the proceeds of the avoided lien under §726. As a result, the avoidance of the lien would be an exercise in futility.

E. Hutchinson

While this appeal was pending, this Court issued its ruling in *Hutchinson v United States*, 15 F4th 1229 (9thCir.2021). In *Hutchinson*, this Court was asked to consider whether the Hutchinsons could take over avoided tax penalty liens like the one at issue here. This Court confirmed that property of the estate was determined at the commencement of the case. 15 F.4th at 1234 ("regardless of whether the debtor claims an exemption, any interest of the debtor in property at the commencement of the bankruptcy case is "property of the estate" - citing *Heintz*). Yet, despite this clear pronouncement in *Hutchinson*, the Panel ruled in a contrary fashion. Circuit Judge Bumatay pointed out the difficulty in reconciling this decision with Hutchinson. Diss. Op. at 35.

F. Staake

The Panel's decision contradicts In *First Nat'l Bank of Baltimore v. Staake*, 202 U.S. 141 (1906). In *Staake*, the trustee sought to avoid liens on property in which the debtor no longer held an ownership interest – i.e., in property that was not "property of the estate". Yet, in *Staake*, the Supreme Court found that avoidance was appropriate even though the underlying property was not property of the estate. Under the Panel's logic, *Staake* is wrongly decided as well.

The unintended consequence of the Panel's decision is to prevent bankruptcy trustees (and debtors-in-possession) from avoiding and preserving not just tax penalty liens under §724(a), but avoidable transfers under all of the avoidance provisions contained in Chapter 5 of the Bankruptcy Code (e.g., §544, §547, §548 and §549) any time that exempt property is involved, or any time that property affected by the avoidance is no longer "property of the estate". Indeed, this decision would render §549 meaningless since §549 deals with the avoidance of post-petition transfers. Since an asset transferred out of the estate is, by definition, no longer property of the estate, then a trustee could never avoid such a transfer under §549 and preserve it under §551.

G. Jacobson

The Panel's decision also contradicts *In re Jacobson*, 676 F.3d 1193 (9th Cir.2012). *Jacobson*, along with *In re White*, 389 B.R. 693, 703-4 (9thCir.BAP2008), *In re Smith*, 342 B.R. 801, 808 (9thCir.BAP2006) and *In re Konnoff*, 356 B.R. 201 (9thCir.BAP2006), recognize that some homestead exemptions, like those in California and Arizona, are subject to forfeiture if the debtor fails to timely reinvest the proceeds. Now that Tillman's 18 month reinvestment period under A.R.S. §33-1101(C) has lapsed (the sale closed on July 29, 2020 (ER-31)) Tillman's homestead exemption in the lien proceeds has been forfeited. That money was never "removed" from the estate. At best, Tillman had a defeasible interest in that money. *Jacobson* is consistent with the Supreme Court's ruling in *Schwab v. Reilly*, 560 U.S. 770 (2010) (a debtor's "dollar" exemption in an asset did not prevent the estate from realizing the remaining value of the asset for the benefit of the estate.) The Panel Decision is not.

J. Double Liability & Unintended Consequences

The Panel justified its judicial amendment of §724(a) on policy grounds. Maj. Op. at 23. In particular, the Panel took the bait offered by the IRS, i.e., that allowing the trustee to avoid the penalty lien, and distribute those funds to the unsecured creditors, subjected the debtor to "double liability".

First, whether the debtor is or will be subjected to "double liability" has never been decided. It is simply an assertion made by the IRS. Not surprisingly, the IRS allowed Tillman to receive a payment on her exemption at the closing of the sale even though the tax penalties were being paid to and held by the trustee. If the IRS *really* intended to pursue Tillman, query why it is that the IRS did not immediately seize those funds, or at least seek permission from the bankruptcy court to do so.

Second, and more importantly, this specter of double liability does not authorize the panel to judicially amend the Bankruptcy Code. As Circuit Judge Bumatay pointed out, the Supreme Court has made it crystal clear that, "The plain text of the Bankruptcy Code begins and ends our analysis." Diss. Op. at 28. §724(a) does not, by its plain terms, exclude from avoidance tax penalty liens that are secured by exempt property. The Panel only reached that conclusion by importing "property of the estate" from §726(a) into §724(a), even though §724(a) make no reference to §726(a). Such a strained reading of the Code is unwarranted and itself leads to unintended consequences.

For example, §726(a) also makes reference to 11 U.S.C. §510. §510(c)(2) provides that a lien securing a subordinated claim can be transferred to the estate. If a claim secured by a first lien deed of trust on exempt property is

subordinated pursuant to §510(c)(2), the Panel's interpretation of §724(a) would prohibit that lien from being transferred to the estate, because the collateral, an exempt asset, is "removed from the estate" upon the allowance of the exemption. Thus, according to the Panel's logic, the subordinated lien could not be transferred to the estate as provided for by §510(c)(2). As a result, §510(c)(2) would now be subject to the same judicial amendment that the Panel has grafted onto §724(a).

If the property were not exempt, and the trustee avoided the penalty lien and kept the proceeds, Tillman would still be subject to this phantom "double liability". The Panel's solution is half a loaf. The decision by Congress to redirect the proceeds of the penalty lien is not subject to judicial veto on policy grounds.

H. 11 U.S.C. §522

The Panel Decision also renders meaningless parts of 11 U.S.C. §522. The analysis begins with §522(c).

First, §522(c) does not NOT say that exempt property is "removed" from the estate. "Removed from the estate" is, at best, an inartful term that has gained a foothold from repetition is a number of judicial opinions. Circuit Judge Bumatay provided a thorough analysis of this very issue at Part B of his dissent. Diss. Op. at 30-34. What §522(c) says is that "property exempted" is "not liable"

for certain debts, with certain exceptions. Those exceptions include, (surprise!) "a tax lien, notice of which is properly filed".

From there, §522(h)(1) allows the debtor to avoid certain transfers under several of the avoidance powers of the Code including §724(a). However, §522(h)(2) limits the debtor's rights in those instances where the trustee has attempted to avoid the transfer.

Pursuant to the Panel's logic, there is absolutely no reason to include §724(a) in §522(h)(1) since, according to the panel, a trustee can NEVER avoid under §724(a) a penalty tax lien on exempt property.

The Panel Decision also renders meaningless the opportunity afforded to the debtor under §522(g) to exempt property which is otherwise preserved for the benefit of the estate under §551 which, of course, EXPRESSLY INCLUDES §724(a). **If the trustee can't avoid tax penalty liens on exempt property under §724(a), and preserve them for the benefit of the estate under §551, then why would Congress give the debtor an opportunity to reclaim that same property under §522(g)?** *DeMarah* recognizes the debtor's rights under §522(g). *DeMarah*, 62 F.3d at 1251 ("DeMarah would have been able to exempt his property from the estate if the trustee had recovered the transfer under either § 550 or § 551—by exercising the trustee's avoidance power under § 724(a).") The Panel Decision does

not. The Panel Decision says that a trustee can *never* avoid a tax penalty lien on exempt property, so the debtor can *never* exercise the rights afforded by §522(g). Both cannot be correct.

If the debtor can in fact exempt the property under §522(g), that solves the "double liability" issue which concerned the panel without the need for amending §724(a). Even if such judicial policy making were permitted, it is unnecessary to do so where Congress has already addressed the issue.

I. Amending The Recipe

As Circuit Judge Bumatay noted, bankruptcy is like a pie. The recipe is found in the Code. When the recipe is amended to suit the perceived need *du jour*, the results are unsatisfactory and the kitchen is thrown into turmoil. This decision creates bankruptcy turmoil.

CONCLUSION

For the foregoing reasons, this Court should grant the plaintiff-appellee's Petition For Rehearing or Rehearing En Banc. On rehearing, this Court should adopt the dissent and affirm the rulings of the district court and the bankruptcy court.

Dated: December 2, 2022

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CERTIFICATE OF COMPLIANCE

I certify pursuant to Ninth Circuit Rules 35-4 and 40-1, the foregoing Petition for Rehearing or Rehearing En Banc is proportionally spaced, has typeface of 14 points, and contains 3218 words.

Dated: December 2, 2022

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CERTIFICATE OF SERVICE

I hereby certify that on December 2, 2022 I electronically transmitted the foregoing document to the Clerk's Office using the ECF system for filing, and transmitted a copy of the filed document to the following ECF registrants:

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