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**Texas Homestead Developments:
Sale Proceeds and
Community Property Rights**

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Protection of the debtor's homestead is one of the key considerations in filing for bankruptcy. The State of Texas has one of the most generous homestead exemptions in the nation. Under the Texas Constitution and Chapter 41 of the Texas Property Code, there is no limit on the value of a homestead that is exempt from forced sale, but rather a (generous) limitation on the number of acres that may be claimed. In addition to allowing an unlimited homestead exemption, Texas further protects the *proceeds* from the sale of a homestead from creditors' claims for six months after the date of sale (the "Texas Proceeds Rule"). Tex. Prop. Code §41.001(c). Texas law also provides strong protections for a spouse's interest in the marital home. *See e.g.* Tex. Fam. Code §5.001; Tex. Estates Code §102.005. The last few years have seen some important developments before the Fifth Circuit Court of Appeals involving the Texas homestead exemption. These developments have focused on two main areas. The first concerns the intersection of the snapshot rule, which states that exemptions are determined at the time of filing and do not change due to subsequent events, *Owen v. Owen*, 500 U.S. 305, 314 n.6 (1991), and the Texas Proceeds Rule, which exempts proceeds from the sale of a homestead for six months after sale. The second area of development concerns a non-debtor spouse's homestead rights under the Texas Property Code and Texas Constitution in cases in which the debtor is not able to fully exempt the homestead.

The Snapshot Rule and the Texas Proceeds Rule

Much of the discussion involving Texas homestead exemptions in recent years has revolved around the 2014 Fifth Circuit case *In re Frost*, 744 F.3d 384 (5th Cir.2014). In the case, the debtor claimed an exemption in his Cibolo homestead under the Texas Constitution and Texas Property Code. After his exemptions were finalized, the debtor filed a motion to sell the home. The procedural history from there was somewhat convoluted. The bankruptcy court ordered that the net sale proceeds be deposited with the Chapter 13 trustee. After six months had passed, the court ruled that the homestead proceeds had lost their exempt status under Texas Property Code §41.001(c). The court therefore ordered the trustee to disburse an amount sufficient to pay all claims in full, and refund the remainder to the debtor. The debtor appealed to the district court, which affirmed the bankruptcy court's ruling.

In its holding, the Fifth Circuit relied almost wholly on the prior case *In re Zibman*, 268 F.3d 298 (5th Cir. 2001). In *Zibman*, the debtor sold his Texas homestead prior to filing his bankruptcy case. On the date of filing, the debtor still had proceeds from the sale, which he exempted under Texas Property Code §41.001(c). Six months after the date of sale, the debtor had not reinvested the homestead proceeds and the Chapter 7 trustee objected to the claimed exemption and demanded turnover of the funds. On appeal, the Fifth Circuit held that the *entire* Texas law applicable on the filing date must be applied, which in this case included the six-month limitation on the exemption of homestead proceeds. *Zibman* at 304.

“In Texas, the 6-month limitation is inextricably intertwined with the exemption the state has chosen to provide for proceeds from the sale of the homestead.” *Id.*

Frost, of course, presented a very different set of facts; at the time of filing, the debtor in *Frost* was in possession of a homestead, not homestead proceeds. The Fifth Circuit did not consider this distinction determinative. The *Frost* court held that “a change in the character of the property that eliminates an element required for the exemption voids the exemption, even if the bankruptcy proceedings have already begun.” *Frost* at 388. Under *Frost*, then, if an exempt asset is converted during the pendency of the case to a form for which no exemption is available, the asset loses its exempt character and returns to the bankruptcy estate.

The *Frost* decision immediately gave rise to the question: Does the holding apply to cases under Chapter 7? Although the Fifth Circuit had not previously ruled on whether the proceeds of a post-petition sale of exempt property could become property of the estate, the opinion *In re Reed*, 184 B.R. 733 (Bankr. W.D. Tex. 1995) provided a thorough analysis of the state of the law at that time. The *Reed* court looked at §522(c) and (l) as well as §541(a)(6) (proceeds from property of the estate are property of the estate) and (a)(7) (interests acquired by the estate are property of the estate) and determined that once exempt property left the estate under §522(c), there was no mechanism under §541(a)(6) or (a)(7) to bring the proceeds from the sale of the exempt property back into the estate. *Id.* at 738, 740. Of course, in Chapter 13, §1306(a)(1) brings into the estate all property acquired by the debtor after the commencement of the case, but that section does not apply in Chapter 7.

In *In re D’Avila*, 498 B.R. 150 (Bankr.W.D.Tex.2013), decided while *Frost* was on appeal to the Fifth Circuit, the court considered the effect of the Texas Proceeds Rule in a Chapter 7 context. The debtor in *D’Avila* sought to sell her exempt homestead and divide the proceeds between herself and her husband pursuant to a court order in her pending divorce. The Chapter 7 trustee objected, seeking an order that the net sale proceeds were subject to the six-month limitation of the Texas Proceeds Rule. The court held that under the “snapshot” rule, “once an exemption has been duly claimed on an actual homestead, the proceeds that result from the post-petition, post-exemption sale of that homestead are not subject to later recovery by the bankruptcy estate under the Texas Proceeds Rule.” *D’Avila* at 159. The *D’Avila* court readily distinguished *Zibman* on the grounds that in *Zibman*, the debtor sold his home pre-petition and only exempted the proceeds at the time of filing. *Id.* at 157. The court acknowledged the district court’s ruling in *Frost*, as well as another case, *In re Zavala*, 366 B.R. 643 (Bankr. W.D. Tex. 2007), in which the proceeds of the sale of a debtor’s homestead post-petition were found to lose their exemption status in a Chapter 13 case. The court emphasized the differences between Chapter 13 and Chapter 7, most notably §1325(b)’s requirement that disposable income—including income derived from an exempt asset—must be paid into the Chapter 13 plan. *Id.* at 158.

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