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**Small Business Owners are Entitled to Exempt Reasonable Compensation from the
Bankruptcy Estate**

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Introduction

The COVID-19 pandemic greatly impacted small business owners in the United States. In March 2020, the United States Small Business Administration (“SBA”) began aiding eligible small business owners in the form of Economic Injury Disaster Loans (“EIDL”).¹ EIDLs were made available to small businesses that were unable to meet existing financial obligations for necessary operating costs.² Those funds can be used to “make regular payments for operating expenses, including payroll.”³

This article addresses whether small business owners are entitled to pay themselves reasonable compensation as earnings for their efforts, which in turn may be exempted from their future bankruptcy estates. Part I analyzes who has the burden of proving that an exemption is not properly claimed in a bankruptcy proceeding. Part II examines whether a debtor is entitled to amend his or her claim of exemptions until the case is closed. Part III discusses whether the debtor’s reasonable earnings can be exempt from the bankruptcy estate and whether the transfer

¹ *COVID-19 Economic Injury Disaster Loan*, U.S. Small Business Administration, <https://www.sba.gov/funding-programs/disaster-assistance/economic-injury-disaster-loans>.

² *Id.*

³ *Id.*

of EIDL funds from an entity's account to a debtor's personal bank account qualify as earnings or as a "transfer of profits."

Discussion

I. The Trustee has the Burden of Proving that an Exemption is not Properly Claimed in a Bankruptcy Proceeding.

Exemptions are interests that are withdrawn from the bankruptcy estate and enable debtors to have a "fresh start," which is a "central feature of American consumer bankruptcy law."⁴ Rule 4003 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") provides that "the objecting party has the burden of proving that the exemptions are not properly claimed" and must do so by a preponderance of the evidence.⁵ Additionally, exemption statutes are to be construed liberally and in favor of the debtor.⁶

II. The Debtor is Entitled to Amend their Claim of Exemptions Until the Case is Closed.

Pursuant to Bankruptcy Rule 1007, a debtor is required to file schedules of assets and liabilities within 15 days of the petition date.⁷ In doing so, the debtor may exempt certain property from the bankruptcy estate. Title 11 of the United States Code (the "Bankruptcy Code") permits states to "opt out" of federal exemptions and enact their own, which most states have opted to do.⁸ Consequently, in states that have "opted out" of federal exemptions, debtors are relegated to the relevant statutory state exemptions.⁹

⁴ Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets On The Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. REV. 235, 235 (1995).

⁵ See FED. R. BANKR. P. 4003(c), 11 U.S.C.A.; *In re Sheeran*, 369 B.R. 910, 918 (Bankr. E.D. Va. 2007).

⁶ See *In re Giffune*, 343 B.R. 883, 896 (Bankr. N.D. Ill. 2006); see also *In re McFarland*, 481 B.R. 242, 248 (Bankr. S.D. Ga. 2012); *In re Sheeran*, 369 B.R. at 918.

⁷ FED. R. BANKR. P. 1007.

⁸ Richard I. Aaron, 1 *Bankruptcy Law Fundamentals* § 1:3 (June 2022).

⁹ See VA. CODE ANN. § 34-3.1 (2021); NEB. REV. STAT. § 25-15, 105 (2022); COLO. REV. STAT. § 13-54-107 (2023).

A debtor is allowed to amend a claim of exemptions as long as the case remains open.¹⁰ Additionally, Bankruptcy Rule 4003 specifically acknowledges amendments to exemptions.¹¹ Courts have looked to the plain language of Bankruptcy Rule 1009(a) in determining that a debtor may amend exemptions without court approval prior to the closing of a case, with a few judicially created exceptions.¹² For example, a debtor cannot amend exemptions if “he or she has done so in bad faith, has concealed property, or if creditors or third parties would be prejudiced by the amendment.”¹³

III. Reasonable Earnings for Small Business Owners can be Exempted from the Bankruptcy Estate in Some Jurisdictions.

Exemption laws not only “seek to balance the needs of debtors and their dependents with the rights of creditors, they [also] inherently reflect a public policy in favor of having debtors retain essential property over the satisfaction of creditor’s claims.”¹⁴ For example, various states have enacted “wage exemption” statutes that enable debtors to exempt reasonable earnings from the bankruptcy estate and therefore, protect their reasonable earnings from creditors.¹⁵

For small business owners declaring bankruptcy and claiming that wages are exempt, courts look to various factors in determining what qualifies as wages as opposed to business profits. For example, while the Second Circuit generally does not allow exemption of earnings for a business that the debtor conducts, it “allows an exemption only when the debtor’s personal services are the chief factor in the creation of net income.”¹⁶ Additionally, the Eleventh Circuit

¹⁰ FED. R. BANKR. P. 1009(a), 11 U.S.C.A. (“A voluntary petition, list, schedule, or statement may be amended by the debtor as a matter of course at any time before the case is closed”).

¹¹ FED. R. BANKR. P. 4003(b)(1) (“[A] party in interest may file an objection to the list of property claimed as exempt within 30 days after the meeting of creditors held under § 341(a) [11 USCS § 341(a)] is concluded or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later.”).

¹² See *In re Averette*, No. 07-04008-DD, 2008 Bankr. LEXIS 1649, at *7–*8 (Bankr. D.S.C. June 2, 2008).

¹³ *Id.*

¹⁴ *In re Foster*, 556 B.R. 233, 241 (Bankr. E.D. Va. 2016).

¹⁵ See VA. CODE ANN. § 34-29 (2021); NEB. REV. STAT. § 25-1558 (2022); FLA. STAT. § 222.11 (2022).

¹⁶ *In re Dziedzic*, 403 B.R. 293, 296 (Bankr. W.D.N.Y. 2009).

held that “a debtor that owns or controls a business cannot exempt the funds he distributes himself from the business simply by calling the money ‘wages’” and that in order for the exemption to apply, “the debtor must not only perform personal services to the business, [but] must also receive regular compensation dictated by the terms of an arms-length employment agreement.”¹⁷ Specifically, the Eleventh Circuit found that an attorney with a private practice was akin to an owner of a corporation because he had complete control of his compensation and employment terms with no formal employment contract.¹⁸ The court therefore held the money derived from the attorney’s law practice was not exempt as wages.¹⁹

Additionally, the Fourth Circuit concluded that the transfer of EIDL funds to a debtor’s bank account qualified as exempt earnings because the business was not profitable at the time of transfer and the debtor had not received compensation in a significant amount of time prior to transfer.²⁰ In *In re Raza*, the debtor was an owner of a small business that contracted with Uber to provide drivers and cars.²¹ The debtor regularly drove for his company when it was understaffed and received a consistent paycheck.²² In December 2021, the debtor applied for an EIDL for 4 Star and received \$75,400.00, which he transferred to his personal bank account.²³ The next day, the debtor filed a voluntary petition under Chapter 7 of the Bankruptcy Code.²⁴ The debtor initially claimed that the EIDL funds were not property of his personal bankruptcy estate but later claimed that \$56,000.00 (approximately 75%) of those funds were exempt as earnings and therefore unavailable for distribution to his personal creditors.²⁵ The Fourth Circuit

¹⁷ *In re Manning*, 163 B.R. 380, 382 (Bankr. S.D. Fla. 1994).

¹⁸ *In re Zamora*, 187 B.R. 783, 785 (Bankr. S.D. Fla. 1995).

¹⁹ *Id.*

²⁰ *In re Raza*, No. 21-12075-KHK, 2022 WL 2348789, at *4 (Bankr. E.D. Va. June 29, 2022).

²¹ *Id.* at *1.

²² *Id.*

²³ *Id.* at *6.

²⁴ *Id.*

²⁵ *Id.*

agreed with the debtor because the business was unprofitable, and the debtor had not received regular compensation.²⁶ Conversely, if there is evidence of a small business being profitable and the small business owner was regularly compensated, the transfer of EIDL funds to a business owner's bank account would likely qualify as a transfer of profits and not be exempt from the bankruptcy estate.

Conclusion

For small business owners declaring bankruptcy, the line between what qualifies as business profits and reasonable earnings often becomes blurred. Bankruptcy courts look to various factors in determining whether small business owners are entitled to pay themselves reasonable compensation as earnings for their efforts, which in turn may be exempted from the bankruptcy estate. Those factors include (1) the impact a business owner's work had on the creation of net income, (2) whether there was an arms-length employment agreement, (3) whether the business owner regularly received a paycheck, and (4) whether the business was profitable leading up to bankruptcy.

²⁶ *Id.* at *4.