

RECENT NOTEWORTHY EXEMPTION CASES

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**2014 Northern District of Texas
Bankruptcy Bench/Bar Conference
June 20, 2014
Dallas, TX**

RECENT NOTEWORTHY EXEMPTION CASES

Exemptions play an important role in bankruptcy cases, since allowing debtors to retain certain assets deemed essential to daily life promotes the debtor's ability to receive a fresh start. On the other hand, exemptions take assets away from the pool of property to be liquidated for the benefit of creditors. The past year has been a banner year for cases interpreting exemption provisions, with the vast majority of these cases involving claims of homestead exemptions.

***Viegelahn v. Frost (In re Frost)*, 12-50811 (5th Cir. March 5, 2014)**

The debtor elected Texas exemptions in his chapter 13 bankruptcy case. He sold his homestead after the bankruptcy filing but before the case was closed. He did not reinvest the proceeds in another homestead or exempt asset within the 6 month period provided under Texas law. The trustee argued that the proceeds became non-exempt after six months and obtained a court order requiring the debtor to add the proceeds to the plan base. The bankruptcy court upheld the trustee's objection and the district court and Fifth Circuit affirmed. The Fifth Circuit rejected the debtor's argument that exemption rights are fixed via a "snapshot" on the petition date, finding instead that compliance with the state law authorizing the exemption is required during the entire pendency of the chapter 13 case.

***In re Garcia*, 499 B.R. 506 (Bankr. N.D. Tex. 2013)**

Debtors filed bankruptcy in February 2011 and claimed an exemption under Section 41.001(a) of the Texas Property Code for their homestead. In September 2012, Debtors moved for authority to sell their homestead, a sale that would net \$64,000.00. Debtors claimed the entire amount as exempt and proposed that the equity be distributed to them. The proceeds were not re-invested in a new homestead. Because the debtors' plan included monthly payments on the pre-petition mortgage arrears, the debtors moved to modify their plan and proposed to keep the \$64,000.00 in proceeds as part of the modification.

In order to determine whether the proposed plan modification would pay the unsecured creditors at least as much as they would receive if the estate were liquidated in a chapter 7, the court considered the effective date to be the effective date of the modified plan, not the original plan. The court concluded that the exemption was not forever fixed when claimed, but that the homestead proceeds were still property of the estate but it was shielded from creditors until the 6-month re-investment period lapsed, at which point the

proceeds were no longer shielded. The court held that in chapter 13 cases, the bankruptcy neither expands nor reduces a debtor's exemption rights.

The court held that the trustee's failure to object to the debtors' exemption of the proceeds at the time of the sale did not have a *res judicata* effect. The key to whether *res judicata* would apply was whether a debtor disclosed his intent to take an act that arguably deviates from controlling law. The court stated that the order could have been read to mean that the debtors would retain the sales proceeds subject to the time limitation of 41.001(c).

***In re D'Avila*, 498 B.R. 150 (Bankr. W.D. Tex 2013)**

Debtor filed under Chapter 7 of the Bankruptcy Code claiming an exempt homestead. At the time of the filing, the Debtor was a party to a divorce proceeding in which an order had been entered requiring the sale of the homestead. Accordingly, the Debtor filed an application to sell the homestead in her bankruptcy case to comply with the divorce court order. The trustee objected, requesting that the Court extend the deadline by which the trustee could object to the Debtor's homestead exemption so that the trustee could ensure that the homestead proceeds were reinvested in a new homestead within the six month period provided under Texas Property Code 41.001(c). The bankruptcy court analyzed the protection of homestead proceeds pursuant to Texas Property Code 41.001(c) and the "snapshot principle" usually applied to an exemption analysis. The bankruptcy court specifically distinguished this case from other court opinions in the chapter 13 context, which had held that proceeds not reinvested in a new homestead within the six month period had to be devoted to the chapter 13 repayment plan. The court based its distinction on the fact that chapter 7 has no provision incorporating post-petition income (including income from exempt sources) into property of the estate (as is found in Bankruptcy Code Section 1306(a)). Accordingly, the bankruptcy court held that application of the snapshot principle exempted the home from the bankruptcy estate and the trustee could never recover proceeds of the sale of that homestead, whether or not the sales proceeds were reinvested within or outside the six month time period provided under Texas Property Code 41.001(c).

***In re Carlew*, 469 B.R. 666 (Bankr. S.D. Tex. 2012)**

The debtor's home was damaged by Hurricane Ike in 2008. When the debtor's insurance claim was denied under his homeowner's insurance policy, debtor sued in state court. A settlement was reached in the case, and the debtor's insurer agreed to pay debtor the sum of \$125,000. After deducting attorney's fees, the remaining proceeds of \$73,353.98 would be paid to the debtor. Two months after receiving the insurance proceeds, the debtor filed for bankruptcy. He had not spent any of the insurance proceeds and continued to hold the funds separately. He claimed the insurance proceeds as exempt pursuant to the Texas homestead exemption. The trustee objected to the exemption. By the time of hearing on the objection to exemption, more than 6 months had passed since the payment of the insurance proceeds to the debtor. The debtor testified that he intended to utilize the insurance proceeds to repair his homestead.

The bankruptcy court found that Texas law regarding homestead exemption allowed the debtor to exempt all of the proceeds from the settlement of the lawsuit. The bankruptcy court further ruled that the homestead exemption of the insurance proceeds is not terminated due to the debtor's non-use of the proceeds for six months because the six-month provision of the homestead exemption applies only when the homestead is sold.

***Law vs. Siegel*, ___ U.S. ___ (2014) (Docket No. 12-5196) (decided March 4, 2014)**

When the debtor filed for Chapter 7 bankruptcy in 2004, he listed a home in California with a claimed value of \$363,000 and stated that the property was subject to a first mortgage of \$150,000 owed to a bank and a second lien for \$168,000 owed to "Lin's Mortgage & Associates." Because the value of the two mortgage

liens, together with California's homestead exemption of \$75,000, was greater than the value of the house, there was nothing available for distribution to the debtor's general unsecured creditors.

It was discovered in subsequent litigation that the second mortgage lien did not exist. The trustee expended more than \$500,000 in fees and costs investigating and litigating the second lien which involved a Lili Lin of Artesia, California who denied loaning the debtor any money and a Lili Lin of China who most likely did not exist. The house sold for about \$680,000 and only one creditor timely filed a proof of claim (the claim was settled for \$120,000.) The trustee sought to surcharge the homestead exemption in order to be reimbursed for his legal expenses. The bankruptcy court ordered that the debtor's homestead must be surcharged in its entirety. The BAP and the Ninth Circuit affirmed.

The Supreme Court reversed, noting that Bankruptcy Code Section 105(a) grants a bankruptcy court authority to "issue any order, process, or judgment that is necessary or appropriate to carry out" the provisions of the Bankruptcy Code and that the court has inherent power to sanction abusive litigation practice but that a bankruptcy court may not contravene a specific statutory provision. As Bankruptcy Code Section 522(k) expressly states that a homestead exemption is "not liable for payment of any administrative expense," the court exceeded the limits of its authority under Section 105(a) and its inherent powers. The Court's ruling in *Marrama* would not have led to a different result, as its dictum only "suggests that in some circumstances a bankruptcy court may be authorized to dispense with futile procedural niceties in order to reach more expeditiously an end result required by the Code."

The bankruptcy court still has various sanctions available to enforce its judgments: (i) it can deny a discharge under Bankruptcy Code Section 727(a); (ii) it can impose sanctions for bad-faith litigation conduct under Federal Rule of Bankruptcy Procedure Section 9011; (iii) it can further sanction under Bankruptcy Code Section 105(a); (iv) it can enforce a monetary sanction that survives the bankruptcy case through the normal procedures for collecting money judgments; and (v) it can refer fraudulent conduct in a bankruptcy case for criminal prosecution under 18 U.S.C. Section 152.

***In re Cowin*, Case 13-30984 (Bankr. S.D. Tex. March 21, 2014)**

This case involved a trustee's objection to the debtor's homestead exemption pursuant to 522(o). In a lengthy opinion, the court discussed the elements necessary to satisfy this statutory provision as well as the form of relief that should be awarded if the elements are satisfied. The elements as determined by the court are: (1) the debtor disposed of property within 10 years of the filing of his case (in this case it occurred within 2 years); (2) the debtor disposed of property which was non-exempt (a 2010 Note which debtor used to apply to the purchase of his condo); (3) the nonexempt property was used to pay for a portion of his homestead; and (4) the debtor disposed of non-exempt property with the intent to hinder, delay or defraud his creditors (the court went through 13 badges of fraud and determined that the trustee had shown 9 of the 13.)

The bankruptcy court ultimately determined that the elements of Section 522(o) had been satisfied and sustained the objection. The court ruled that the homestead exemption would be reduced by the value of the non-exempt asset used for the acquisition of the home (\$236,000 – which amount was in excess of debtor's equity in the property.) The court then imposed an equitable lien on the homestead in favor of the trustee that could be immediately foreclosed upon and also required the debtor to provide "adequate protection" to the trustee until the property was sold or debtor vacated the premises. The adequate protection consisted of the debtor's payment of all mortgage payments, HOA fees, property taxes, insurance and other ongoing expenses (plumbing and electrical) necessary to preserve the estate's interest in the property.

***Cipolla v. Roberts (In re Cipolla)*, 2013 WL5596848 (5th Cir. Oct. 14 2013) (unpublished).**

The debtor was a lawyer licensed in Texas and Missouri. He acquired a partial interest in residential property in Missouri in 1985 and acquired the rest in 1995 as a gift from his parents. In 1999 he used a home equity loan on the previously unencumbered Missouri property to purchase real property on South Padre Island as a recreational and retirement property. Debtor made the South Padre property his principal residence in 2001. Debtor borrowed additional sums against the Missouri property (\$16,000 in 2002 and \$56,000 in 2005) while the Texas property remained unencumbered. Debtor also amassed substantial unsecured debts from 2000 through 2009. The debtor filed for bankruptcy and claimed the Texas property as his homestead. The trustee objected to the exemption to extent that it was purchased with funds borrowed against the Missouri property pursuant to Bankruptcy Code Section 522(o).

The bankruptcy court sustained the trustee's objection and the district court affirmed most of the bankruptcy court's ruling. The Fifth Circuit remanded because the bankruptcy court erred in imputing knowledge of homestead exemptions to the debtor because he was a lawyer (the debtor's practice was limited to mediation and arbitration. On remand, the objection to the exemption was again sustained by the bankruptcy court and affirmed by the district court. On appeal, the Fifth Circuit held that the four badges of fraud found by the bankruptcy court were sufficient evidence that the debtor's property was transferred with the intent to hinder, delay or defraud creditors.

Debtor's disposal of the property fell under the Texas Uniform Fraudulent Transfer Act (TUFTA) even if it was not an actual transfer of property because TUFTA encompasses every mode of disposing of property. The Fifth Circuit found that the bankruptcy court did not err in considering the entire course of the debtor's finances after the transfers at issue were made, but transfers closer in time to the transfer were clearly more relevant than later ones. The bankruptcy court was allowed to use the debtor's demeanor in judging credibility. Also relevant was the significant amount of debt incurred close in time to the Texas property purchase.

***In re Thaw*, 496 B. R. 842 (Bankr. E. D. Tex. 2013)**

Debtor filed a chapter 7 bankruptcy, listed a lavish homestead as an asset, and agreed that exemption of his homestead interest was capped pursuant to 11 U.S.C. Section 522(p). The trustee argued that the debtor engaged in intentional fraud that would entirely extinguish his exempt interest in his home under Bankruptcy Code Section 522(o). The non-debtor spouse claimed she had an exempt interest in their homestead that was not capped by Section 522(p) or extinguished by Section 522(o).

At a time when a former business partner was suing the debtor for his portion of guaranteed business debts, new business entities were formed in the name of the debtor's spouse, but the debtor managed all operations of the new business entities. Around the time that the former business partner was receiving a final judgment against the debtor, the debtor and his spouse entered into a contract to build a \$2 million home. The court found that payments were made on the home through a series of sham transactions from these new business entities meant to defraud, hinder or delay debtor's creditors. The court found that the debtor concocted an elaborate scheme to funnel non-exempt assets into his exempt homestead in a way that would be difficult for creditors such as his former business partner to detect or trace. The court concluded that the requirements of Section 522(o) were met and reduced the debtor's homestead exemption to \$0.

The court also rejected the non-debtor spouse's argument that she had a separate, vested homestead property right that did not enter the debtor's estate and that was not subject to the limits provided by Sections 522(o) and 522(p).

***Kim v. Dome Entertainment Center, Inc. (In re Kim)*, No. 10-10882 (5th Cir. April 9, 2014)**

The debtor purchased a home in Texas for \$1 million at a time when litigation was pending against him in California. Approximately two years after he purchased the residence, a judgment was entered against him

for more than \$5 million. The judgment creditor instituted an involuntary bankruptcy proceeding against him to collect the judgment and argued that the homestead exemption was capped pursuant to Bankruptcy Code Section 522(p) because it was purchased within 1215 days prior to the filing (and did not include equity rolled over from a prior homestead). The debtor then sought a declaratory judgment to determine his interest in the bankruptcy estate and to determine the rights and claims of his non-debtor spouse to the residence by virtue of her claim that it constituted her homestead under Texas law. The bankruptcy court held that the non-debtor spouse did not have a “separate and distinct exempt homestead interest in the property that would entitle her to compensation or to prevent the sale of the property.” The district court affirmed the bankruptcy court ruling that the wife as a non-debtor could not assert homestead rights to prevent the forced sale of the residence. The debtor and his non-debtor spouse appealed the decision to the Fifth Circuit.

The Fifth Circuit held that upon filing, Section 541 brought into the estate all interests (i.e. the fee interest and the homestead interest) of the debtor and the non-debtor spouse. While there are provisions of the Texas Constitution and Texas Property Code which protect homesteads from forced sale for the repayment of debts, the Bankruptcy Code permits the forced sale of estate property. The homestead protection of a non-debtor spouse has no impact on determining the extent of estate property under 522(p). The Fifth Circuit expressly declined to decide whether the non-debtor spouse might be entitled to compensation under Section 363 (j) when a forced sale occurs.

Brundage v. Anderson (In re Brundage) No. 12-3453 (Bankr. S.D. Tex. March 7, 2014)

The debtor filed for bankruptcy and sought to avoid an invalid second lien on his homestead. The holder of the second lien had also purchased the first lien on the property from its previous owner. The mortgage holder argued that the debtor should be judicially estopped from claiming the land as homestead because the debtor signed the second lien note, deed of trust and HUD settlement agreement. The court found that this argument lacked merit because the debtor never asserted in the documents that the property was not his homestead. Additionally, the mortgage holder was charged with knowledge that the debtor used and intended to use the property as his homestead due to the fact that the mortgage holder was an active participant with the debtor in the debtor’s business activities for many years and personally invested substantial funds in loans to the debtor and the debtor’s company. The court also found that the debtor’s claim of homestead was not a personal defense to which the holder-in-due-course doctrine might apply.

In re Stokesberry, 2013 WL4806426 (Bankr. S.D. Tex. Sept. 5, 2013)

The trustee objected to two of debtor’s claimed exemptions – all funds held in a certain checking account and a John Deere tractor. The parties stipulated that the only funds deposited into the checking account were social security payments and the debtor’s 401k distribution. Debtor testified that the tractor was used in a land-clearing business that generated in excess of \$15,000 in 2012. Debtor planned to return to this work after recovering from a heart attack.

The court overruled the objection to exemption of the tractor finding that Texas Property Code Section 42.002(a)(3) exempts personal property that constitutes farming or ranching vehicles and implements. The tractor was used to clear brush on the debtor’s property and his neighbor’s property and the court liberally construed the exemption statute to permit exemption of the tractor.

The court overruled the objection to exemption of the checking account in part, holding that the social security portion was exempt but that the amount attributable to the 401(k) distribution was not exempt. The trustee did not dispute that the debtor’s 401k plan was fully exempt under the Internal Revenue Code, but argued that once the debtor received payment into a regular checking account, the funds were no longer exempt. The Texas Turnover Statute provides that a court may not enter or enforce an order that requires the turnover of proceeds of or disbursements of exempt property. The court found that while a court may

not require the turnover of proceeds from a 401k plan, once the payment is voluntarily received and deposited in a non-exempt account, it becomes non-exempt. The court's interpretation gave meaning to Section 42.0021(c) of the Texas Property Code which provides for a continuous 60-day exemption for distributions from a qualified plan that constitute nontaxable rollover contributions. The court traced the nonexempt funds in the account and used the lowest intermediate balance test because neither party suggested a satisfactory tracing method. This approach created the legal fiction that non-exempt funds would be spent before exempt funds.

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Julianne M. Parker graduated from Northwestern State University of Louisiana in 1980 with a BA degree in political science and received her Juris Doctor from Louisiana State University College of Law in 1984. Since that time, she has been engaged in private practice. Ms. Parker limits her practice to consumer bankruptcy matters.

Ms. Parker is board certified in consumer bankruptcy law by the Texas Board of Legal Specialization and is a member of the National Association of Consumer Bankruptcy Attorneys. She is a former council member of the Bankruptcy Law Section of the State Bar of Texas, former member of the Bankruptcy Law Exam Commission of the Texas Board of Legal Specialization and current member of the Bankruptcy Paralegal Exam Commission of the Texas Board of Legal Specialization. A frequent speaker on bankruptcy related topics, she is best known as one of the recurrent chairpersons, program directors and driving forces behind the International Bankruptcy Law Seminar held by the State Bar of Texas Bankruptcy Law Section.

BIO

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Howard Marc Spector is a principal in the firm of Spector & Johnson, PLLC. Mr. Spector practiced with the firm of Sheinfeld, Maley & Kay, P.C. and Hughes & Luce PLLC prior to starting his own firm in 1999. Mr. Spector focuses his practice on the representation of debtors and creditors in bankruptcy proceedings, and often serves as a receiver in Texas state courts. He is licensed before the United States District Court for the Northern, Western, Eastern and Southern Districts of Texas, the Fifth Circuit Court of Appeals and the United States Supreme Court.

Education and Activities

B.S. in Applied Economics from Cornell University, with honors, 1989
J.D. from Vanderbilt University School of Law, 1992
2013 Chair, Bankruptcy & Commercial Law Section, Dallas Bar Association

Notable Cases:

Odes Kim v. Dome Entertainment Center, Inc. (5th Circuit 2014)
Odes Kim v. Dome Entertainment Center, Inc. (5th Circuit 2010)
Tax Ease Funding, L.P. v. Thompson (In re Kizzee-Jordan), 626 F.3d 239 (5th Circuit 2010)
Hersh v. United States, 553 F.3d 743 (5th Cir. 2008)

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Pam Bassel was appointed as a Standing Chapter 13 Trustee for the Northern District of Texas on October 1, 2013. She was the senior partner of Bassel & Wilcox, PLLC from 2005 to 2013 and the senior partner of the bankruptcy section of Law, Snakard & Gambill in Fort Worth, Texas from 1987 to 2005 (associate attorney from 1982 to 1987). She also served as Law Clerk to the Honorable John Flowers, United States Bankruptcy Judge for the Northern District of Texas, Fort Worth Division, from September 1981 to September 1982. She is licensed before the United States District Court for the Northern, Eastern and Southern Districts of Texas and the Fifth Circuit Court of Appeals.

Education:

B.S.F.A. from Texas Christian University in 1976 - graduated Summa Cum Laude.

Doctor of Jurisprudence from the University of Texas School of Law in 1981, with top honors.

Activities:

Master in the John C. Ford Inns of Court.

Outstanding Bankruptcy Lawyer in Tarrant County, Texas, in 1998.

CM/ECF Attorney/Trustee Advisory Committee - Northern District of Texas 2002-2003.

Attorney/Trustee Liaison Committee, 2005.

Creditor representative to the Fort Worth Study Group regarding local practices and proposed rule changes - 2007.

Frequent speaker on bankruptcy topics.