Frost, Smith, and Hawk

Transformation of Previously Exempt Assets
Preservation of Their Proceeds
Possible Future Implications

(WITH A REMINDER ABOUT INHERITED IRA'S)

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Paper by Michael Baumer. All of the opinions expressed herein are solely his own.

In *In re Frost*, 744 F.3d 384 (5th Cir.2014), the Fifth Circuit held that proceeds of a homestead sold post-petition after the exemptions were allowed lost their exempt status if not reinvested in a new homestead within six months after the sale. It is perhaps worthy of note that the *Frost* opinion is all of six pages long. In what would otherwise be a fairly typical Chapter 13 case, the docket sheet in the bankruptcy case is 32 pages long and includes 142 docket entries. (See below for details.)

The facts are undisputed although slightly convoluted. The debtor filed Chapter 13 on November 30, 2009. He claimed his homestead located in Cibolo, Texas as exempt and, after the exemptions were allowed, filed a motion to sell the property. The Chapter 13 trustee objected to the proposed sale, largely because:

> "The [proposed] Order to the Motion to Sell states the proceeds will be deposited with the Chapter 13 Trustee pending further orders of this court, but does not state what the debtor intends to do with the proceeds or what the Trustee is to do with the proceeds.
>
> Homestead was exempted under Texas Property Code Sections 41.001-.002. Debtor has six months from the sale of the home to reinvest the proceeds into a new home."

On March 26, 2010, the court (Judge Ronald King) entered an "Order Granting Debtor's Motion to Sell Real Property Free and Clear of All Liens and Interests" with respect to the sale which provides, in relevant part: "Ordered that all liens or interests not specifically provided for in this order shall attach to the proceeds of sale, which proceeds shall be deposited with the Chapter 13 Trustee in this case ***pending further orders of this Court as to the validity, priority and extent of such liens and interests***." [Emphasis added.] However, and this is a very large however in this case, the order authorized payment of the outstanding mortgage balance and pro-rated ad valorem taxes at closing, so the amount to be deposited with the trustee was the net sale proceeds after payment of all then existing liens – there were no other "liens or interests" whose validity, priority or extent needed to be determined. Notwithstanding the trustee's outstanding objection to the sale, the debtor did not reinvest the approximately $81,000 in a new homestead within six months of the closing. After the expiration of the six month reinvestment period, the debtor filed an amended plan which proposed a 1% distribution to unsecured creditors, the trustee objected, and the bankruptcy court denied confirmation.

On January 3, 2011, the court entered an "Interim Order Granting Partial Disbursement of Proceeds of Sale of Real Property Free and Clear of All Liens and Interests" which authorized the trustee to disburse $40,000 to the debtor and retain the approximately $41,000 balance which would be sufficient to fund a 100% plan.

On May 11, 2011, the court entered its "Final Order Regarding Trustee's Objection to Debtor's Motion to Sell Real Property Free and Clear of All Liens and Interests Filed

March 3, 2010." That order essentially provides that because the trustee was in custody of the funds, equitable tolling applied to the six month reinvestment period and the debtor would be allowed additional time (six months from the January 3, 2011 order) to reinvest the proceeds into another homestead. The debtor did not reinvest the proceeds in a new homestead before July 4 and unfortunately for the debtor but fortunately for the creditors, the $41,000 the trustee was holding was more than sufficient to pay 100% to unsecured creditors.

A simple reading of the Fifth Circuit opinion in *Frost* does not provide all of this procedural detail. I got it from going through the docket and pleadings. Given what transpired, I have to acknowledge that the debtor had ***ample*** warning that the trustee was objecting to the sale, but only to the extent that the debtor did not reinvest the proceeds in another homestead within six months. The debtor coulda/shoulda seen this fight coming and either retained the homestead, or reinvested the proceeds, or simply dismissed his case and dealt with his unsecured creditors if and when it became necessary.

With all of that said, *Frost* raises all kinds of new concerns. In its holding, *Frost* relies almost entirely on *In re Zibman*, 268 F.3d 298 (5th Cir.2001). *Zibman* is clearly factually distinguishable. In *Zibman*, the debtor sold his homestead 74 days ***prior*** to filing his bankruptcy case. On the date of filing the debtor owned proceeds which were exempted under Texas Property Code §41.001(c). The debtor failed to reinvest the proceeds in a new homestead within six months of the sale. The *Zibman* Court "***held***" "that it is the *entire* state law applicable on the filing date that is determinative. Courts cannot apply a judicial airbrush to excise offending images necessarily pictured in the petition-date snapshot." *Zibman*, at 304. [Emphasis in original.]

I think that the ***actual holding*** in *Zibman* is absolutely correct on its facts, but I would suggest that it is limited to its facts, i.e., that homestead proceeds owned on the date of filing are subject to the six month period to reinvest those proceeds in a new homestead. *Frost*, unfortunately, then identifies the holding of *Zibman* as '"the six month limit on the exemption was 'an integral feature of the Texas law applicable on the date of the filing'" and that "this essential element of the exemption must continue in effect even during the pendency of a bankruptcy case." *Zibman*, at 301; Frost, at 387. In the context of the facts of *Zibman*, all of this analysis is dicta, not holding.

If the facts in *Zibman* were different, i.e., the debtor owned a homestead on the date of filing and sold the homestead post-petition, the ***stated*** holding in *Zibman* might be the ***actual*** holding. BUT since the facts were what they were – the debtor owned proceeds on the date of filing – the essential element of the ***property*** (not the ***exemption***) did continue in effect during the bankruptcy case.

Frost states that the "temporal distinction" between a pre-petition sale and a post-petition sale is "insufficient to escape the holding of *Zibman*" because of the *Zibman* "court's insistence that an 'essential element of the exemption must continue in effect even during the pendency of the bankruptcy case' indicates that a change in the character of the property that eliminates an element for the exemption voids the exemption, even if the

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