Divorce, Homestead and Bankruptcy after the 2005 Amendments

Can a Divorce Property Settlement Constitute an "Acquisition" of a Homestead?

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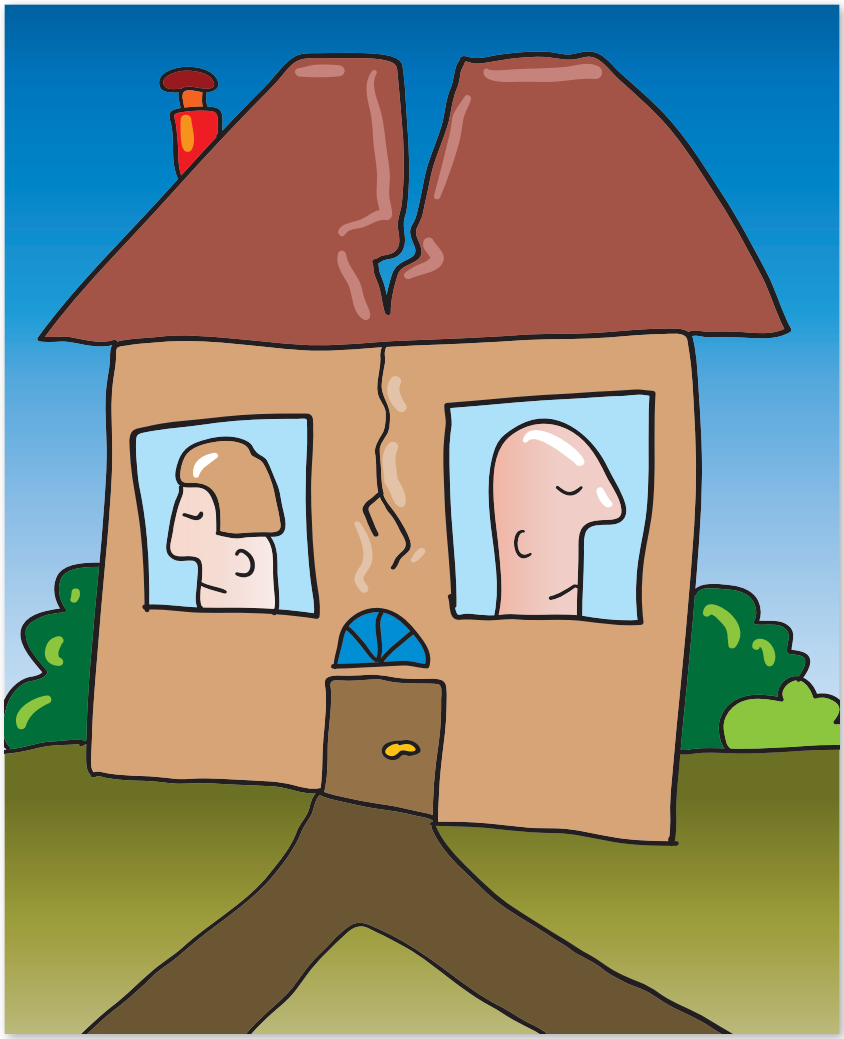

I. Introduction

The 2005 changes in the Bankruptcy Code significantly affected a number of rules applicable to homestead protection in bankruptcy. The primary change, of course, was that if one acquires a Texas homestead within 1,215 days of filing for bankruptcy, homestead protection might be limited to $125,000.[2] A recent Texas case considers, among other things, how this rule should be applied if the debtor divorces within 1,215 days of filing.

II. The Impact of Divorce within the 1,215-Day Window Period

In re Presto[3] involved a man who acquired a community property homestead in Texas with his wife more than 1,215 days before his bankruptcy filing. He and his wife divorced within the 1,215-day window, however, and he received the house in the property settlement (he was awarded the Texas house and the wife received a house in Colorado). This case presented the question of whether this settlement amounted to an "acquisition" of an "interest" within 1,215 days of the filing.[4]

The court first considered whether the wife's community property interest in the home was included in the term "any amount of interest" as that term is used in section 522(p) of the Bankruptcy Code.[5] To answer this question, the court looked to *In re Rogers*,[6] a case where the claimant acquired title to the property more the 1,215 days before filing but had designated the property as homestead within the 1,215-day period. The *Rogers* court determined that designating the property as homestead within the period was not an "amount of interest" within the Bankruptcy Code.[7] The court reasoned that to constitute an interest it needed to be a legal or equitable interest that can be assigned a monetary value.[8] The court in *Presto* noted that the situation before it was quite different, in that at divorce the husband received a property interest capable of being valued, so the court held the acquisition of the wife's interest via divorce was an "amount of interest" under section 522(p).[9]

The court then considered whether receipt of property via a divorce property settlement constituted an "acquisition" under section 522(p). The court consulted Black's Law Dictionary, which defines "acquire" as "to gain possession or control of; to get or obtain," and section 522(p), which uses the phrase "acquired by the debtor."[10] The court concluded that this phrase requires more than a passive acquisition by the debtor; it requires an active acquisition. The court noted that the acceptance of realty as a gift had been considered by another court as an "acquisition by the debtor."[11]

The opinion states that receipt of property via a divorce, standing alone, would not always create an "acquisition". However, in this instance, both parties were represented by counsel and both parties agreed to the property division.[12] The court decided that if property received by gift is an "acquisition" under this section,[13]then property received pursuant to a negotiated property settlement is as well. [14]

The court noted that some courts have applied an alternate interpretation of the term "acquisition" that focuses on transfer of legal title, rather than the active/passive distinction first discussed.[15] However, the property settlement would constitute an acquisition under this analysis as well. It should be noted that this distinction could be important in a future case, if it is found that the debtor passively received property in connection with a divorce decree. Then the court would have to decide which approach to use to determine the scope of an "acquisition" at divorce for purposes of the bankruptcy laws.

The debtor argued that the court was punishing him for filing for divorce within the 1,215-day period.[16] The court responded that all debtors who divorce within the 1,215-day window would not be impacted by the decision.[17] However, the section 522(p) restriction does apply in situations such as this where a debtor structures the divorce settlement so that he receives additional potentially exempt property in exchange for his interest in other non-exempt property. The court characterizes its holding as a means of discouraging debtors from using a divorce decree as a tool for homestead exemption planning.

In *Presto* the debtor was awarded all of the Texas community property house at divorce, thereby "acquiring" his wife's 50% interest. This would not be true if the debtor is awarded his or her separate property in connection with the divorce; the debtor would not thereby be "acquiring" anything additional not owned by the debtor before the divorce.[18]

The *Presto* court then outlined the amount of the debtor's exemption. The property was valued as of the date of the divorce (more than a year before the filing date), when the court determined that the total equity in the house was approximately $900,000. Of this amount, the debtor had acquired 50% from his wife within the 1,215-day window, so the debtor had approximately $450,000 in homestead protection.

III. Transforming Non-Exempt Property into Exempt Property via Homestead Improvements

The *Presto* case presented a number of other additional issues. One issue, which also highlights the difference between the old bankruptcy law and the new one, arose out of the debtor's sale of the old homestead (the one he acquired in the property settlement) a few months before filing and the purchase of a new one shortly thereafter. (The debtor also had obtained a home equity loan on the old homestead in the interim after the divorce.) The debtor received approximately $675,000 in cash in connection with the sale of the old homestead. He used $522,000 in cash from the proceeds to buy a new homestead, and spent most of the remaining proceeds making improvements to the new homestead before the filing date.

The Trustee challenged these improvements under section 522(o), which provides that the value of the homestead exemption should be reduced to the extent that the value is attributable to expenditures by the debtor made with non-exempt property in the ten year period before filing, if the expenditures were made with the intent to hinder, delay or defraud a creditor. The only element seriously contested was whether the trustee established that the debtor made the expenditures with the intent to defraud a creditor. The court summarized thirteen "badges of fraud," and found that nine were present in this case. Because of this, and due to the timing of the debtor's expenditures, the court found

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that the Creditors' Committee established the debtor's fraudulent intent.

The court then considered the amount by which the debtor's homestead should be reduced as a result of the fraudulent expenditures. In cases involving paying down a loan secured by the homestead, courts have reduced the homestead value by the amount prepaid.[19] In situations involving capital improvements, however, the *Presto* court held that the homestead amount should be reduced by the enhancement in value caused by the improvements, not the total cost.

The 2005 changes seem to have had a very large impact on pre-filing bankruptcy planning. The prior law was somewhat unclear, but did seem to allow the debtor to transform non-exempt property into exempt property shortly before filing (by, for example, paying down the purchase money note before filing).[20] After the 2005 changes, such expenditures will be more closely monitored.

IV. Summary

The 2005 changes to the bankruptcy law have had a significant impact on the treatment of Texas homestead in bankruptcy. These changes primarily impact debtors if they have "acquired" any "amount of interest" in the homestead within 1,215 days of filing for bankruptcy. If this has occurred, the maximum homestead protection might be $125,000 per debtor. *Presto* shows that if the debtor has divorced within the 1,215-day period, and received community property realty in the property settlement, this might constitute such an acquisition. In addition, amounts spent by the debtor on the homestead shortly before the filing for capital improvements or to reduce the principal balance of the purchase-money note may reduce the amount of homestead protection to which the debtor is entitled.

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2 For cases commenced after April 1, 2007 the limit is $136,875 per debtor. *See In re Fehmel*, 2008 WL 215 1797 (Bankr. W.D. Tex.).
3 *In re Presto*, 376 B.R. 554, 576 (S. D. Tex. 2007).
4 *Id*. at 576.
5 *Id*. at 577.
6 *In re Rogers,* 354 B.R. 792 (N. D. Tex. 2006).
7 *Id*. at 798; This holding was affirmed in *In re Rogers*, 513 F.3d 212 (5th Cir. 2008).
8 *Id.* at 797. The *Rogers* District Court did note that another court in *In re Green*, 346 B.R. 835 (Bankr. D. Nev. 2006) applied a broader definition.
9 *In re Presto* at 577-78.
10 *Id.* at 578.
11 *See In re Leung*, 356 B.R. 317, 322 (Bankr. D. Mass. 2006).
12 *In re Presto* at 578.
13 As the court found in *Leung, supra n. 11.*
14 *In re Presto* at 579.
15 *Id.*
16 *Id.*
17 *Id.* at 580.
18 *See In re Rogers*, 513 F.3d 212, 222 (5th Cir. 2008).
19 *See*, *e.g., In re Keck*, 363 B.R. 193 (Bankr. D. Kan. 2007).
20 *See NCNB Texas Nat'l Bank v. Bowyer*, 932 F.2d 1100, 1102 (5th Cir. 1991); *In re Bossart*, 2007 WL 4561300 (Bankr. S.D. Tex.).