

# Consumer Corner

BY STEPHEN W. SATHER

## Fifth Circuit Walks Back on the Disappearing Exemption Case

Avoiding a conflict with established U.S. Supreme Court precedent,<sup>1</sup> the Fifth Circuit has reconsidered a decision that would have allowed a chapter 7 trustee to administer property finally claimed as exempt that later changed to a nonexempt form.<sup>2</sup> Had the original decision<sup>3</sup> remained in place, chapter 7 trustees in the Fifth Circuit could have left cases open indefinitely and waited for a debtor to sell an exempt homestead or car or liquidate a retirement account in order to generate an asset to administer. The case demonstrates how a phrase in an older opinion can impact the outcome of later cases.



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### Watching the Debtor Like a Hawk

Gregory and Marcie Hawk filed a chapter 7 petition on Dec. 15, 2013, and disclosed that they held two individual retirement accounts (IRAs) totaling \$164,902.<sup>4</sup> No party objected to the claimed exemption, but the following year, a creditor filed an objection to Mr. Hawk's discharge. In discovery, it was learned that the debtors had begun withdrawing funds from their IRAs beginning four days before the bankruptcy petition and continuing for the next eight months.<sup>5</sup> At the time of his deposition in November 2014, Mr. Hawk testified that all that remained from the IRA funds was \$30,000 that he kept in a shoebox.<sup>6</sup>

When the trustee, Eva Engelhart, learned that the debtors had withdrawn the funds and had not reinvested them within 60 days, she filed a motion for turnover. After an evidentiary hearing, the bankruptcy court ordered the debtors to turn over \$133,434.64 on the basis that the funds had "lost their exempt status" under Texas law because the debtors did not "roll over" the funds to another individual retirement account within 60 days.<sup>7</sup> The bankruptcy court concluded its opinion with a "wake up call" to the debtor's bar, stating:

In issuing this Opinion, the Court urges the debtors' bar to counsel carefully their clients

about preserving their exemptions. [The] Debtors should refrain from selling exempt assets until their case is closed; or, if they sell during the pendency of their case, they must strictly abide by applicable state law exemption provisions, as no provision in the [Bankruptcy] Code or Rules will preserve the exempt status of the proceeds if they are not timely reinvested pursuant to the applicable exemption statute.<sup>8</sup>

Thus, the bankruptcy court served notice that it was not enough to simply claim property as exempt and rely on the failure to object. Instead, the exempt status had to be preserved throughout the case.

The district court affirmed the bankruptcy court,<sup>9</sup> as did the original panel opinion.<sup>10</sup> In doing so, they relied heavily on language in an earlier Fifth Circuit opinion stating that an "essential element of the exemption must continue in effect even during the pendency of the bankruptcy case."<sup>11</sup> To understand the panel's initial opinion, it is important to understand two prior Fifth Circuit decisions dealing with proceeds from sale of exempt property: *In re Zibman*<sup>12</sup> and *Frost v. Viegelahn*.<sup>13</sup>

*Zibman* was a chapter 7 case. On the petition date, the debtor held proceeds from the sale of a Texas homestead that had not been reinvested. Under Texas law, proceeds from the sale of a homestead are exempt for the shorter of six months or until the debtor obtains a new homestead.<sup>14</sup> The deadline for objecting to an exemption is 30 days after the conclusion of the first meeting of creditors.<sup>15</sup> Because the first meeting was reset several times, the six-month period elapsed prior to the deadline to object to exemptions. The alert trustee objected to the exemption, and the objection was sustained.

On appeal, the debtor argued that the exempt character was determined on the petition date so that the subsequent expiration of the reinvestment period did not negate the exemption. The Fifth Circuit held that it was required to apply all of Texas law, including the six-month window for

1 In *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), the Supreme Court held that property claimed as exempt permanently leaves the estate in the absence of a timely objection to exemptions.

2 *Hawk v. Engelhart (In re Hawk)*, 871 F.3d 287 (5th Cir. Sept. 5, 2017) (*Hawk II*).

3 *Hawk v. Engelhart (In re Hawk)*, 864 F.3d 364 (5th Cir. 2017), vacated, 871 F.3d 287 (*Hawk I*).

4 *Hawk v. Engelhart (In re Hawk)*, 556 B.R. 788 (S.D. Tex. 2016), rev'd, 2017 U.S. App. LEXIS 17143.

5 *Hawk II* at 290.

6 *Id.*

7 *In re Hawk*, 524 B.R. 706, 710, 714 (Bankr. S.D. Tex. 2015). Texas law allowed funds withdrawn from an exempt IRA to be reinvested within 60 days.

8 *Id.* at 717.

9 556 B.R. 788 (S.D. Tex. 2016).

10 864 F.3d 364.

11 *In re Zibman*, 268 F.3d 298, 301 (5th Cir. 2001).

12 *Id.*

13 744 F.3d 384 (5th Cir. 2014).

14 Tex. Prop. Code § 41.001(c).

15 Fed. R. Bankr. P. 4003(b)(1).

reinvestment. In describing the interaction of the Bankruptcy Code and the Texas Property Code, the court stated that property being claimed as exempt must retain its “essential elements” throughout the pendency of the case. However, because the trustee was able to file a timely objection, the case did not conflict with Rule 4003(b)’s requirement of a timely objection.

*Frost v. Viegelahn* was a chapter 13 case where the debtor owned a homestead on the petition date. No party objected to the exemption of the homestead. While the case was pending, the debtor received permission to sell the homestead and spent some of the proceeds without reinvesting the funds. Once the reinvestment period expired, the trustee moved for turnover of both the remaining funds and the funds that had been spent. The bankruptcy court granted this relief, which was affirmed by the Fifth Circuit. While the court could have ruled based on the distinction between chapter 13 and chapter 7, it did not.<sup>16</sup> Instead, it found that because the “essential elements” of the exempt property changed, the exemption was voided. Building on *Zibman* and *Frost*, the panel in *Hawk I* found that property claimed as exempt in a chapter 7 case could lose its exempt status if it did not retain the “essential elements” of the exemption while the case remained pending.

## Hawk Gets Its Wings Clipped

Following a petition for rehearing, an article in *Rochelle’s Daily Wire*<sup>17</sup> and an *amicus* brief filed by four bankruptcy scholars and practitioners,<sup>18</sup> the panel vacated its original opinion and reversed the bankruptcy court. On rehearing, the court distinguished between the operation of chapter 7 and 13 by stating:

*Frost* relied heavily on principles from *Zibman*.... The Hawks note that the bankruptcy estate in a Chapter 13 case includes property [that] “the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted.” They contend that our decision in *Frost* effectively brought “proceeds that became nonexempt after the expiration of the time-limited exemption back into the estate,” which was permissible under § 1306(a)(1) because the proceeds constituted a new property interest [that] *Frost* acquired after the commencement of the case. Because Chapter 7 does not contain a provision like § 1306(a)(1), the Hawks reason that an unconditionally exempted property interest that is subsequently transformed into a new nonexempt property interest remains excluded from a Chapter 7 bankruptcy estate. We agree.<sup>19</sup>

The court noted that under 11 U.S.C. § 522(l) and the Supreme Court decision in *Taylor v. Freeland & Kronz*,<sup>20</sup> the property that is claimed as exempt leaves the estate if no objection is filed within 30 days. The panel then asked how the homestead proceeds in *Frost v. Viegelahn* could

have re-entered the estate. Answering its own question, the court explained that chapter 13 brings in subsequently acquired property:

In light of the Supreme Court’s decision in *Taylor*, it is somewhat difficult to understand how proceeds from the sale of the homestead in *Frost* could be brought into the bankruptcy estate “at a time when the homestead had already been declared exempt from the estate.” However, as the Hawks suggest, *Frost* makes sense in the context of a Chapter 13 case. We stressed that it was “the land itself — not its monetary value — that [was] protected under Texas law and ‘exempted under [§ 522].’” But when *Frost* sold the homestead, his property interest “changed from an unconditionally exempted interest in the real property itself to a conditionally exempted interest in the monetized proceeds from the sale of that property.” In other words, *Frost* obtained a new conditionally exempted property interest (the proceeds) when he sold his homestead. And in a Chapter 13 case, a new property interest “the debtor acquires after the commencement of the case” becomes part of the estate under § 1306(a)(1).<sup>21</sup>

The court also explained that it was not reading the 60-day limitation on exemption of IRA proceeds or the six-month limitation on exemption of homestead proceeds out of the statute. If the asset held on the petition date was proceeds, they would still be subject to the temporal limitation on exemption of proceeds. However, where, as it was here, the asset held on the petition date was the IRA itself, and no objection was filed, so the funds could not be reclaimed at a later date.

By relying on the distinction between chapters 7 and 13, the Fifth Circuit deftly threaded the needle between the Supreme Court’s *Taylor v. Freeland & Kronz* opinion, which required a timely objection to prevent property from leaving the estate, and the court’s own opinion in *Frost v. Viegelahn*, which appeared to violate this rule. Because one panel of the Fifth Circuit could not overrule a prior panel hearing, the court was limited to distinguishing *Frost* and limiting its effect.

## The Danger of Dicta

The path from the correct ruling in *Zibman* to the vacated panel decision in *Hawk I* depends on one key statement:

The Trustee contends that this determination was error because the 6-month limit of the exemption for proceeds is an integral feature of the Texas law “applicable on the date of the filing of the [bankruptcy] petition.” Therefore, reasoned the Trustee, this essential element of the exemption must continue in effect even during the pendency of a bankruptcy case. We agree with the Trustee.<sup>22</sup>

Although the “essential element” language was the Fifth Circuit’s summary of the trustee’s argument, it was picked up as the central tenet of the case in *Frost* and *Hawk I*. In *Frost*, the court cited the “essential element” language to explain

16 In chapter 13, post-petition property is brought into the estate under 11 U.S.C. § 1306.

17 Bill Rochelle, “Rehearing Petition Attacks Fifth Circuit Opinions Stripping Exemptions of Their Finality,” *Rochelle’s Daily Wire*, available at [abi.org/newsroom/daily-wire/rehearing-petition-attacks-fifth-circuit-opinions-stripping-exemptions-of-their](http://abi.org/newsroom/daily-wire/rehearing-petition-attacks-fifth-circuit-opinions-stripping-exemptions-of-their) (last visited Nov. 20, 2017).

18 The *amici* included Austin, Texas, bankruptcy attorney Michael Baumer, Prof. Christopher Bradley of the University of Kentucky College of Law, retired Bankruptcy Judge Leif M. Clark and the author of this article.

19 *Hawk II*, *supra* n.2 at 293-94 (citations omitted).

20 503 U.S. 639 (1992).

21 *Hawk II*, *supra* n.2 at 294 (citations omitted).

22 *Zibman*, *supra* n.11 at 301.

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that once the homestead was sold, its “essential character” changed from homestead to proceeds and lost their exemption when they were not reinvested.<sup>23</sup> In *Hawk I*, the court quoted the “essential element” language to state that a change in the character of the property “voids the exemption.”<sup>24</sup>

Retaining the “essential element” of the property was not essential to the holding in *Zibman*. What was essential was that on the petition date the exempt property was subject to a temporal limitation and there was a timely objection to exemption. The “essential element” language was an attempt to describe an aspect of Texas homestead law. However, *Frost* and *Hawk I* interpreted this careless language to provide exemptions that could be lost if the property changed its character.

Requiring property to retain its character throughout the pendency of the case would have yielded arbitrary results. Many forms of exempt property will likely change their form during a bankruptcy case. Suppose that on the petition date, the debtor owns a car valued at \$25,000 with \$10,000 of equity. In order to reduce expenses, the debtor sells the vehicle and uses the equity to buy a less-expensive vehicle. Is the new vehicle exempt? The “essential element” of the original exemption changed when the vehicle was converted into cash and later reinvested in a new vehicle. Would this void the exemption?

Similarly, the “essential element” test would encourage debtors to file chapter 7 rather than chapter 13 because chapter 7 cases are over quicker. Should the value of a chapter 13 debtor’s exemptions be less than those of a debtor who files chapter 13? Even within chapter 7, no-asset cases are resolved more quickly than asset cases, since the trustee must administer assets, send out a notice to file claims and file a final report.

<sup>23</sup> *Frost*, *supra* n.13 at 387.

<sup>24</sup> *Hawk I*, *supra* n.3 at 370.

### What Does It Mean for Practitioners?

The holding in *Hawk II* reaffirms the principle of finality expressed in *Taylor v. Freeland & Kronz*. It is also consistent with the recent opinion in *Law v. Siegel*<sup>25</sup> stating that courts could not grant equitable exceptions to exemptions. As a result, the Fifth Circuit has veered away from making exemptions conditional, at least in chapter 7. However, the judge’s warning that debtor attorneys should carefully counsel their clients remains valid.

*Hawk II* only solved part of the problem emanating from the *Zibman/Frost* line of cases. *Hawk II* eliminated the possibility that property subject to a final exemption could lose its exempt status in a chapter 7 case. However, because it distinguished *Frost* rather than overrule it, exemptions remain vulnerable in chapter 13 cases in the Fifth Circuit.

Practitioners in the Fifth Circuit should counsel clients on what might happen to exempt property during the course of a case. When selling exempt property, counsel should plan for how the proceeds will be used. If the homestead is being rolled over into another homestead, the sale order should provide for the proceeds to be held separately, preferably at a title company, pending reinvestment. If proceeds from exempt property are being used to pay off a plan early, there should be a court order authorizing the early payoff before the property is sold.

In addition, if exempt proceeds are being used to pay down a plan, they should be paid to the trustee while they are still exempt (*i.e.*, within six months for a homestead or 60 days for an IRA). Finally, if the proceeds are going to be used to cover living expenses or an unexpected cost, counsel should obtain an order authorizing this use in advance. If the debtor has an overwhelming need to use proceeds from exempt property that the court will not approve, the debtor should consider dismissing the chapter 13 proceeding or converting to chapter 7. **abi**

<sup>25</sup> 134 S. Ct. 1188 (2014).

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