EXEMPTIONS

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I. The Snapshot Rule

The Snapshot Rule was first conceived in *White v. Stump* where the debtor filed bankruptcy before properly establishing his homestead as exempt under Idaho law. 226 U.S. 310, 311 (1924). The debtor claimed the homestead exemption anyway, and the trustee objected. In holding for the trustee, the Supreme Court stated:

> The Bankruptcy Law does not directly grant or define any exemption but directs...that the bankrupt be allowed the exemptions 'prescribed by the state laws in force at the time of the filing of the petition'; in other words, it makes the state law existing when the petition is filed the measure of the right to exemptions.

The Snapshot Rule requires that the law that existed on the date of the filing of the petition prevail along with all of the law's contingencies, conditions, and limitations whether favorable or unfavorable.

The Supreme Court refined the Snapshot Rule in *Myers v. Matley*, 318 U.S. 622 (1943). There, just as in *White v. Stump*, the debtor attempted to designate a homestead exemption after filing the bankruptcy petition. *Myers,* 318 at 624. Because the underlying exemption entitled the debtor to his homestead exemption if the selection and recording occurred any time before actual execution sale, the Supreme Court held:

> In conformity to the principle announced in *White v. Stump* that the bankrupt's right to a homestead exemption becomes fixed at the date of the filing of the petition in the bankruptcy and cannot thereafter be enlarged or altered by anything the bankrupt may do, it remains true that, under law of Nevada, the right to make and record the necessary declaration of homestead existed in the bankrupt at the date of filing the petition as it would have existed in case a levy had been made upon the property. *Id.* at 628.

While confirming *Stump v. White's* holding, *Myers* clarifies that it is the entire exemption law applicable on the filing date that is determinative.

As years passed, most courts interpreted these decisions to mean that proceeds of exempt property do not become property of the bankruptcy estate under 11 U.S.C. § 541(a)(6). The familiar analysis began by stating that when a debtor files bankruptcy, all of the debtor's property becomes property of the estate which necessarily includes any property which the debtor intends to claim as exempt. § 541(a)(1)-(2); *Taylor v. Freeland & KronzI,* 503 U.S. 638, 641 (1992). Unless the debtor claims the property as exempt, the property will remain in the estate. *See Hardage v. Herring Nat. Bank*, 837 F.2d 1319, 1322 (5th Cir. 1988). If the debtor claims property as exempt, the interested parties must object within thirty days of the first meeting of creditors, or the property will be deemed exempt. § 522(l); FED. R. BANKR. P. 4003; *Taylor*, 503 U.S. at 642. The proper date for determining whether an exemption exists is, in the usual case, the date of filing of the bankruptcy petition. *Owen v. Owen*, 500 U.S. 305, 314 n. 6 (1991).

Applying this rationale, a majority of courts held that a post-petition change in character of property properly claimed as exempt will not change the exempt status of that property by relying on the principle that once property is exempt, it is exempt forever and nothing occurring post-petition can change it. *Armstrong v. Peterson (In re Peterson)*, 897 F.2d 935, 937 (8th Cir. 1990) (debtor's post-petition death did not cause his homestead exemption to lapse); *Payne v. Wood (In re Payne)*, 775 F.2d 202, 204 (7th Cir. 1999) (insurance proceeds of destroyed exempt property did not become property of the estate); *Lasich v. Estate of A.N. Wickstrom (In re Wickstrom),* 113 B.R. 339, 343-44 (Bankr. W.D. Mich. 1990)(debtor's post-petition death did not cause exempt worker's compensation proceeds to lapse); *In re Whitman*, 106 B.R. 654, 656-57 (Bankr. S.D. Cal. 1989)(conversion of homestead to proceeds post-petition does not cause proceeds to become property of the estate); *In re Harlan*, 32 B.R. 91, 92-92 (Bankr. W.D. Tex. 1983)(conversion of homestead to proceeds post-petition does not cause proceeds to become property of the estate); *Reed v. Yochem (In re Reed)*, 184 B.R. 733, 738 (W.D. Tex. 1995)(Note and its proceeds from the post-petition disposition of exempt homestead did not become property of the estate). These cases reasoned that property which is deemed exempt is no longer property of the estate, so subsequent changes in character do not restore it to the estate. *See Owen*, 500 U.S. at 307-08.

II. The Texas Homestead Exemption

Under the Snapshot Rule, and as made clear by *Myers*, the analysis of any claim of an exemption always begins with the applicable statute. The authority for the Texas Homestead exemption is found Tex. Const. art XVI §§ 50, 51; TEX. PROP. CODE §§41.001 to 41.002.

Tex. Const. art XVI § 50 sets out that the ". . . homestead of a family, or of a single adult person, shall be, and is hereby protected from forced sale for the payment of all debts . . ." except for certain enumerated mortgages, trust deeds, and liens. Tex. Const. art XVI § 51 then defines the size and permissible uses of a homestead by providing:

> The homestead, not in a town or city, shall consist of not more than two hundred acres of land, which may be in one or more parcels, with the improvements thereon; the homestead in a city, town or village, shall consist of lot or contiguous lots amounting to not more than 10 acres of land, together with any improvements on the land; provided, that the homestead in a city, town or village shall be used for the purposes of a home, or as both an urban home and a place to exercise a calling or business, of the homestead claimant, whether a single adult person, or the head of a family; provided also, that any temporary renting of the homestead shall not change the character of the same, when no other homestead has been acquired; provided further that a release or refinance of an existing lien against a homestead as to a part of the homestead does not create an additional burden on the part of the homestead property that is unreleased or subject to the refinance, and a new lien is not invalid only for that reason.

These constitutional protections are then codified in the Texas Property Code beginning with § 41.001. Subsection (c) which contains the "six-month rule" is particularly important in the discussion that follows. The statute provides:

(a) A homestead and one or more lots used for a place of burial of the dead are exempt from seizure for the claims of creditors except for encumbrances properly fixed on homestead property.

(b) Encumbrances may be properly fixed on homestead property for:
    (1) purchase money;
    (2) taxes on the property;
    (3) work and material used in constructing improvements on the property if contracted for in writing as provided by Sections 53.254(a), (b), and (c);
    (4) an owelty of partition imposed against the entirety of the property by a court order or by a written agreement of the parties to the partition, including a debt of one spouse in favor of the other spouse resulting from a division or an award of a family homestead in a divorce proceeding;
    (5) the refinance of a lien against a homestead, including a federal tax lien resulting from the tax debt of both spouses, if the homestead is a family homestead, or from the tax debt of the owner;
    (6) an extension of credit that meets the requirements of Section 50(a)(6), Article XVI, Texas Constitution; or
    (7) a reverse mortgage that meets the requirements of Sections 50(k)-(p), Article XVI, Texas Constitution.

(c) The homestead claimant's proceeds of a sale of a homestead are not subject to seizure for a creditor's claim for six months after the date of sale.

Finally, § 41.002 simply defines a homestead under Texas law. It provides:

(a) If used for the purposes of an urban home or as both an urban home and a place to exercise a calling or business, the homestead of a family or a single, adult person, not otherwise entitled to a homestead, shall consist of not more than 10 acres of land which may be in one or more contiguous lots, together with any improvements thereon.

(b) If used for the purposes of a rural home, the homestead shall consist of:
    (1) for a family, not more than 200 acres, which may be in one or more parcels, with the improvements thereon; or
    (2) for a single, adult person, not otherwise entitled to a homestead, not more than 100 acres, which may be in one or more parcels, with the improvements thereon.

(c) A homestead is considered to be urban if, at the time the designation is made, the property is:
    (1) located within the limits of a municipality or its extraterritorial jurisdiction or a platted subdivision; and

(2) served by police protection, paid or volunteer fire protection, and at least three of the following services provided by a municipality or under contract to a municipality:
   (A) electric;
   (B) natural gas;
   (C) sewer;
   (D) storm sewer; and
   (E) water.

(d) The definition of a homestead as provided in this section applies to all homesteads in this state whenever created.

III. Sale of a Texas Homestead in Chapter 7 Cases

England v. Fed. Deposit Ins. Corp. (In re England) is cited in all subsequent Fifth Circuit opinions regarding the Texas homestead exemption's six-month rule and forms the foundation of the Court's subsequent decisions regarding the Texas homestead exemption. 975 F.2d 1168 (5th Cir. 1992). Two weeks before filing bankruptcy, Chapter 7 debtors sold their urban homestead for cash and a note and moved onto their ranch. *Id.* at 1170. Two days later, they filed bankruptcy. *Id.* Debtor elected Texas exemptions and tried to exempt the ranch as a rural homestead and the note proceeds which were used to improve the ranch and pay living expenses. *Id.*

The Fifth Circuit Court of Appeals stated that when a debtor sells a Texas homestead, the six-month window instantly activates and the sale proceeds are exempt. *Id.* at 1174. But when someone acquires another homestead during that six months, they change the prior homestead (and the proceeds from the sale of that prior homestead) to a former homestead and instantly deactivate the protection of the proceeds. *Id.* The Court concluded that the exemption statute solely allowed the claimant to use the proceeds to purchase another homestead, but it did not protect the proceeds in and of themselves or permit investment in improvements to the homestead. The court held that when the debtor designated his ranch as his homestead, he automatically terminated his right to exempt any proceeds, including the note proceeds, from the sale of his urban homestead. *Id.*

Building on that case, in *Zibman*, Chapter 7 debtors sold their Texas homestead and filed bankruptcy before the six month period elapsed. *Zibman v. Tow (In re Zibman)*, 268 F.3d 298, 300 (5th Cir. 2001). Debtors deposited the proceeds into a bank account, claimed the proceeds as exempt, and relocated to Massachusetts. *Id.* The debtors never returned to Texas and never purchased a Texas homestead with the proceeds. *Id.* at 301. After the six-month period passed, the Chapter 7 trustee objected to the exemption of the proceeds. *Id.* The bankruptcy court overruled the trustee's objection holding that because the debtors filed bankruptcy within six months of the sale, the proceeds were protected and remained permanently exempt. *Id.*

The Fifth Circuit concluded that the bankruptcy court did not apply the entire exemption law that applied by freezing the exemption for proceeds simply because the exemption was in effect on the date the bankruptcy petition was filed. *Id.* at 304. The lower courts had transformed a limited exemption into a permanent exemption. *Id.* In holding that a debtor who elects exemptions accepts the rights and limitations of those exemptions, the court stated that not only

must the debtor use the homestead proceeds in the six-month time period but also that the debtor must invest the proceeds in another Texas homestead. *Id.* at 305.

Studensky v. Morgan (In re Morgan) is an unpublished opinion where a Chapter 7 debtor owned a homestead, elected federal exemptions, and did not claim any value of his homestead as exempt. 481 Fed. Appx. 183, 184 (5th Cir. 2012). On August 6, 2010, after filing bankruptcy, he sold his home and used the proceeds to pay off a lien held by debtor's brother. The trustee discovered the sale, contested the brother's lien, and demanded the sale proceeds. *Id*. On February 11, 2011, debtor amended his schedules to apply Texas exemptions and claimed a Texas homestead exemption. *Id*. To distinguish his case from *Zibman*, the debtor argued that he was not subject to the six month rule because he owned the actual real property at the commencement of the case, not proceeds from its sale. *Id*. at 185. The bankruptcy court accepted the argument and allowed the Texas homestead exemption; once exempt, always exempt. *Id.* at 184.

The Fifth Circuit referred to its decision in *England* stating that the only reason for the six-month rule is to allow a homestead claimant to invest sale proceeds in another Texas homestead and not to protect the proceeds in and of themselves. *Id.* at 185. The Court dismissed the argument that there is no temporal limitation on a homestead exemption and that the exemption therefore lasted forever. *Id.* Because the debtor failed to reinvest the proceeds in another Texas homestead within the six month window, the proceeds lost their exempt status pursuant to state law. *Id.*

In re D'Avila involved a Chapter 7 debtor who claim the Texas homestead exemption. 498 B.R. 150, 152 (Bankr. W.D. Tex. 2013). An order in a divorce proceeding required the debtor to sell the homestead. *Id.* The trustee objected to the debtor's application to sell and requested an extension to the objection to exemption deadline of more than six months so that he could determine whether all of the sale proceeds were reinvested into another homestead. *Id.* The court distinguished this case from cases in Chapter 13 because Chapter 7 does not have a provision similar to § 1306 which brings post-petition property and earnings into the bankruptcy estate. *Id.* at 157-159. Therefore, the court held that the best application of the Snapshot Rule is that once an exemption has been claimed on an actual Texas homestead in Chapter 7, any proceeds that result from the post-petition sale of the homestead are exempt and are not subject to later recovery by the bankruptcy estate. *Id.* at 159.

In *Lowe v. DeBerry*, the Fifth Circuit Court of Appeals distinguished its holdings in *England* and *Zibman* where Chapter 7 debtors sold Texas homesteads before filing bankruptcy. 844 F.3d 526, 528-529 (5th Cir. 2018). In this case, the Chapter 7 debtor listed his Texas homestead as exempt and no objections were filed. *Id.* at 527. Seven months after filing, the debtor filed a motion to sell the home, sold the home, and did not reinvest the proceeds from the sale in a new homestead. *Id*. The court reasoned that unlike *England* and *Zibman*, where the homestead was sold pre-petition, this debtor did not need to invoke the six-month rule because he owned the homestead at the time of filing bankruptcy. *Id*. at 528-529. Further relying on the Snapshot Rule and the reasoning of *Hawk v. Englahart (In re Hawk),* 871 F.3d 287 (5th Cir. 2017) (an analogous case where a Chapter 7 debtor's post-petition withdrawal of funds from an exempt retirement account and failure to reinvest the funds within 60 days did not render the funds subject to the seizure), the court held that an unconditionally exempted property interest that is subsequently transformed into a new non-exempt property interest remains excluded from the Chapter 7

bankruptcy estate. *Id.* at 529. The court further distinguished this case from *In re Frost* because *Frost* was a Chapter 13 case, and Chapter 13 contains § 1306 which mandates that all property the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted becomes part of the Chapter 13 estate. *Id.* at 530. Therefore, the timing of the sale in relation to the filing of the bankruptcy petition is critical in Chapter 7 cases but is not in Chapter 13 cases.

IV. Sale of a Texas Homestead in Chapter 13 Cases

In re Zavala following the rationale of *Zibman* held that sale proceeds lost their exempt status to the extent they were not reinvested in the debtor's new homestead within six months. 366 B.R. 643, 653 (Bankr. W.D. Tex. 2007). Chapter 13 debtors elected Texas exemptions, exempted a homestead property, and listed a rental property as an asset. *Id.* at 645. During the case, the husband died and the wife sold the homestead property earning over $100,000.00 in net proceeds. *Id.* After the sale, she moved into the rental property and paid the balance on the rental property's mortgage, the balance owed on a truck, property taxes, and for a trip to Chicago for her son's graduation. *Id.* What remained of the proceeds was spent on living expenses. *Id.* She then tried to pay off her Chapter 13 Plan without paying 100% to unsecured creditors. *Id.* The trustee moved to modify the plan to require a 100% payment to the unsecured creditors arguing that *Zibman* required that the proceeds which were not reinvested in the new homestead were non-exempt. *Id.* The Court decided that under *Stump v. White* and *Zibman*, it is immaterial for purposes of applying the six-month rule whether the sale of the homestead occurs pre- or post-petition. *Id.* at 653. The sales proceeds lost their exempt status to the extent they were not reinvested in the debtor's new homestead within six months. *Id.*

> [I]f the Trustee can trace any of the proceeds, even to exempt property (other than a new homestead), he is entitled to that property. The Debtor's argument that the Debtor's dissipation of the proceeds in effect renders the Trustee's request for modification moot, is therefore rejected. To accept such an argument would basically reward a debtor for…disposing of estate property without authority. *Id.*

Similar decisions have been reached locally under the direction of *England* and *Zibman*. In *Garcia* Chapter 13 debtors elected Texas exemptions, and while the case was pending, they sold their homestead netting over $60,000.00 which was not reinvested in another homestead within the six-month window. *In re Garcia*, 499 B.R. 506 (Bankr. N.D. Tex. 2013), *aff'd sub nom.*, *Garcia v. Bassel*, 507 B.R. 907 (N.D. Tex. 2014). The debtor filed a modification to keep the proceeds, the trustee objected, and the court denied the modification stating that it did not comply with the best interest test. *Id*. The court stated, "[T]he proceeds from the sale of the homestead fall under the definition of property of the estate because (1) they are proceeds of the homestead, an asset held as of the commencement of the case, or (2) the proceeds themselves are an asset acquired by debtor's post-petition." *Id.* at 510-11.

The court in *Garcia* also discussed whether an exemption actually removes an asset from the estate. After noting that § 541(b) does not exclude exempt property, the court concluded that exempt property does not leave the estate but remains in the estate, although insulated from creditors' claims, and it remains so *unless some event occurs that changes the nature of the asset*

such that it is no longer exempt. *Id.* The court reasoned that the pendency of the bankruptcy case neither expands nor reduces a debtor's exemption rights. *Id.* at 514. So once an asset no longer enjoys exempt status under the exemption law, that asset is vulnerable to claims and distributable to creditors. *Id.*

The Fifth Circuit spoke again in *Frost* where when a Chapter 13 debtor filed bankruptcy, the debtor owned and exempted a homestead using the Texas homestead exemption. *Viegelahn v. Frost (In re Frost)*, 744 F.3d 384, 385 (5th Cir. 2014). During the case, the debtor sold the homestead. *Id.* The court rejected the debtor's argument that his exemptions were fixed at the date of filing stating, "Frost's homestead was exempted from the estate...by virtue of its character as a homestead.... [T]his essential element of the exemption must continue in effect even during the pendency of the bankruptcy." *Id.* at 387. Upon the sale, "the essential character of the homestead changed from 'homestead' to 'proceeds'…." *Id.* "[A] change in the character of the property that eliminates an element required for the exemption voids the exemption even if the bankruptcy proceeding has already begun." *Id.* at 388. The court concluded by stating that Frost's reliance on *Schwab v. Reilly* was misplaced because when the debtor is exempting a monetary interest in an asset (i.e. using federal exemptions), the debtor's interest is simply limited to the value of the exemption claimed. *Id.* at 391. A change in the character of the property that eliminates an element required for an exemption voids the exemption even if the bankruptcy proceeding has already begun. *Frost*, 744 F.3d at 388. The essential elements of the exemption must continue in effect even during the pendency of the bankruptcy. *Id.* at 387.

Due to § 1306, a change in character of the underlying asset enables the trustee to contest the exempt status of the asset which will typically occur by plan modification and application of §§ 1329 and 1325(a)(4). Thus, in a Chapter 13 case, the homestead is never unconditionally exempted and whether the sale occurs pre- or post-petition is immaterial.

Exemption Issues when Converting from Chapter 13 to Chapter 7

I. Disclaimer

The focus of this topic assumes conversion from chapter 13 to chapter 7. However, many of the concepts and issues surrounding exemptions in a converted case apply equally when converting to and from different chapters (particularly when converting from any reorganization chapter to chapter 7). Nevertheless, the inherent assumption for purposes of this discussion is a case which begins as a chapter 13 and then later is converted into chapter 7. Another factor complicating the finality of exemptions upon conversion to chapter 7 is whether the debtor's plan provides for vesting of estate property in the debtor at the time of confirmation. The "vesting" issue is a complicated one and lies beyond the scope of this discussion. For the purposes of this paper, it is assumed that estate property does not vest in the debtor at confirmation.

II. Introduction

When a bankruptcy case is filed, one of the initial tasks is assembly of a complete list of all the debtor's property and determination of which items of property shall be claimed as exempt. In a reorganization case such as chapter 13, this is certainly important as the claimed exemptions play directly into the "best interests of creditors test" (aka liquidation analysis) contained in 11 U.S.C. §1325(a)(4). In a case where no one objects to the claimed exemptions within thirty (30) days after the §341 meeting is concluded, the exemptions become final. See Bankruptcy Rule of Procedure 4003(b); See also *Taylor v. Freeland & Kronz*, 503 U.S. 638, (1992). However, what happens to the finality of the claimed exemptions when a chapter 13 case is converted to chapter 7?

When a case is converted, the order of conversion constitutes an "order for relief" under the new chapter. 11 U.S.C. §348(a). Consequently, Rule of Bankruptcy Procedure 2003(a) mandates the calling of a creditors' meeting in the newly converted case. Rule of Bankruptcy Procedure 4003(b) provides that any party in interest may file an objection to the claimed exemptions within thirty (30) days after the §341 meeting is concluded or within thirty (30) days after any amendment to the claimed exemptions is filed, whichever is later. Now that a new trustee is involved and a new §341 meeting will take place, do the previously claimed exemptions become fair game for objections?

III. History of Issue

Prior to December 1, 2010, the answer was unclear as courts were divided on the issue. However, an amendment to Bankruptcy Rule 1019 has provided clarity in cases converted to chapter 7. To understand the need for the amendment, one should first look at the opposing arguments surrounding the issue.

The argument historically favored by debtors in support of denying parties the ability to object to exemptions in converted cases when no amendments are made is based on the interplay between Bankruptcy Rules 4003(b) and 1019 (as it existed prior to its amendment in 2010). Rule 1019(2) provides for the commencement of new time periods for objecting to discharge and objecting to the dischargeability of a debt. However, notably missing was any mention of a new

time period for objecting to the claim of exemptions. Thus, the argument was one of plain meaning. The absence of any language providing for a new time period must mean that there is no further opportunity to file an objection to the claimed exemptions. Additionally, 11 U.S.C. §348(a) states that conversion of a case does not change the date of the "order of relief." Consequently, all deadlines, including objecting to exemptions, should not be affected by the conversion. The line of cases following this reasoning was known as the "majority rule." See In re Brown, 375 B.R. 362, Bankr. W.D. Mich. 2007 for an excellent overview of the supporting cases following this line of reasoning; see also, e.g., Bace v. Babitt (In re Bace), 07 Civ. 2421, 2008 WL 800672 (S.D.N.Y.2008); In re Rogers, 278 B.R. 201 (Bankr.D.Nev.2002); DiBraccio v. Ferretti (In re Ferretti), 230 B.R. 883 (Bankr.S.D.Fla.1999), aff'd without opinion, Dibraccio v. Ferretti, 268 F.3d 1065 (11th Cir.2001); In re Beshirs, 236 B.R. 42 (Bankr.D.Kan.1999); see also In re Bell, 225 F.3d 203 (2d Cir.2000) and In re Halbert, 146 B.R. 185 (Bankr. W.D.Tex. 1992) (conversions from chapter 11 to chapter 7).

The opposing argument is reflected in a line of cases referred to as the "minority view." These cases hold that a new thirty (30) day period of time to object commences after a case is converted. The rationale is that there is nothing in Bankruptcy Rule 4003(b) which limits the reference of objections being due within the thirty (30) day period following conclusion of the "meeting of creditors" to the initial meeting held in the case under its original chapter. These cases also support their decisions with fairness and policy considerations. See, e.g., In re Alexander, 236 F.3d 431 (8th Cir.2001); In re Brown, 375 B.R. 362 (Bankr. W.D. Mich. 2007); In re Hopkins, 317 B.R. 726, (Bankr. E.D. Mich. 2004); In re Fish, 261 B.R. 754 (Bankr. M.D. Fla. 2001); In re Mims, 249 B.R. 378 (Bankr. D. N.J. 2000) (re-conversion of chapter 13 case to chapter 7).

These two disparate arguments were made moot by the addition of language to Bankruptcy Rule 1019 which became effective December 1, 2010. In the amendment a new sub-section (2)(B) was added which reads:

> (B) A new time period for filing an objection to a claim of exemptions shall commence under Rule 4003(b) after conversion of a case to chapter 7 unless:
>
> (i) the case was converted to chapter 7 more than one year after the entry of the first order confirming a plan under chapter 11, 12, or 13; or
>
> (ii) the case was previously pending in chapter 7 and the time to object to a claimed exemption had expired in the original chapter 7 case.

Thus, the amended rules provide an opportunity for new objections to exemptions when a case is converted into chapter 7 if the conversion takes place one year or less following confirmation of a plan, <u>or when there is an amendment to the claimed exemptions!</u>

IV. Practical Considerations

Certainly, there are circumstances which could require converting a case into chapter 7 less than one year after confirmation of a plan. As such, there is no way around opening the door for potential objections to the claimed exemptions. However, normally one can choose whether an amended claim of exemptions is filed in the converted case. In fact, it is <u>typically not necessary</u> to

file amended schedules of exemptions upon conversion. Bankruptcy Rule 1019(1)(A) provides that the schedule of exemptions filed in the previous chapter are deemed to be filed in the chapter 7 case (unless the court directs otherwise). In the Northern District of Texas, upon conversion of a case to chapter 7, Local Bankruptcy Rule 1019-1 requires the filing of the following items:

1) Schedule of assets remaining in the possession of the debtor as of the date of conversion;
2) List of abandoned property;
3) List of property against which the automatic stay has terminated;
4) Schedule of unpaid post-petition obligations (if any); and
5) Statement of Current Monthly Income and Means Test Calculation (Form 122).

Nowhere in this list is a requirement to file amended claims of exemptions. To do so will create an opportunity for an interested party to file objections even in those cases where the conversion takes place more than a year following confirmation of a plan. While it might seem easier to file a new set of Schedules A/B through J upon conversion, especially when adding debt that was incurred after the filing of the chapter 13 but prior to conversion, you are not required to do so.

V. Property subject to exemptions in a converted case

To further complicate things, filing a new set of Schedules A/B through J may well confuse determining what property in the chapter 7 case is subject to a claim of exemption. If new schedules are filed which include property acquired during the course of the chapter 13, it may present an inflated, but illusory, list of property available for administration by the trustee. Except in limited circumstances, the property available to the chapter 7 trustee is no greater than what existed in the estate when the chapter 13 petition was originally filed.

Property of the estate is generally defined in 11 U.S.C. §541 as all property in which the debtor holds legal or equitable ownership as of the commencement of the case plus any property interest acquired as the result of a death occurring within the 180-day period after the petition date. This concept applies equally in all chapters. However, the definition of estate property in a chapter 13 case is much broader as it also includes any property interest acquired by the debtor (by any means) following the petition date up to the date the chapter 13 case is closed, dismissed or converted to chapter 7. 11 U.S.C. §1306(a). Thus, the potential for additional property to flow into the chapter 13 estate far exceeds the first 180 days following the filing as a chapter 13 case may be open for up to five (5) years or slightly longer depending on how quickly the case can be closed following the completion of all payments under the plan.

What happens to after-acquired property of the chapter 13 estate when a case is converted to a chapter 7? The answer lies in §348 of the bankruptcy code. The general rule is that property of the newly created chapter 7 estate consists of all property of the former chapter 13 estate that

existed on the date the original petition was filed. 11 U.S.C. §348(f)(1)(A). Therefore, property acquired by the debtor during the course of the chapter 13 case does not ordinarily flow into the chapter 7 estate upon conversion. However, one very important exception exists! If the debtor's conversion from chapter 13 to chapter 7 is found to be in "bad faith," the chapter 7 estate will include all property of the chapter 13 estate which existed on the date of conversion. 11 U.S.C. §348(f)(2).

VI. Practice Tip

Debtors' counsel would be well advised to resist the temptation to automatically file a new set of schedules in every converted case. Rather, a strict adherence to Bankruptcy Rule 1019 and Local Rule 1019-1 could well avoid having to litigate exemption objections in converted cases and preserve the finality of the exemptions claimed during the chapter 13.

Completing Schedule C after *Schwab*

I. Disclaimer

In 2010 the U. S. Supreme Court handed down its decision in the *Schwab* case wherein there was ample discussion regarding claimed exemptions and when objections may be necessary. *Schwab v. Reilly*, 560 U. S. 770, (2010). Justice Thomas authored the court's opinion and attempted to harmonize the ruling with the *Taylor* case from 1992 which dealt with the finality of an exemption when no timely objection is filed. *Taylor v. Freeland & Kronz*, 503 U. S. 638, (1992). The *Schwab* decision caused substantial consternation and confusion among practitioners which ultimately led to the design of the current Official Form 106C (Schedule C: The Property You Claim as Exempt). One might hope the design of the form would help clarify how to claim exemptions in light of the Supreme Court's guidance, but it would seem that the form itself has just caused additional confusion.

II. History of the Issue

The *Schwab* case dealt with a situation wherein the debtor scheduled an ownership interest in kitchen equipment valued at $10,718. The debtor then asserted two exemptions under 11 U. S. C. §522(d)(6) (tools of the trade) and 11 U. S. C. §522(d)(5) (wildcard) in an aggregate amount equal to the value. No timely objections to the claimed exemptions were filed. At some point after the deadline for exemptions had passed, the trustee moved to sell the kitchen equipment. The trustee believed the equipment to be worth more than the debtor's estimate of value (which was equal to the amount of the claimed exemption). Debtor opposed arguing that the kitchen equipment was fully exempt regardless of its actual value due to the fact that the exemption on Schedule C was equal to the estimated value listed on Schedule B. Debtor further argued that claiming an exemption in the same amount as the listed value put the trustee on notice of her intent to exempt the equipment's full value even if the value was actually more than the amount listed or more than than the available exemption limits. According to the debtor, because no timely objections to the claimed exemptions were filed, the property passed out of the estate and was unavailable to the trustee. The bankruptcy court denied the trustee's motion to sell. The district court and 3rd Circuit Court of Appeals affirmed. However, the Supreme Court reversed and sided with the trustee.

The ultimate holding in *Schwab* is there must be clear and unequivocal notice of a debtor's intent to claim an asset as fully exempt and, thereby, remove it from the estate. Claiming an exemption in an amount equal to the estimated value is not enough to remove the asset from the estate. Rather, such an exemption claim is only for an "interest" in the asset up to the available amount of the exemption. The court then provided examples of how a debtor could provide clear notice of an intent to claim the asset itself as exempt. Listing the amount of the exemption as "full fair market value (FMV)" or "100% of FMV" is sufficient to put the trustee on notice of the debtor's intent to claim the asset itself as exempt (as opposed to merely claiming an "interest" in the asset as exempt). If such an exemption is asserted and no objections are raised, then the asset would be moved beyond the reach of the trustee.

Subsequent to the *Schwab* decision practitioners began following the suggestion of Justice Thomas and inserting language such as "100% of FMV" or something similar in Schedule C

thereby indicating it was the debtor's intent to exempt the asset in full from the estate. Predictably, trustees began objecting to debtor's attempts to claim an item of property as exempt from the estate when the underlying exemption statute only allowed the debtor to exempt an "interest" in the item subject to some statutorily capped amount. In late 2010 and early 2011 there were two bankruptcy court opinions out the Northern District of Texas which dealt with how to resolve an objection to exemptions in a case where the debtor asserted the magic 100% language. However, these courts did not reach the same conclusion.

The first decision was by Judge D. Michael Lynn in the *Moore* case. *In re Moore*, 442 B. R. 865 (Bankr. N. D. Tex. 2010). Judge Lynn held that if a debtor asserts the 100% language and an objection follows, the court is then required to conduct an evidentiary hearing wherein the debtor has the initial burden to establish a plausible claim that the value of the asset falls within the statutory limit. If the debtor carries his burden, it then shifts to the objecting party to prove that the claimed exemption exceeds the statutory cap. If the objecting party fails to carry its burden, the objection will be overruled and the exempt asset will be removed from the estate. *Id.* at 868.

The next decision was by Judge Robert L. Jones in the *Salazar* case. *In re Salazar*, 449 B. R. 890 (Bankr. N. D. Tex. 2011). Judge Jones held that any objection to the use of 100% language in conjunction with a statute which has a monetary limit is automatically considered a facially valid objection because such an exemption fails to apprise the trustee, or other parties in interest, of a definitive amount being claimed. In such circumstances the court will sustain the objection unless the debtor amends the exemption to claim "a dollar amount for his exempt interest in the property." *Id.* at 897. Further, even if there is no objection to the use of 100% language, the exemption claim is still limited to the debtor's interest in the property and the property remains in the estate. *Id.* At 900.

These two interpretations of the *Schwab* holding could hardly be more different. Judge Lynn clearly believes that use of the 100% language may be sufficient to remove an asset from the estate. Conversely, Judge Jones believes that such language will never fully remove an asset from the estate when the underlying exemption statute contains a cap on its amount.

Ultimately, the fallout from *Schwab* led to the creation of the Schedule C we presently use (Form 106C) which became effective December 1, 2015. The purpose of the new form, in part, is to incorporate the option of asserting the 100% language into the form itself. The column of the form titled "Amount of the exemption you claim" contemplates choosing one of two options. You may list a dollar amount or check a box indicating the amount being claimed is 100% of fair market value, up to any applicable statutory limit.

Subsequent to the implementation of the new Schedule C, Judge Marvin Isgur weighed in on this issue in the *Ayobami* case. *In re Ayobami*, 2016 WL 828743 (Bankr. S. D. Tex. Mar. 2, 2016). This case has had an interesting, if not tortured, path. The case was filed in October, 2015. The original Schedule C filed by the debtor was on the "old" forms. In December, 2015 the chapter 13 trustee objected to the claimed exemptions. In response to the trustee's objection, debtor filed amended exemption claims and used the "new" form that went into effect on December 1, 2015. Of particular note is when the debtor amended her exemption claims, she used the 100% option

provided for in the new form relative to several exemptions asserted under §§522(d)(1), (3)–(5). As one might expect, the chapter 13 trustee then objected to the amended exemptions arguing that debtor should not be able to shield any appreciation in value from the estate by using the 100% option. On this issue Judge Isgur very clearly stated his belief that utilizing the 100% option on Schedule C when the equity is below the statutory cap withdraws the asset from the estate. This is more in line with Judge Lynn's decision in *Moore*.

After the court issued its initial opinion in March, 2016, the trustee sought clarification which resulted in the issuance of a Supplemental Opinion. Judge Isgur doubled down on his belief that an asset may be removed from the estate using the 100% option. While Judge Isgur effectively overruled the trustee's objection, he did require the debtor to expressly state a specific dollar amount for the value of her interest in the claimed exemption. The debtor accomplished this by including a dollar amount in the column titled "Specific laws that allow exemption. " The issue was then certified for direct appeal to the 5th Circuit with the question being "May a debtor claiming federal exemptions under § 522 of the Bankruptcy Code ever exempt a 100% interest in an asset?" *In re Ayobami*, 2016 WL 3708761 (Bankr. S. D. Tex. July 1, 2016).

In addressing the question presented, the 5th circuit found there are circumstances, such as the facts in the present case, where it is permissible to exempt a 100% interest in an asset. Important to this finding was the fact that the debtor had clearly chosen the 100% option and also clearly designated a specific dollar value for the claimed exemption that was within the statutory limit. However, the 5th circuit made abundantly clear that it was not answering the question of whether a 100% exemption would be allowable when there was no dollar amount stated. Additionally, the court did not address the question of whether an allowed 100% exemption allows the debtor to "walk away" with the asset itself. *Peake V. Ayobami (In Re Ayobami)*, 879 F. 3d 152 (5th Cir. 2018).

III. Summary / Practice Tip

The importance of whether an asset remains in the estate or is removed from the estate has to do with who owns the value of any appreciation in the property. For example, assume a debtor's principal residence has equity of $10,000 on the petition date. Further assume that no attempt is made to claim the asset itself as exempt from the estate by using the 100% language; rather, the debtor merely claims an "interest" in the asset subject to the statutory limit under 11 U. S. C. §522(d)(1). Clearly, no trustee should attempt to sell the asset for the benefit of creditors as the equity is far less than the available exemption under §522(d)(1). However, if before the case is closed, the asset were to substantially appreciate in value such that the equity rises to $50,000, the trustee would have the right to sell the asset, pay the debtor the value of his claimed exemption and distribute the excess to creditors. Alternatively, if the asset is exempted in-kind and removed from the estate, any appreciation in value would inure to the debtor's benefit.

The 5th circuit in *Ayobami* has certainly left the door open (just barely) to the idea that an asset might be removed from the estate by using the 100% option. Unfortunately, the decision is really only instructive in explaining how a debtor can overcome an objection to the 100% option. To do so requires electing the 100% option along with stating a specific dollar value for the

exemption. While this seems to contradict how the form was designed to work, it can be accomplished without too much difficulty. Even more disappointing is that we still do not have an answer for whether using the 100% option allows the debtor to "walk away" with an asset.

In light of the 5th circuit's ruling that allows a 100% exemption so long as the value of the exemption is also clearly stated and falls within the statutory cap, it would seem prudent to assert exemption claims in this manner. Failing to assert the exemption claim in this fashion leaves no argument for the debtor that he or she is entitled to any appreciation in value.

It is important to note that objections to the use of the 100% option should only arise when asserting an exemption which has a monetary cap. If asserting the 100% option along with an exemption such as the Texas homestead exemption, which allows a debtor to exempt the asset itself, as opposed to merely an "interest" in the asset, objections should be rare and fairly easy to overcome.

Perhaps the most important take away is to know your judge. While debtors appearing in front of Judge Isgur in Houston will receive a warm reception to efforts to remove property from the estate by using the 100% option, debtors appearing in front of Judge Jones in Lubbock will likely see a different result when attempting the same.

Exemptions for New Residents

I. Disclaimer

Prior to the 2005 Amendments, consumers filing for bankruptcy protection could use the exemptions available in the State where their case was filed as long as they were a "resident" of that State. The 2005 Amendments changed this result, (anecdotally to prevent consumer debtors from moving to a State with more generous exemptions) implementing an obtuse calculation to determine what exemptions are available to a consumer that has been "domiciled" in a State for less than 730 days.

II. Practice Pointer No. 1: THIS ISSUE MAY NOT MATTER.

While it may be intellectually stimulating to go through the process described below and determine what exemptions are available for the Debtor, before you go through that exercise make sure that it is necessary to do so. In my experience many, if not most, of the Debtors that have recently moved to Texas from another State do not have any assets that the Trustee would be interested in even if Schedule C was not completed! Thus, this issue is most often more academic than practical. So, determine if there is any property that exemptions are important for before you spend your time analyzing this issue.

The Bankruptcy Code sets out the method to determine what exemptions are available in §522(3) (A). This section provides that the Debtor is entitled to exempt:

> subject to subsections (o) and (p), any property that is exempt under Federal law, other than subsection (d) of this section, or State or local law that is applicable on the date of filing of the petition to the place in which the debtor's domicile has been located for the 730 days immediately preceding the date of the filing of the petition or if the debtor's domicile has not been located in a single State for such 730-day period, the place in which the debtor's domicile was located for 180 days immediately preceding the 730-day period or for a longer portion of such 180-day period than any other place;

III. Practice Pointer No. 2: WHAT IS "DOMICILE"?

For a potential consumer debtor that has lived in Texas for less than two years, Counsel needs to determine the correct "domicile" to know what State's exemption law applies. Domicile differs from "residence" in that a potential consumer debtor "resides" in the physical location where they are living, while they are domiciled in the place that they consider their home and intend to return to. If it matters, domicile will be a fact question that the Judge has to decide.

For the potential consumer debtor that has lived in Texas for less than two years, the first question to ask is where the potential debtor lived before moving to Texas and how long the potential debtor lived in that state.

IV. Practice Pointer No. 3: THE PETITION DATE CONTROLS.

Note that the key date in the calculation is the petition date, not the date the potential debtor moved to Texas. Thus, if the filing can be delayed, Counsel can simply wait out the 730-day period and avoid the issue.

If delaying the filing date is not an option, then look back 2 years from the anticipated filing date and determine what State the potential debtor was domiciled in at that time. The State where the potential debtor lived, continuously, for at least 180 days (days 731 to 911) will provide the applicable exemption law. If the potential debtor did not live in the same state for the 180-day period (days 731 to 911) then the law of the State where the Debtor lived for the greater part of the 180-day period (days 731 to 911) provides the applicable exemption law.

Once Counsel determines what State provides the applicable exemption law, the next issue is what exemptions are available to the potential debtor under the applicable exemption law. This analysis requires Counsel to research the law of other jurisdictions, which is almost certain to be unfamiliar.

V. Practice Pointer No. 4: WEBSITE ON EXTRATERRITORIAL APPLICATION OF STATE EXEMPTION LAW.

John R. Bates has compiled a detailed chart regarding the application of State Exemption Law. This chart can be reviewed at: https://weberlaw.com/BAPCPA/pdf-misc/Guide-to-Exemption-Options.pdf I highly recommend this chart as a starting place for research if you have a case that requires you to address this issue.

The primary issue that Counsel can expect to encounter is whether the exemptions provided by the other state are "extraterritorial". In other words, do they apply to property located in Texas instead of in the State whose exemption law is being consulted? The answer to this varies by State, but the answer is generally "no". If the State has "opted out" of allowing residents to use the Federal Exemptions of §522(d), that would leave the potential debtor with no exemptions available. In what looks like a last-minute addition, Congress added a "hanging paragraph"[1] to §522(b):

[1] Not to be confused with the more well-known "hanging paragraph" of §1325(a)

> If the effect of the domiciliary requirement under subparagraph (A) is to render the debtor ineligible for any exemption, the debtor may elect to exempt property that is specified under subsection (d).

This enables a potential consumer debtor that would otherwise be left with no available exemption (because they have not lived in Texas for 730 days and the applicable law of the State(s) where they lived for days 731 to 911 is not extraterritorial and forbids use of the Federal Exemptions) to use the Federal Exemptions in §522(d).

Points to remember:

- Federal Exemptions (§522(d)) are not available in all states, some have "opted out" of letting their residents use the Federal Exemptions pursuant to §522(b)(2);
- If the potential consumer debtor did not live in any state during the day 731 to 911 period (i.e. they were out of the country) then the Debtor can use the Federal Exemptions, see the "other hanging paragraph" in §522(b):

  > If the effect of the domiciliary requirement under subparagraph (A) is to render the debtor ineligible for any exemption, the debtor may elect to exempt property that is specified under subsection (d).

- Counsel should be aware of an issue regarding the meaning of the phrase "any exemption" in the other hanging paragraph of §522(b). This phase can be interpreted to mean that if the potential debtor would be denied any exemption allowed by the applicable State Law then the potential debtor can elect the Federal Exemption. Alternatively, it can be interpreted to mean that if the Debtor has any exemption (even one) available under the applicable State Law then they are not entitled to elect Federal Exemptions (presuming the applicable State is an "opt-out" State).

Exempting Personal Injury Claims

I. Disclaimer

In addition to their financial difficulties, it is not uncommon for consumer debtors to suffer injuries as a result of the wrongful acts of third parties. When this happens before or during a bankruptcy case Counsel is tasked with preserving as much of the potential recovery as possible for the debtor.

II. Practice Pointer No. 1: LIST THE CLAIM.

There is an entire body of law in the Fifth Circuit, beginning with Reed v. City of Arlington, 634 F.3d 769 (5th Cir. 2011) discussing the often-disastrous effect of failing to list claim. While the result in such a case is beyond the scope of this paper, suffice it to say that the best course of action is to query the Client before the case is filed regarding the existence of any such claims and to amend the schedules promptly if Counsel learns of such a claim after the case is filed.

When addressing the exemption of a personal injury claim, choice of exemptions is important. The Texas Exemptions, found primarily in Chapters 41and 42 of the Property Code, do not provide **<u>any</u>** exemption for a personal injury claim. Thus, if it is going to be necessary for the potential consumer debtor to use the State Exemptions, they have to be prepared to risk losing the personal injury claim in a Chapter 7 Case or paying value into the Chapter 13 Plan.

III. Practice Pointer No. 2: BE SKEPTICAL.

When discussing a potential tort claim with a prospective consumer bankruptcy client, it is typical that the prospective client will overvalue the claim. Counsel should certainly disclose all potential claims but be wary of relying on claims as a funding source for your Chapter 13 Plan. Likewise, remember that the net recovery to the debtor will be reduced by attorney's fees (usually 1/3 or more of the gross recovery) and costs of suit. After costs the amount received by the Debtor from a $50,000 recovery can easily be reduced to the amount available under the Federal Exemptions.

If the Debtor is able to use the Federal Exemptions, then there are several sections that may be useful. First, §522(d)(11)(D) allows the debtor to exempt:

> a payment, not to exceed $23,675, on account of personal bodily injury, not including pain and suffering or compensation for actual pecuniary loss, of the debtor or an individual of whom the debtor is a dependent;

This section will often be sufficient to allow the exemption of the portion of the recovery that the Debtor will actually receive.

IV. Practice Pointer No. 3: THE TERMS OF THE JUDGMENT MATTER.

If possible, Counsel for the Debtor should seek to have input into the language of the Judgment or Settlement Agreement. Getting recital in the Judgment or Settlement Agreement that assigns a specific amount of the award to each element, for example: medical expenses, lost income, pain and suffering, will be very helpful when trying to maximize the portion that is exempt.

Similarly, §522(d)(11)(E) allows the debtor to exempt:

> A payment in compensation of loss of future earnings of the debtor or an individual of whom the debtor is or was a dependent, to the extent reasonably necessary for the support of the debtor or any dependent of the debtor.

Note that there is **no dollar limit** on this exemption, which is unusually generous for the Federal Exemptions. Counsel should endeavor to get language in the Settlement Agreement assigning as much of the award to loss of income as is appropriate. Also note that the language limiting the exemption to amounts that are "…reasonably necessary for the support…" of the debtor or the debtors dependents is likely illusory for a debtor that is in bankruptcy.

V. Practice Pointer No. 4: TRACING IS YOUR FRIEND.

The language at the start of §522(d)(11) provides that the exemption is applicable to: The debtor's right to receive, **or property that is traceable to**…" (emphasis added). Thus, if the potential debtor got a personal injury recovery before the case is filed and used the money to buy an asset (like a truck) then if you can meet the tracing burden (fact question) the asset can still be exempted.

Finally, do not forget that the §522(d)(5) "wild card" allows the debtor to exempt:

> The debtor's aggregate interest in any property, not to exceed in value $1,250 plus up to $11,850 of any unused amount of the exemption provided under paragraph 1 of this subsection.

The "paragraph 1" referenced in §522(d)(5) refers to the Federal Homestead Exemption (currently $23,675). This means that if the debtor uses less than $11,825 of the §522(d)(1) exemption on a home the maximum "wild card" will be available. In any event, the debtor will likely be using State Exemptions if there is equity in a home to protect so this exemption potentially

provides up to $13,150 ($1,250 + $11,850) in exemption for a personal injury claim. If the situation dictates that the wildcard exemption is used for a portion of a personal injury claim then, Counsel should be careful to discuss valuations with the potential client. For example, Clients will often initially value personal items such as clothes, furniture and jewelry at the purchase cost or other unrealistic numbers. Since the Trustee is unlikely to want to pursue clothes, furniture or everyday jewelry Counsel should try to preserve as much of the "wildcard" as possible so it can be used on the personal injury claim.