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Tools-of-the-Trade Exemption Includes Digital Files as Documents

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The U.S. District Court for the District of Kansas recently affirmed a bankruptcy court decision holding that digital photographs and a website are exempt from creditors (and hence, the trustee's administration) under a Kansas tools-of-the-trade exemption statute.[1] The decision is an important data point in the treatment of digital assets by courts. More specifically, it appears to be the only published decision to consider whether intangible, digital assets such as a website and digital pictures can be "tools of the trade" under an exemption law. As a result, this decision provides useful authority for individual debtors seeking to protect digital business assets.

The Facts of the Case

A husband and wife, Colin and Cassandra MacMillan, filed for chapter 7 relief. Mr. MacMillan was a photographer for a company and had a side business selling his own photographs through a website as a sole proprietor.[2] Mrs. MacMillan helped with her husband's side business by managing the business's books, promoting the business and purchasing supplies,[3] as well as handling all of the accounting.[4] She performed this work without pay,[5] but also worked as a nanny "[o]n the side."[6] There was no evidence on the relative apportionment of Mrs. MacMillan's time between the side business and her work as a nanny.[7] That being said, there also was no dispute that Mrs. MacMillan did not create the "digitally manipulated landscape photographs" that the debtors sold to the public.[8]

The debtors' dispute with the trustee originated with the trustee's questions about the value of digital assets related to Mr. MacMillan's photography business. The debtors stored thousands of business and personal images for the website on a three-terabyte external hard drive.[9] To put it into perspective, a single terabyte hard drive can reportedly hold 310,000 photographs — and the debtors had three times that capacity.[10] The debtors did not exempt the digital images and website, and they were listed on their Schedule B as jointly owned with a value of $100.[11] According to the trustee, however, Mr. MacMillan testified at the § 341 meeting that $100 was the value on a per-image basis.[12]

Perhaps unsurprisingly given the trustee's inquiry about the value of the digital assets at the 341 meeting, the debtors filed an amended Schedule C[13] in which they claimed the digital photographs and website as exempt under the Kansas exemption statute.[14] In relevant part, Kansas provides that the following items may be exempted from estate property:

> books, *documents*, furniture, instruments, tools, implements and equipment, the breeding stock, seed grain or growing plants stock, or the *other tangible means of production regularly and reasonably necessary in carrying on the person's* profession, trade, *business* or occupation in an aggregate value not to exceed $7,500.[15]

The debtors also filed an amended Schedule B, valuing the digital assets at $3,500.[16] Shortly thereafter, the trustee objected to the claimed exemptions in the debtors' digital assets, contending that "they were not tangible means of production" and "the items were not required for [Mr. MacMillan's] primary occupation."[17]

The first argument was based on the trustee's preferred construction of the applicable exemption statute. The trustee read the words "or other tangible means of production" to mean that each of the prior categories of exempt assets (*e.g.*, documents) also had to be tangible in order to be exempt as a tool of the trade.[18] The second argument was based on the fact that state law restricted the tools-of-the-trade exemption to the implements of a debtor's

1 *Hamilton v. MacMillan (In re MacMillan)*, Civ. No. 15-4008-KHV, 2015 WL 8664203 (D. Kan. Dec. 11, 2015).
2 *In re MacMillan*, 2015 WL 8664203, at *1.
3 *Id.*
4 *Id.*
5 *Id.*
6 *Id.*
7 *In re MacMillan*, No. 14-40965, 2015 WL 148339, at *1 (Bankr. D. Kan. Jan. 9, 2015).
8 *Id.*
9 *Id.* at *3. It is not entirely clear from the bankruptcy or district court's decisions how many photographs were in play in the exemption dispute, but the debtors contended that there were thousands of images on the drive in their trial brief. *In re MacMillan*, Case No. 14-40965, Debtors' Trial Brief, p. 7 (Bankr. D. Kan. Dec. 10, 2014).
10 Melvin Foo, "How Much Can a 1-TB External Hard Drive Hold?," *PC Ninja*, Feb. 8, 2012, *available at* pcninja.us/how-much-can-a-1-tb-external-hard-drive-hold/ (unless otherwise indicated, all links in this article were last visited on Jan. 20, 2016).
11 *In re MacMillan*, 2015 WL 148339, at *1.
12 *In re MacMillan*, Case No. 14-40965, Trustee's Objection to Debtors' Amended Exemption of Digital Photos and Business Website, ¶¶ 3, 10 (Bankr. D. Kan. Nov. 5, 2014).
13 As the U.S. Supreme Court has now made clear, a debtor can amend Schedule C documents to alter or amend claimed exemptions as a matter of right, and bankruptcy courts do not have a "general, [federal] equitable power ... to deny exemptions based on a debtor's bad-faith conduct." Accordingly, courts may not do so unless there is applicable state law that would permit a disallowance of the exemption. *Law v. Siegel*, 134 S. Ct. 1188 (2014).
14 *In re MacMillan*, Case No. 14-40965, Amended Schedule C (Bankr. D. Kan. Nov. 4, 2014).
15 *In re MacMillan*, 2015 WL 148339, at *1 (quoting K.S.A. § 60-2304(a) (emphasis added)).
16 *In re MacMillan*, Case No. 14-40965, Amended Schedule B (Bankr. D. Kan. Nov. 4, 2014).
17 *Id.* at *1.
18 *Id.* at *2-*3.

primary occupation, rather than the hobbies or secondary work of a debtor.

The debtors responded by emphasizing the policy goal of the exemption statute: to ensure that debtors have sufficient assets to make a fresh start possible. Consequently, "the exemption laws are to be liberally construed, so as to effect the humane purpose of the legislature in enacting them."[19] They subsequently argued that the exemption statute applied just as equally to the digital assets as it would to an artist's tools:

> What debtors claim as exempt are his pallet, his brushes, his tints, his colors, his charcoals and his artistic works in progress.... Like the blacksmith, the milliner, the cheese maker, the vintner, the pressman and the architect, he is entitled to claim his tools of the trade and his tangible means of production regularly and reasonably necessary in carrying on his artistry.[20]

As to the trustee's second argument, that digital assets were not related to *Mr. MacMillan's* primary occupation, the debtors contended that Mr. MacMillan was principally engaged as an artist.[21] His employer sometimes paid him for his art, and sometimes he sold it directly.[22] "In either instance, it is his artistic efforts he sells, and the results of his work and the devices and the output claimed as exempt fit precisely within [the exemption statute]."[23]

19 *In re MacMillan*, Case No. 14-40965, Debtors' Trial Brief, p. 3 (Bankr. D. Kan. Dec. 10, 2014) (citing *Jenkins v. McNall*, 27 Kan. 532, 533 (Kan. 1882)).
20 *Id.* at p. 8.
21 *Id.* at p. 3.
22 *Id.*
23 *Id.*

The Bankruptcy Court's Decision

Following an evidentiary hearing, the bankruptcy court overruled the trustee's objections. The court first addressed the question of statutory construction: Was the Kansas exemption statute broad enough to include intangible, digital assets as tools of the trade? The short answer was "yes."[24]

The statute exempted a number of different types of property, including "documents" and "tools, implements and equipment," as well as "the other tangible means of production regularly and reasonably necessary in carrying on the person's ... business."[25] Although the exemption statute was "susceptible" to the trustee's narrow reading of it — treating "other tangible means" as indicating that each type of exempted property had to be tangible — the court disagreed and construed the statute broadly to effectuate its underlying policy.[26] As a result, the court determined that intangible, digital assets could be exempt as tools of the trade because "exemption laws are to be construed liberally in favor of exemption."[27] The court emphasized that "this reading is especially appropriate given the nature of many of the 'books, documents, ... instruments, [and] tools in today's electronic era, which are entirely digital and thus likely not tangible items. In this case, the digital images and the web-

24 *In re MacMillan*, Case No. 14-40965, 2015 WL 148339, at *3.
25 *Id.* at *2 (quoting K.S.A. § 60-2304(e)).
26 *Id.* at *3.
27 *Id.*

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law. As a consequence, the CFPB will likely move against other firms for other practices that they deem unfair or impermissible. Unfortunately, the practice of debt recovery will remain a perilous minefield until the CFPB eventually and belatedly promulgates its debt-collection rules, which it has delayed.

Until then, the CFPB will signal its intentions and view of the law by penalizing individual actors with expansive language. Consider the broad ambit of the language preceding the required relief in the CFPB's settlement with Hanna, applying it to "[d]efendants and all other persons in active concert or participation with any of them who receive actual notice of this Order, whether acting directly or indirectly through Outside Counsel." The CFPB has achieved the punishment of not only Frederick J. Hanna & Associates, PC and its three managing partners, but also of those who associated with them and, more alarmingly, those who might consider engaging the firm.[19]

19 Bankruptcy practitioners might be ill-advised to presume that the CFPB will be satisfied with targeting the collections practices of this firm. On the contrary, there is every reason to assume that the CFPB's expansive view of its powers will lead it to examine other practices such as bankruptcy.

The warning signs seem clear. Documentation requirements have been expanded and are more onerous for creditors, debt buyers and their attorneys. Attorneys may not rely on, but take responsibility for, the services provided by their paraprofessional staff, including routine reviews of the federal judiciary's case-management and docketing system. Instead, an attorney, properly admitted to his/her bar upon rigorous examination and oath, must personally read and review automated and tabular records regarding each of the many thousands of consumers who have not paid their debts, have filed bankruptcy petitions or both. Attorneys must ensure that affidavit evidence is demonstrably based on the affiant's personal knowledge and review, as well as be accurate. Surprisingly, an attorney is now personally responsible and culpable for defects in the affidavit executed by a client.

Exactly how it is possible that an attorney could police the quality and sufficiency of a client's affidavit remains unclear. More practically, the inevitable result of this case, as with all new regulations, is an increase in the cost of attorney services and, consequently, a likely additional burden for consumers. abi

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site are electronic documents and ... are amenable to exemption under [the exemption statute]."[28]

The court's treatment of the digital assets as "documents" is sensible because it reflects commercial realities and is consistent with laws such as the widely adopted Uniform Electronic Transactions Act, which provides that signatures and contracts shall not be deemed unenforceable solely because they are in electronic form.[29]

Next, the bankruptcy court rejected the trustee's argument that the debtors could not claim the digital assets as exempt because they were "not related to [Mr. MacMillan's] primary occupation."[30] There was another basis for the claimed exemption: Mrs. MacMillan claimed the digital assets as exempt in her own right.[31] Having the burden of proof as the party objecting to the debtors' exemptions, the trustee "fail[ed] to address [the] argument that [Mrs. MacMillan] could exempt the items herself."[32] Namely, the court observed that the "trustee provided no evidence to suggest that the items in question were not tools of the trade for ... [*Mrs. MacMillan's*] primary occupation" of doing the business's accounting and promotional work.[33]

To support this conclusion, the court cited to a "long line of 'farmer's wife' cases, which establish that a spouse, engaged together in an occupation with the other spouse, is able to claim the Kansas tools-of-the-trade exemption for property used to run that business if that business is the *primary occupation* for the spouse claiming the exemption."[34] While the trustee "appeared" implicitly to challenge Mrs. MacMillan's claim of an exemption based on the argument that her husband owned the assets as part of his sole proprietorship, the "farmer's wife" cases take a different approach.[35]

Under the "farmer's wife" theory, "[t]he test for co-ownership between a husband and wife engaged in an enterprise like this is not the form of the business or whose name appears on the business documents."[36] Instead, the debtors' "intent and conduct controls."[37] Because Mrs. MacMillan was not paid for her work for the photography business, "it [was] clear ... that the Debtors consider ... [Mrs. MacMillan] not an employee of her husband's business, but rather a co-owner engaged in building the business."[38] An affirmative finding about ownership of the photography business and its assets was unnecessary to overrule the objection because the trustee had the burden of proof, which she failed to meet.[39]

The District Court's Decision

On appeal,[40] the district court acknowledged that the bankruptcy court did not address whether the debtors used the digital images as a means of production, as is seemingly required by the statute. However, the district court declined to remand for this reason because the facts supporting the use of digital images were "clear and undisputed,"[41] akin to "business cards or a portfolio" used to promote Mr. MacMillan's photography business.[42] With respect to

28 *Id.*
29 Uniform Law Commission, Electronic Transactions Act, *available at* uniformlaws.org/Act.aspx?title=Electronic%20Transactions%20Act.
30 *In re MacMillan*, No. 15-4008-KHV, 2015 WL 8664203, at *1.
31 *In re MacMillan*, 2015 WL 148339, at *3. It does not appear that either party briefed this issue prior to the hearing.
32 *Id.*
33 *Id.* (emphasis added).
34 *Id.* (emphasis added).
35 *Id.* at *4.
36 *Id.*
37 *Id.* (quoting *In re Lampe*, 331 F.3d 70 (10th Cir. 2003)).
38 *Id.*
39 *Id.*
40 *In re MacMillan*, Case No. 14-40965, Notice of Appeal and Statement of Election to District Court (Bankr. D. Kan. Jan. 21, 2015).
41 *In re MacMillan*, 2015 WL 8664203, at *2.
42 *Id.*

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the trustee's argument that Mrs. MacMillan could not have claimed the exemption because she did not own the images, the district court agreed with the bankruptcy court that the trustee "did not satisfy that burden."[43]

But It's Just an Exemption Fight, Right?

This case presents several practice pointers. First, exemption statutes are usually broadly construed, and practitioners should look for appropriate opportunities to schedule and exempt digital assets. In this case, the court rejected a narrow reading to further the statute's underlying policy goals. Given that many areas of the law are still catching up to the explosive growth and proliferation of all manner of digital assets (*e.g.*, social media accounts, websites and more), debtor's counsel should schedule digital assets and be sure to claim them as exempt if it is reasonably possible to do so.

Second, with the rising cost of commercial chapter 11 cases (even for small businesses), practitioners should consider whether there are creative strategies to make a chapter 7 or 13 filing possible, such as conveying business assets to a principal subject to the business debt (to minimize fraudulent transfer claims). Not only could this be a less-expensive route to a discharge or reorganization, but it could also provide debtors with creative arguments to exempt assets used in business once owned and used by the individual, such as websites, social media accounts and the like. Emerging case law has confirmed what practitioners should already know: Social media accounts such as Facebook and Twitter have value to business debtors.[44] Given these business realities, *In re MacMillan* presents a strong argument in favor of exempting these types of assets.

Finally, as new and largely intangible forms of property emerge, are integrated into daily life and are ultimately employed by individuals in the pursuit of their livelihoods, practitioners, trustees and courts will continue to wrestle with the boundaries of exemption statutes that were drafted at a time that had a much different conception of "tools of the trade." This presents fertile ground for creative strategies for attorneys to continue to explore. abi

43 *Id.* at *3.

44 *See, e.g.*, Danny C. Kelly, Bria LaSalle Mertens and David J. Pacheco, "What's in a (Domain) Name? Considerations for Perfecting Liens on Cyber Assets," XXXII *ABI Journal* 8, 22, 97, September 2013 (noting that there is open debate as nature of property interests represented by domain names); Andrew C. Helman, "Debtor Owns Social Media Accounts Created by Its Former Principal," XXXIV *ABI Journal* 7, 26-27, 66-67, July 2015. Both articles are available at abi.org/abi-journal.

Benchnotes

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over which appellant argued there should be no related-to jurisdiction because they have no actual effect on estate);

• *Dittmaier v. Sosne (In re Dittmaier)*, 806 F.3d 987 (8th Cir. 2015) (affirmed denial of debtor's exemption in $5,000 portion of her pre-petition tax refund attributable to her earned income credit, explaining that under applicable Missouri law, exemption only applied to debtor's "right to receive" future public assistance such as tax credits and Social Security, but not actual money that debtor may have already received; thus, because debtor received her tax refund five hours before filing her bankruptcy petition, she could not claim money as exempt);

• *In re UAL Corp.*, --- F.3d ---, 2015 U.S. App. LEXIS 22913, Case No. 13-2800 (7th Cir. Dec. 31, 2015) (bankruptcy court's refusal to reopen complex bankruptcy cases three years after they were closed was not abuse of discretion, given claimant's failure to protect his interests for nearly decade; district court clerk's error in failing to docket removed lawsuit as bankruptcy adversary proceeding and then remanding suit to California instead of Illinois Bankruptcy Court did not excuse claimant's utter lack of action from 2006-13);

• *In re Margulies*, 541 B.R 156 (Bankr. S.D.N.Y. 2015) (regarding incident where debtor intentionally rolled his car into construction worker who was standing in middle of busy Manhattan street to slow traffic, and construction worker obtained default judgment because debtor's insurer declined to defend civil action, bankruptcy court held that debt was nondischargeable under § 523(a)(6) because debtor acted willfully and maliciously, even though he did not intend to injure worker; debtor knew likely outcome of his actions was that he would run over the worker, and no "economic benefit" (even prospective meeting with Gov. Mario Cuomo, to which debtor was running late) could justify rolling one's car into another merely to clear path);

• *Computershare Trust Co. NA v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 539 B.R. 723 (Bankr. D. Del. 2015) (rejecting second-lien holders' efforts to obtain make-whole premiums in their secured claim, and adopting Bankruptcy Judge **Robert D. Drain**'s *Momentive* decision, which similarly denied make-whole premiums under identical indenture language and explained that there are only two ways to receive make-whole premiums upon acceleration under New York law: (1) explicit recognition that make-whole would be payable notwithstanding acceleration, or (2) provision that requires borrower to pay make-whole whenever debt is repaid prior to original maturity — neither of which circumstance was presented here);

• *Meadows v. AMR Corp.*, 539 B.R 246 (S.D.N.Y. 2015) (late-filed amendments could not relate back to timely filed claim because original claim did not reference or put debtors on notice of possibility for additional claims to be filed, and late-filed amendments sought 10 times the amount as original claim, and were based on events that occurred years after events referenced in original claim);