

In the United States Bankruptcy Court

for the Northern District of Iowa

BYRON D. SMEBY and LINDA J. SMEBY
Debtors.

Bankruptcy No. X88-00159M
Chapter 11

ORDER RE OBJECTION TO EXEMPTION OF LIFE INSURANCE

The matter before the court is the objection to the debtors' claims of exemption in life insurance policies issued by State Farm Life Insurance Co. (STATE FARM).

A hearing was held in Mason City, Iowa on March 15, 1989. The court now issues the following ruling. This is a core proceeding under 28 U.S.C. 157(b)(2)(B).

Debtors Byron and Linda Smeby filed their chapter 11 case on February 1, 1988. On January 20, 1988, the Smebys met with an agent from State Farm and on that date each made application to State Farm and paid for a universal life insurance policy. The debtors claimed the insurance policies as exempt under Iowa Code 627.6(7). The exemption claim is more appropriately considered under 627.6(6) (1987).

Farm Credit Services (FCS) filed an objection to the claims on March 10, 1988 stating:

The objection to the life insurance exemption is made based upon information and belief of the Federal Land Bank of Omaha that all or a portion of the funds used to purchase the life insurance claimed exempt were funds in which the Federal Land Bank had an interest. This objection is also made upon the information and belief that the Debtors purchased all or a major portion of the life insurance claimed exempt for the sole purpose of hindering, delaying or defrauding their creditors.

Copies of the policies and applications for policies were introduced into evidence. During the course of discovery, FCS obtained information from Smebys as to the dates of application, payment, issue and effectiveness of the policies.

The same evidence was introduced at trial. In arguing its objections at the close of the evidence, FCS also raised the legal issue of whether the policies were "insurance" within the meaning of Iowa Code 627.6(6) (1987) on the date of the filing of the case or whether as FCS argued, the debtors had merely made application for insurance and had deposited funds with State Farm.

Debtors objected that this issue had not been timely raised and claimed surprise. Debtors say that the court should not consider this issue, but if it does, the court should permit the debtors to introduce additional evidence because of surprise.

Debtors elaborate that it would have been impossible for the debtors to prepare a defense to all possible grounds of objection, and that they were entitled to advance notice from FCS on this issue. Counsel for debtors argued that he had inquired during a deposition of an FCS representative as to the

basis of the objection to the life insurance exemption. The lack of the existence or effectiveness of the policies at the time of filing, if that is the case, was not given as the basis for any objection.

The record is unclear as to when FCS discovered this issue. FCS did not receive the applications and policies until the day it examined or deposed Smebys. The court cannot say from the representations of counsel or from the evidence that FCS had identified this issue prior to debtors' deposition of the FCS representative. FCS did identify it as an issue prior to trial and made no application to amend its objections. Both counsels state, and the court believes, that any lack of advance notice to debtors from FCS on this issue was not intentional.

Rule 4003 of the Federal Rules of Bankruptcy Procedure governs objections to exemptions. The Rule does not specify the exact form of the objection necessary. Issues as to the debtors' claim of exemption are not raised by motion. However, they are contested matter proceedings under Bankr. R. 9014. Contra Shuman v. McDonald (In re Shuman), 78 B.R. 254, 256 (Bankr. 9th Cir. 1987). As to contested matters, Bankr. R. 9014 does not make applicable the general rules of pleading (Bankr. R. 7008) or amendment to pleadings (Bankr. R. 7015). Rule 4003(b) is generally silent on the form or specificity of the objections.

Rule 4003(c), however, does indicate that "After hearing on notice, the court shall determine the issues presented by the objections." This seems to imply that objections to exemptions should be lodged with specificity as to "issues" which term is not defined by the Code or Rules. "Issues" could be construed to require specificity as to either the items claimed as exempt or as to the grounds for the objection, or both.

Debtors argue that at sometime prior to the date of hearing on an objection to exemption, debtors are entitled to know the basis for those objections in order to reasonably prepare for trial. The court agrees that an objector should provide the debtor(s) with some basis for the objection to the exemption prior to the hearing. The debtors need sufficient details regarding the objections in order to adequately prepare for hearing on the exemption issue. It is unreasonable to expect the debtors to be prepared to defend an objection without knowing the basis of the objection. However, there does not appear to be any applicable rule which requires the objecting party to state the basis of its objection in its written filing.

The problem is somewhat compounded by the fact that there is a time limitation for filing objections to exemptions, and therefore any attempt to change the "issues" of the objections might face opposition from debtors on the ground that it is untimely from the standpoint of the deadline provided in Bankr. R. 4003(b). At least two bankruptcy judges have indicated that if amendments to objections to exemptions raise new legal grounds to support the original, timely filed objections, they might permit amendments to objections to relate back to the original objections. In re Froid, 89 B.R. 950, 952 (Bankr. M.D. Fla. 1988); In re Blum, 39 B.R. 897, 898 (Bankr. S.D. Fla. 1984). The Blum court would apparently make the rules of pleading and amendment applicable to exemption objectors. *Id.* at 898.

An objection to exemptions listing only the property claimed as exempt but listing no grounds in support of the objection, may not provide a debtor sufficient due process. Shuman v. McDonald (In re Shuman), 78 B.R. 254, 256 (Bankr. 9th Cir. 1987). However, such denial of due process may be cured during the course of the proceedings. *Id.* at 256. Supporting the argument of FCS is First National Bank of Mobile v. Norris, 701 F.2d 902 (11th Cir. 1983). In that case, the Court of Appeals stated:

If an objection to a claimed exemption is filed, the trustee should be able to raise any arguable ground, even if it was not specifically set forth in the objection. Although we have been cited no authority to support this proposition, it seems sound to us in view of the trustee's representative position and the fact that an objection puts the debtors on notice that they must defend the claimed exemptions against any argument that may develop in the proceeding. This is especially true when the issue is legal rather than factual.

First National Bank of Mobile v. Norris, 701 F.2d 902, 903 (11th Cir. 1983). The Circuit did not express whether such a rule should be less liberal for other parties-in-interest.

The case at bar is made more difficult by the fact that complex facts were not necessary to support the objection now raised by FCS. As the court views it, the applications for the policies, the policies, and the evidence as to the application date, premium payment date, issue date, and effective date were evidence that would normally have been introduced in support of FCS's written objections. The development of these facts during discovery would not naturally have alerted the debtors as to this ground of objection, given the specific objections of FCS already filed.

Based on the written objections, debtors reasonably prepared their defense without the use of testimony of an insurance agent or other insurance company employees. Debtors' preparation may have been different, however, as to the existence of the insurance on the date of filing.

Debtors made an effort to learn of the basis for the FCS objection. They engaged in discovery, and in this discovery, the issue of the policies not existing on the date of filing did not surface.

The purpose of discovery is to reduce the possibility of surprise at the time of trial. Nedimyer v. Pennsylvania R. R. Co., 6 F.R.D. 21, 23 (E.D. Pa. 1946); Chandler v. Cutler-Hammer, Inc., 31 F.Supp. 453, 454 (E. D. Wis. 1940).

Debtors were surprised at trial and were at a disadvantage in responding to the argument of objector on this issue.

There are three potential judicial responses to this problem. The court could refuse to entertain the issue raised by FCS because it failed to specify this issue in its written objections or to advise the debtors of the issue's existence once it was identified by FCS. Second, the court could entertain the issue without further evidence. Third, the court could reach the issue but reopen the record to allow debtors to introduce further evidence as to the existence of the policies as of the date of filing.

The court believes in this case, the latter result is the most fair and acceptable. The court reaches this conclusion for several reasons. There was no advance warning to FCS that rules of pleading, either Bankr. R. 7008 or 7015, would be applicable to the objections to exemptions. There is support for the argument of FCS that objections to exemption should be a free-swinging affair.

the policies did exist. This court will, therefore, issue its order reopening the record in this case to permit further hearing and introduction of evidence as to whether the insurance policies claimed as exempt were insurance policies within the meaning of Iowa law on the date of the filing of the bankruptcy case.

This ruling should not be read as establishing the general application of rules of pleading to contested matter proceedings. This is better handled by local rule or by individual orders entered in individual

cases pursuant to Bankr. R. 9014. The intent of this order is to resolve the dilemma which exists in this particular case and under these particular circumstances.

ORDER

IT IS THEREFORE ORDERED that the record in the contested matter proceeding arising out of the Farm Credit System's objections to debtors' claim of exemption shall be reopened and that the debtors may introduce further evidence as to the issue of whether the purchase policies claimed as exempt **by** them were insurance within the meaning of Iowa law at the time of the filing of the bankruptcy case. FCS shall have the opportunity to rebut. The clerk shall set this matter for further hearing forthwith.

SO ORDERED ON THIS 5th DAY OF MAY, 1989.

Judge William L. Edmonds