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CASE LAW UPDATE:

United States Supreme Court and Fifth Circuit Court of Appeals Bankruptcy Decisions

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ATTORNEYS

Netsch v. Sherman (Matter of Prism Graphics, Inc.), 666 Fed. Appx. 355 (5th Cir. December 22, 2016, **Per Curiam**)

Issue: Whether an attorneys' confusion between the 14-day deadline to file a notice of appeal under the Federal Rules of Bankruptcy Procedure and the 28-day deadline to file a notice of appeal under the Federal Rules of Civil Procedure is excusable neglect. Whether the court must consider the merits of the appeal in determining excusable neglect.

Holding: No excusable neglect when the error is a mistake concerning the applicable rules of procedure. The merits of the appeal have no relevance to the question of whether counsel's failure to timely file a notice of appeal is excusable neglect.

Chapter 7 Trustee initiated adversary proceeding and won final judgment against Appellants on October 27, 2014. The Bankruptcy Court later amended its final judgment on November 20, 2014 to correct a clerical mistake. Counsel for the Appellant mistakenly calendared a 28-day deadline to file a notice of appeal of the final judgment, rather than the 14-day deadline under Federal Rule of Bankruptcy Procedure 8002(a). Realizing the mistake, Appellants filed a motion to extend time and an untimely notice of appeal on December 16, 2014, 12 days after the Rule 8002(a) deadline to file a notice of appeal. Appellant's motion to extend time requested the Bankruptcy Court to extend the time to file a notice of appeal for excusable neglect, citing counsel's mistaken belief that Appellants had 28 days to file a notice of appeal and post-judgment motions. The Bankruptcy Court denied Appellants' motion, finding that the mistake of Appellants' counsel did not constitute excusable neglect. The District Court affirmed.

The Fifth Circuit found no abuse of discretion in the Bankruptcy Court's denial of Appellant's motion to extend time. The standard for excusable neglect under Rule 8002 is set forth in the Supreme Court's *Pioneer Investment Services*[1] opinion, which identifies the following factors: (1) whether the movant acted in good faith; (2) the danger of prejudice to the nonmovant; (3) the length of the delay and its potential impact on judicial proceedings; and (4) the reason for the delay, including whether it was within the reasonable control of the movant. The determination is ultimately an equitable one, taking into account all relevant circumstances surrounding the mistake.

The Bankruptcy Court found that Appellants' counsel acted in good faith and was candid as to the reasons for the late filing, that the Trustee was not prejudiced by the late filing since he expected the judgment to be appealed, and that the 12-day delay, although long, was consistent with Appellants' counsel's mistaken belief that the 28-day period applied. Yet the Bankruptcy Court ultimately found, and the Fifth Circuit agreed, that the reason for the delay weighed strongly against finding excusable neglect. The *Pioneer* opinion makes clear that ignorance of the rules or mistakes concerning the rules do not usually constitute excusable neglect. At all times throughout the proceedings before the Bankruptcy Court, the parties had been subject to the Federal Rules of Bankruptcy Procedure. Furthermore, Rule 8002(a) is unambiguous. Since Appellants' counsel admittedly confused the Federal Rules of Civil Procedure with the Federal Rules of Bankruptcy Procedure, the Fifth Circuit found that the Bankruptcy Court properly applied the *Pioneer* standard to find no excusable neglect.

As an additional argument, Appellants suggested that the court should consider, in addition to the *Pioneer* factors, whether the party seeking the extension has a meritorious appeal. The Fifth Circuit held unequivocally that, although the court must take into account

[1] *Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. P'ship*, 507 U.S. 380 (1993).

all relevant circumstances concerning the party's error, the merits of the underlying appeal are not relevant to the question whether the failure to comply with a deadline is attributable to negligence. The Bankruptcy Court was correct to focus exclusively on the *Pioneer* factors in determining whether Appellants' counsel failure to timely file the notice of appeal was excusable neglect.

Selenberg v. Bates (Matter of Selenberg), 856 F.3d 393 (5th Cir., May 8, 2017, **Judge Prado**)

Issue: Whether an attorney debtor may discharge a promissory note given to a former client as an inducement not to file a malpractice lawsuit.

Holding: A promissory note given to a former client in settlement of a malpractice claim in violation of the rules of professional conduct is nondischargeable as an extension of credit obtained by false representations under Section 523(a)(2)(A).

Attorney debtor, who did not have malpractice insurance, gave former client a promissory note as compensation for legal malpractice. The offer of the note was communicated to the former client only after former client agreed not to hire malpractice counsel before she met with attorney debtor. As incentive to accept the note, the attorney debtor advised his former client that she would have five years to file suit to collect on the note, whereas she had only one year to file a malpractice lawsuit against him. Further, attorney debtor advised former client that she was not likely to recover any malpractice judgment against him. Former client agreed to accept the note from the attorney debtor, but the attorney debtor failed to make any payments on the note. Former client filed a disciplinary complaint against the attorney debtor and then later filed a lawsuit to collect on the note. At that point, the prescriptive period for her malpractice claim against the attorney debtor had run. Attorney debtor filed a Chapter 7 petition and stayed the state court case to enforce the note. Former client filed an adversary proceeding to have the promissory note declared nondischargeable under Section 522(a)(2)(A)-(B), The Bankruptcy Court found that the promissory note was nondischargeable under Section 522(a)(2)(A). The District Court affirmed.

The Fifth Circuit agreed with the Bankruptcy Court's characterization of the promissory note as an extension of credit contemplated by Section 523(a)(2). Giving the promissory note to the former client had the intended effect of giving the debtor more time to pay his obligation to her, and the debtor gave the note to the former client as an inducement for her to forego attempts to pursue a malpractice claim against him.

The Court also concluded that the attorney debtor's violation of the Louisiana Rules of Professional Conduct, which require an attorney to advise an unrepresented client or former client to seek outside counsel when settling a malpractice claim with a former attorney, was a false representation under Section 523(a)(2)(A). The Court found evidence of the debtor's intent to deceive the former client, including his insistence that she not hire malpractice counsel during their discussions concerning the note, his failure to advise her of other available options for her to pursue her claims against the debtor, including a consent judgment, that would have put her in a better legal position than an unsecured note, and his representations to her that he might be able to pay the note in the future, despite his knowledge that repayment was a remote possibility.

Finally, the Court concluded that the debtor's false representations directly caused the former client's losses because he never made any payments on the note and the former client lost the opportunity to pursue her malpractice claim against him in reliance on his advice that she would be more likely to recover if she

bypassed a malpractice suit and sought to collect on the note on a later date.

CLAIMS

Midland Funding, LLC v. Johnson, 137 S. Ct. 1407 (May 15, 2017, **Justice Breyer**)

Issue: Whether filing a time-barred proof of claim is a violation of the Fair Debt Collection Practice Act (FDCPA).

Holding: Filing a time-barred proof of claim is not "false, deceptive, or misleading" or "unfair" or "unconscionable" under the FDCPA.

Midland Funding filed a proof of claim for a ten-year-old credit card debt in debtor's Chapter 13 case. Under Alabama law, the credit card debt was subject to a six-year statute of limitations. Debtor objected to the claim on the basis that it was time-barred. The Bankruptcy Court granted Debtor's objection after Midland Funding did not respond. Debtor subsequently brought suit against Midland Funding seeking damages, attorneys' fees, and costs under the FDCPA. The District Court found that the FDCPA did not apply and dismissed the Debtor's action. The Court of Appeals for the Eleventh Circuit disagreed and reversed.

Recognizing a circuit split, the Supreme Court granted a writ of certiorari to determine whether Midland Funding's conduct was "false," "deceptive," "misleading," "unconscionable," or "unfair" within the meaning of the FDCPA.

The Supreme Court found that Midland's filing of a proof of claim in a Chapter 13 proceeding that, on its face, indicated that the limitations period had run does not fall within the scope of the FDCPA. The Court first reasoned that even a time-barred claim fits within the broad definition of "claim" under Section 101(5), recognizing that Alabama law, as well as other state's laws, provide that a creditor has a right to payment of a debt even after the limitations period has expired.

The Court recognized several lower court decisions finding that, in the context of an ordinary civil action, a debt collector's assertion of a claim known to be time barred is "unfair." Yet the Court reasoned that the potential harm from such "unfair" assertions in the Ch. 13 context were significantly reduced relative to those in the context of a civil action. The Bankruptcy Code's claims allowance procedures allowed for the statute of limitations to be raised as an affirmative defense and the basis for an objection to a claim. Additionally, the Chapter 13 claims procedure, including the involvement of a Chapter 13 Trustee, ensures that a debtor is not likely to pay a stale claim just to avoid going to court.

Considering the interplay between the Bankruptcy Code and the FDCPA, the Court hesitated to authorize a new, significant bankruptcy-related remedy in the absence of express language in the Code providing for it. The Court cited the decision of the Advisory Committee on Rules of Bankruptcy Procedure not to include a requirement that creditors certify that there is no valid statute of limitations defense to a claim, doing so in part because the working group did not want to impose an affirmative obligation on a creditor to make a prefiling investigation of a potential limitations defense.

DISCHARGEABILITY

Scarbrough v. Purser, *et al* (Matter of Scarbrough), 836 F.3d 447 (5th Cir., September 1, 2016, **Chief Judge Stewart**)

Issue: Whether a sanctions order incurred by a vexatious litigant in a state court proceeding may be nondischargeable under a Section 523(a)(2)(A) false pretenses, false representations, or actual fraud theory or a Section 523(a)(6) willful and malicious injury theory.

Holding: State court sanctions orders for fraud, civil conspiracy, and defamation incurred by a vexatious litigant may be nondischargeable as debt incurred through false pretenses, false representations, or actual fraud, as well as debt for willful and malicious injury.

Debtor attorney represented a party in a highly contentious state court case involving several familial disputes stemming from an employment lawsuit, an alleged extramarital affair, the death of the family patriarch, and secret recordings. Debtor was added as a defendant to the state court proceedings and was found to have participated in concealment of secret recordings that were relevant evidence in the state court proceeding, conspired to file a false police report against another party claiming that she had threatened to kill Debtor's client, filed reports of elder abuse against parties, moved to appoint a guardian ad litem over the family patriarch, made false claims that the patriarch's death was caused by an intentional drug overdose, and uploaded videos of altercations among the parties to YouTube in an effort to discredit a counter-party's campaign to the local school board.

Appellees contended that the actions of the Debtor and his client were intended to secure financial gain from the family patriarch as his health declined. Appellees obtained several orders in the state court proceeding against the Debtor for fraud, civil conspiracy, and defamation. After Debtor filed a Chapter 7 petition, Appellees brought an adversary proceeding seeking a nondischargeability determination against Debtor for multiple debts stemming from the state court orders under Sections 523(a)(2), (4), and (6).

The Bankruptcy Court granted partial summary judgment for Appellees on a collateral estoppel basis, conducted a nine-day trial to make additional findings of fact, and granted judgment for Appellees. The Bankruptcy Court found that the judgments for defamation and fraud were nondischargeable under the Section 523(a)(6) willful and malicious injury exception and that the fraud judgment due to Debtor's failure to disclose and fraud by misrepresentation were nondischargeable under the Section 523(a)(2)(A) false pretenses, false representations, or actual fraud discharge exception. The District Court affirmed.

The Debtor made several arguments on appeal, each of which the Fifth Circuit rejected. The Debtor first argued that Appellees' dischargeability claims stemming from a late-filed amended complaint were waived since the amended complaint was not filed within the 60-day filing period. The Fifth Circuit found that the amended complaint related back to the original complaint, which was timely filed, since the facts giving rise to the added claims emanated from the same conduct supporting the claims in Appellees' original complaint. The amended complaint did not allege new grounds to find Debtor's debt nondischargeable, but rather added specific facts consistent with the nondischargeability claim advanced in the original complaint.

Next, the Debtor argued that the Bankruptcy Court erred in granting partial summary judgment relying on the collateral estoppel effect of state court sanctions orders entered in connection with his concealing secret recordings in violation of a series of discovery orders to find a debt for willful and malicious injury under Section 523(a)(6). Looking to the record, which showed that the Debtor intentionally concealed evidence, willfully violated court orders, and filed frivolous motions before the state court in a scorched earth litigation strategy, the Fifth Circuit found sufficient state court findings to show that the Debtor had caused a willful and malicious injury with both an objective, substantial certainty of harm and a subjective motive to cause harm.

The Debtor also argued that the state court fraud findings, rooted in his intentional failure to disclose the secret recordings and

falsehoods disclosed about the Appellees, did not qualify as "money, property, services, or an extension, renewal, or refinancing of credit" obtained by false pretenses, false representations, or actual fraud. The Fifth Circuit found that the Appellees justifiably relied on Debtor's conduct in the underlying lawsuit, resulting ultimately in the Debtor's co-conspirators obtaining money and jewelry through fraud. The Court also found that it was not necessary for the Debtor to have been the direct recipient of the money and jewelry obtained through fraud, but rather that the debt may be nondischargeable under Section 523(a)(2)(A) even if the Debtor obtained only an indirect benefit.

Finally, the Debtor challenged the Bankruptcy Court's finding that the state court's defamation and defamation per se judgment against him was nondischargeable under Section 523(a)(6) for willful and malicious conduct. Unlike defamation, which is a false statement about a person, published to a third party, which damages the person's reputation without legal excuse, defamation per se involves statements so obviously hurtful that they require no proof of injury to be actionable. The Fifth Circuit found no error in the Bankruptcy Court's determination that the Debtor's actions – including falsely reporting to Adult Protective Services, posting a video of family conflict on YouTube in an attempt to hinder an Appellee's bid for a school board seat, conspiring to make false statements and reports that an Appellee threatened to kill others and consumed illegal drugs – satisfied the high requirement for defamation per se and were thus nondischargeable under Section 523(a)(6).

Cowin v. Countrywide Home Loans, Inc., *et al* (Matter of Cowin), 864 F.3d 344 (5th Cir., July 18, 2017, **Judge Higginson**)

Issue: Whether a debt arising from a debtor's participation in a conspiracy to commit larceny may be nondischargeable under 523(a)(4) without any finding of the debtor's specific intent to commit larceny.

Holding: The character of the debt, not the intent of the debtor, is dispositive. If the debt is incurred through larceny, the bankruptcy court is not required to make any findings of the debtor's intent to commit larceny to find a debt nondischargeable under 523(a)(4).

Debtor participated in a scheme to deprive mortgage holders of excess foreclosure sale proceeds through the use of tax-transfer liens authorized under the Texas Tax Code. A purchaser/borrower, acting as part of the scheme, would buy a condo property at a foreclosure sale subject to a first lien mortgage. After purchasing the property, the purchaser/borrower would enter into a tax-transfer loan agreement with a company controlled by the Debtor to pay real property taxes assessed against the property. The Debtor controlled company would receive a first priority tax-transfer lien against the property, which it would foreclose after the purchaser/borrower defaulted on its payment obligations. From the foreclosure sale proceeds, the Debtor's company would pay the trustee of the tax-transfer deed a $1,000 fee, pay the private lenders' tax-transfer lien in full, and deliver the excess proceeds to the purchaser/borrower, in violation of the Texas Tax Code, which requires excess proceeds to be paid first to junior lienholders in seniority order.

Bank of America and Countrywide Home Loans each separately sued the Debtor for nondischargeability in a succession of filed and dismissed bankruptcy proceedings. In the Countrywide proceeding, the Bankruptcy Court found that Debtor was liable to Countrywide for the aggregate amount of excess proceeds, and that his debts arising from the state-law violations were nondischargeable. Bank of America subsequently obtained a summary judgment determination of nondischargeability against the Debtor, relying upon the collateral

estoppel effect of the Countrywide judgment. Debtor appealed both judgments.

On appeal, the Debtor did not challenge the Bankruptcy Court's findings that Debtor participated in the conspiracy, that he was liable for state-law violations due to his participation in the conspiracy, or that the conduct and intent of the conspiracy met the federal common law standard for "larceny" or "willful or malicious injury." Rather, the Debtor argued that the Bankruptcy Court erred in imputing the actions and intent of his co-conspirators to the Debtor in determining nondischargeability. The Fifth Circuit found that the Bankruptcy Court made findings about the Debtor's personal conduct and intent sufficient to satisfy the federal common law standard for larceny, which includes the intent to convert the property of another for the taker's use and the intent to permanently deprive the owner of the property.

Notwithstanding the Bankruptcy Court's findings of the Debtor's personal intent, the Fifth Circuit found that Section 523(a)(4) does not require a specific intent on the part of the debtor, but rather that, simply, the debt be for larceny with no further criteria or qualifications. The plain reading of Section 523(a)(4) exempts from discharge a debt that arises from larceny so long as the debtor is liable to the creditor for the larceny. Since the Debtor did not contest the Bankruptcy Court's findings that he participated in the civil conspiracy to commit larceny and that the Bank of America and Countrywide debt stemmed from the state law violations, then the Debtor's debts to Bank of America and Countrywide arise from larceny and are nondischargeable in bankruptcy.

Husky v. Ritz (Matter of Husky), 832 F.3d 560 (5th Cir., August 10, 2016, **Judge King**, on remand from U.S. Supreme Court); 567 B.R. 715 (Bankr. S.D. Tex. April 19, 2017, **Judge Bohm**, on remand from the Fifth Circuit)

Issue: On remand first to the Fifth Circuit and then to the Bankruptcy Court, the standard applicable to pierce the corporate veil to find a principal liable for the debt of a corporation for actual fraud under Section 523(a)(2)(A).

Holding: Establishing that a transfer is fraudulent under the actual fraud prong of TUFTA is sufficient to satisfy the actual fraud requirement of veil-piercing.

Debtor was a shareholder in financial control of an electronics company that had purchased components from Creditor. The Debtor drained the company of assets available to pay the debt by transferring large sums of money to other entities that he controlled. After Debtor filed his Chapter 7 bankruptcy petition, Creditor filed a dischargeability complaint seeking to pierce corporate veil to hold Debtor personally liable on corporate debt and to except the debt from discharge under Section 523(a)(2)(A) on a false pretenses, false representation, or actual fraud theory. The Bankruptcy Court denied creditor's complaint, which was affirmed by the District Court and Fifth Circuit. The Supreme Court granted certiorari and reversed the Fifth Circuit, holding that the term "actual fraud" in Section 523(a)(2)(A) encompasses fraudulent conveyance schemes, even when those schemes do not involve a false representation. The Supreme Court's opinion left open the questions whether actual fraud had occurred in the Debtor's case and whether creditor could ultimately prevail in denying the Debtor a discharge of the relevant debt.

On remand from the Supreme Court, the Fifth Circuit addressed the first question left in the Supreme Court's opinion: whether the Debtor was liable to Creditor under Texas veil piercing law. The Fifth Circuit concluded that, under Texas law, establishing that a transfer is fraudulent under the actual fraud prong of TUFTA is sufficient to satisfy the actual fraud requirement of veil piercing since a transfer that is made with actual intent to hinder, delay, or defraud any creditor necessarily involves

dishonesty of purpose or intent to deceive. Under Texas law, a creditor may pierce the corporate veil to hold a shareholder personally liable only when the shareholder caused the corporation to be used for the purpose of perpetrating an actual fraud on the creditor for the shareholder's direct, personal benefit. The Fifth Circuit instructed the Bankruptcy Court to conduct a badges of fraud analysis on remand to determine whether Debtor's transfers satisfy the actual fraud prong of TUFTA and whether the actual fraud was for the Debtor's direct, personal benefit.

On remand from the Fifth Circuit, and in an incredibly thorough opinion, the Bankruptcy Court found that the Debtor's transfers out of the company into other entities he controlled were made with actual intent to hinder, delay, or defraud creditors under TUFTA, that the fraudulent transfers were primarily for his personal benefit so as to trigger veil piercing liability, and the Debtor's personal liability under the veil-piercing statute fell within the Section 523(a)(2)(A) discharge exception for false pretenses, a false representation, or actual fraud. The Bankruptcy Court unequivocally found that the transfers were made with actual intent to defraud, noting that the following badges of fraud were present: (1) the transfers in question were to an insider; (2) the Debtor retained possession or control of the property transferred after the transfers were made; (3) the Debtor had been sued or threatened with suit before the transfers were made; (4) the value of the consideration received by the company was not reasonably equivalent to the value of the funds transferred; (5) the company was insolvent or became insolvent after the transfers were made; (6) the transfers were concealed; (7) the Debtor removed or concealed assets; (8) the transfer occurred shortly before or after a substantial debt was incurred; and (9) the Debtor transferred the essential assets of the corporation to a lienor who transferred the assets to an insider of the Debtor. Additionally, the Bankruptcy Court found that the Debtor admitted in his testimony that he had personally benefitted from the transfers made to the entities he controlled, including transfers into entities whose debts the Debtor had personally guaranteed.

Looking to the requirements of Section 523(a)(2)(A), the Bankruptcy Court found that the Debtor effectively obtained the money transferred out of the company, that the Debtor committed actual fraud when he transferred the money from the company to entities he controlled, and that the Debtor incurred a personal debt as a result of the transfers under the veil-piercing statute.

The Bankruptcy Court raised the question whether Section 523(a)(2)(A) requires that the Debtor personally receive the money, a question unanswered in the Supreme Court opinion, noting that the Fifth Circuit has adopted the broad view that the exception to discharge applies whenever the debtor fraudulently obtains money, regardless whether it is for himself or whether the debtor received any benefit, but also noting that other circuits have taken different views on the issue. Regardless of the potential circuit split, the Bankruptcy Court found that the Debtor in this instance did in fact receive a benefit from the transfers, a finding that satisfies the test under all interpretations of Section 523(a)(2)(A) among the circuits. Consistent with the Fifth Circuit's opinion on remand, the Bankruptcy Court found that creditor was entitled to a nondischargeable judgment against Debtor in the amount of the company's debt to Creditor under the veil piercing statute, in addition to pre- and post-judgment interest and attorneys' fees, allowed under the contract between the company and Creditor as well as under TUFTA.

EXEMPTIONS

Hawk v. Engelhart (Matter of Hawk), 871 F.3d 287 (5th Cir. September 5, 2017, **Judge Prado**)

Issue: Whether funds in an exempt retirement account become non-exempt after a debtor withdraws the

funds postpetition and fails to deposit the funds in an exempt account within 60 days.

Holding: Retirement funds do not lose exempt status when debtors withdraw funds from their exempt retirement account postpetition and fail to deposit the funds into another exempt retirement account within 60 days as required by Texas law.

Chapter 7 Debtors claimed an exemption for funds held in an individual retirement account (IRA) under Texas and federal law. No party in interest objected to Debtors' exemption within the time allowed under the Code. Postpetition, the Debtors withdrew all of the funds from the IRA to pay for living and other expenses. They did not deposit the funds into another retirement account. Upon discovery of the Debtors' withdrawal of the funds from the IRA, the Trustee filed a motion to compel the Debtors to turn over the funds. The Bankruptcy Court ordered the Debtors to turn over the funds withdrawn from the IRA, concluding that the funds lost their exempt status under Texas law since the Debtors did not roll them over to another IRA within 60 days. The District Court affirmed the Bankruptcy Court's decision.

On panel rehearing, the Fifth Circuit reversed the District Court and Bankruptcy Court, finding that there was no basis for the Bankruptcy Court to order the Debtors to turn over the liquidated IRA funds once the exemption in the IRA had been allowed. The Court stressed that the Trustee did not object to the IRA exemption within the time allowed under the Code and Rules. Upon the allowance of the unconditional exemption in the IRA, it was removed from the estate and beyond the reach of pre-petition creditors. Distinguishing this result from the Court's prior opinion *In re Frost*,[2] the Court reasoned that there is no analog to Section 1306(a)(1) in Chapter 7 to include property acquired by the debtor post-petition to the Chapter 7 estate. The policy considerations underpinning the Chapter 7 process, by which a debtor keeps only exempt property and makes a fresh start by shielding his postpetition earnings and assets from prepetition creditors, require a different result compared to the Chapter 13 process, in which a debtor is allowed to retain his exempt and nonexempt property if he proposes a plan to pay his creditors with his future income. A new property interest that a Chapter 7 debtor acquires after filing for bankruptcy does not become part of the estate, even if the debtor acquires the new property interest by transforming a previously exempted asset into a nonexempt one.

The Court drew an important distinction between unconditional and conditional exemptions under state law. The exemption for an IRA is an unconditional exemption under Texas law, whereas the exemption for proceeds from an IRA is a conditional exemption under Texas law subject to a 60-day reinvestment requirement. If the Debtors had held amounts distributed from their retirement account on the petition date, then the exemption in those funds would have been conditioned by the 60-day limitation on the exemption, and the Trustee could have objected to the exemption on this basis. The opinion indicates that at least a small amount of the IRA proceeds had been withdrawn on the petition date, but the Trustee waived the right to claw back these proceeds into the estate after the 60-days had expired by failing to timely object to the exemption within the time allowed under Rule 4003(b).

HOMESTEAD

Ocwen Loan Servicing, LLC v. Berry, 852 F.3d 469 (5th Cir., March 29, 2017, **Judge King**)

Issue: What statute of limitations applies to a borrower's allegation of violations of the Texas Constitution's home equity loan provisions in a quiet title action in federal court.

[2] 744 F.3d 384 (5th Cir. 2014).

Holding: Applying the Texas Supreme Court's recent opinion in *Wood v. HSBC Bank USA, N.A.*,[3] no statute of limitations applies to a federal quiet title action alleging violations of the home equity protections in Art. 16, § 50(a)(6) of the Texas Constitution.

In a rare foreclosure lawsuit brought in federal district court under diversity jurisdiction, lender Ocwen Loan Servicing sought a judgment allowing it to foreclose its lien on defendant's homestead. Defendant asserted an affirmative defense and counter-claims that Ocwen's security interest was unenforceable under Article 16, section 50(a)(6) of the Texas Constitution. In response, Ocwen argued that defendant's Constitutional affirmative defenses were time barred by the four-year, residual statute of limitations. The District Court granted summary judgment for Ocwen, holding that defendant's alleged violations of the Texas Constitution were barred by a four-year statute of limitations and rejecting defendant's argument that he could rely on Tex. Civ. Prac & Rem. Code § 16.069 to raise the Constitutional violations as a counter-claim.

On appeal, the Fifth Circuit vacated the summary judgment in favor of Ocwen, relying upon the Texas Supreme Court's 2016 opinion in *Wood v. HSBC Bank, N.A.*[4] In *Wood*, the Texas Supreme Court found that constitutionally noncompliant home equity liens are invalid, and no statute of limitations applies to a quiet title action alleging such violations under Texas Constitution Art. 16, § 50(a)(6). The Texas Supreme Court expressly cited and rejected the Fifth Circuit's reasoning in *Priester v. JP Morgan Chase Bank, N.A.*,[5] applying a four-year statute of limitations to allegations of invalidity under Texas Constitution Art. 16, § 50(a)(6). Acknowledging that *Priester* had been decided in the absence of any Texas Supreme Court guidance on the limitations period, the Fifth Circuit found that the *Wood* opinion represented a change in Texas law requiring a different result from *Preister*. In light of *Wood*, no statute of limitations will apply to affirmative defenses and counterclaims alleging violations of Texas Constitution Art. 16, § 50(a)(6).

Wiggains v. Reed (Matter of Wiggains), 848 F.3d 655 (5th Cir., February 14, 2017, **Judge Southwick**)

Issue: Whether a debtor may act with intent to hinder or delay, but not defraud, creditors in executing a partition agreement of homestead property on the eve of bankruptcy in order to protect a non-debtor spouse's interest in the homestead.
Whether a non-debtor spouse has a separate interest in homestead proceeds for which compensation is due beyond what is paid to the debtor.

Holding: In the absence of fraudulent intent, a partition agreement executed by the debtor on the eve of bankruptcy with the purpose of removing assets from creditor reach may be avoided as a transfer with intent to hinder or delay creditors.
A non-debtor spouse is not entitled to any additional compensation for the loss of a homestead interest absent a showing of a gratuitous confiscation.

Debtor and his non-debtor spouse purchased their homestead, made substantial improvements to the homestead, and began to market the home for sale less than one year after its purchase. One hour before the Debtor filed his Chapter 7 bankruptcy petition, the Debtor and his spouse executed and recorded a partition agreement recharacterizing the home from community property to separate property, one half belonging to each spouse, and granting each spouse sole and exclusive authority, management, and control of their separate

[3] 505 S.W.3d 542 (Tex. 2016).
[4] *Id*.
[5] 708 F.3d 667 (5th Cir. 2013).

property. Debtor claimed an exemption in his one-half separate interest in the home, which was subject to the Section 522(p) homestead exemption cap since it was acquired within the 1,215 days prior to the petition date, and agreed to a reduced exemption in the amount of $130,675. The Trustee sold the homestead postpetition, netting over $400,000 to the estate in proceeds after payment of liens, claims, encumbrances, and the reduced exemption to the Debtor.

Non-debtor spouse filed an adversary proceeding seeking a declaratory judgment recognizing the partition agreement and her entitlement to half the net proceeds from the sale of the house. The Trustee counterclaimed to avoid the partition agreement and for a declaration that the remaining homestead proceeds were property of the estate. The Trustee stipulated that there was no intent to defraud and that the Debtor received reasonably equivalent value in the partition agreement. At trial, the Debtor testified that he had entered into the partition agreement upon the advice of counsel with the purpose of excluding his wife's community property interest in the homestead from his bankruptcy estate. He also testified that his wife had chosen not to join the bankruptcy petition because she was not liable for the Debtor's business debts.

The Bankruptcy Court avoided the partition agreement as a fraudulent transfer and found that the Debtor's sole intent in entering the partition agreement "in the shadow of an imminent bankruptcy filing" was to shield assets from creditors and avoid the Section 522(p) exemption cap. The non-debtor spouse subsequently filed a motion, under Section 363(j), requesting the Trustee to distribute a portion of the homestead proceeds to the non-debtor spouse on account of her separate homestead interest, notwithstanding the avoidance of the partition agreement. The Bankruptcy Court denied the non-debtor spouse's motion, finding that the homestead did not have anything more than general intrinsic value to her. The parties jointly certified the appeal to the Fifth Circuit.

On appeal, the non-debtor spouse challenged the Bankruptcy Court's finding that the Debtor acted with intent to hinder or delay, but not defraud, creditors in executing the partition agreement. Based on the Debtor's testimony at trial, the Fifth Circuit agreed with the Bankruptcy Court's assessment that the Debtor's intent to keep property in the hands of his spouse is the mirror of keeping property out of the hands of creditors. The benign purpose of enabling the non-debtor spouse to retain value from the homestead was pursued at the moment before the Debtor filed a bankruptcy petition that would have caused the entire property to go into the bankruptcy estate for the benefit of creditors, leaving nothing beyond the Debtor's capped homestead exemption for the couple's benefit. The Fifth Circuit also agreed that the Debtor's purpose in executing the partition agreement went beyond legitimate pre-bankruptcy planning given the timing of the transfer and the fact that the partition was one of several options considered to allow as much value as possible to be retained outside the bankruptcy estate.

The non-debtor spouse also argued on appeal that the Bankruptcy Court had misapplied caselaw protecting a non-debtor spouse's separate homestead interest. She argued that the Court's prior homestead caselaw suggested that Section 363(j) is a mechanism for distribution of proceeds to a non-debtor spouse on account of a homestead interest. Section 363(j) provides that "[a]fter a sale of property to which subsection (g) or (h) of this section applies, the trustee shall distribute to the debtor's spouse or the co-owners of such property, as the case may be, and to the estate, the proceeds of such sale, less the costs and expenses, not including any compensation of the trustee, of such sale, according to the interests of such spouse or co-owners, and of the estate."[6] Section 363(h), in turn, provides that "the

[6] 11 U.S.C. § 363(j).

trustee may sell both the estate's interest, under subsection (b) or (c) of this section, and the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety….”[7]

Rejecting the non-debtor spouse’s argument that she was entitled to a distribution, the Fifth Circuit agreed with the Bankruptcy Court’s conclusion that a non-debtor spouse was not entitled to any compensation for the taking of a separate homestead interest in a homestead acquired post-BAPCPA unless the taking would be a “gratuitous confiscation” of property. The Fifth Circuit found that, on its face, Section 363(h) could not be applicable to a Texas homestead, although it may be applicable to homesteads in other states, since Texas spouses do not hold community property as tenants in common, joint tenants, or tenants by the entirety. Rather, in a community property state, the entirety of a community property homestead, including a non-debtor spouse’s interest, becomes property of the estate by operation of Section 541(a)(2).

Ultimately, the Court determined that, notwithstanding the robust protection afforded a Texas homestead, allowing the non-debtor spouse to sidestep statutory limits on the homestead exemption enacted through BAPCPA and obtain homestead proceeds that otherwise are for creditors would lay waste to the provisions of the Bankruptcy Code implicated by the Debtor’s case.

[7] 11 U.S.C. § 363(h).