

By Judon Fambrough

A legal term that signals disaster for creditors is *judgment proof*. Although a misnomer, it indicates that a debtor has insufficient assets to satisfy a judgment. Contrary to the language, it does not mean that a debtor is insulated from judgments.

In Texas, general (or unsecured) creditors may satisfy judgments by attaching (or seizing) a debtor's nonexempt assets and having them sold. Nonexempt assets consist of all property not designated as exempt by Texas law. There are two types of exempt property, realty and personalty.

Exempt real estate, described in the Texas Property Code (TPC), Chapter 41, consists of the homestead (either urban or rural) and one or more lots held as a sepulcher (burial plot). Exempt personal property, described in the TPC, Chapter 42, includes items such as home furnishings, tools, equipment, apparatus used in a trade or profession and livestock.

Given the exempt and nonexempt status of property, can a debtor convert from one to the other simply to defeat creditors' claims? Similarly, can a person protect wrongfully obtained money or property by purchasing or improving exempt property? Texas statutes, constitutional provisions and case law address these issues.

The Texas Business and Commerce Code, better known as the Uniform Fraudulent Transfer Act, provides that a transfer of assets is fraudulent if made with the intent to hinder, delay or defraud a creditor (Section 24.001 *et seq.*). If the statute is violated, the creditor may cancel the transfer and have the assets seized and sold.

On the surface, the statute appears to prohibit the conversion scheme described earlier. However, the prohibition is tempered somewhat by the Texas Constitution, which protects the homestead from forced sales (Article 16, Section 50). The statute applies as long as it does not contradict the constitutional provisions for a homestead. Texas case law casts a revealing light on the interplay of the two rules of law.

Protecting Nonexempt Assets

As to the first issue, Texas case law holds that a debtor may use nonexempt assets (or the proceeds from the sale thereof) to purchase or improve a homestead as long as no valid judgments exist against the debtor at the time.

Six cases cited *In the Matter of Reed* support this proposition (700 F. 2d 986 [1983]). The federal judge construing Texas law regarding "eleventh-hour conversions" held that "Texas constitutional and statutory protection of the homestead is absolute . . . (the) intent of the debtor is irrelevant."

Another case not cited in *Reed* ruled that "the head of a family has the right to invest his property in a homestead, and creditors without liens cannot complain" (*Thomas v. International & G.N.R. Co.*, 100 S.W. 197 [1907]).

Federal bankruptcy courts imposed an interesting twist on eleventh-hour conversions. Debtors who convert assets prior to declaring bankruptcy are protected by Texas law. However, the same debtors may not be entitled to a discharge in bankruptcy. The *Reed* case illustrates this point.

A few weeks before declaring bankruptcy, *Reed* sold his antique collection for \$8,500; his coin collection for \$19,500; his gun collection and some financial stocks for \$5,000. These assets were nonexempt, and the proceeds were used to reduce his home mortgage.

The federal judge, applying Texas law, held the procedure to be proper. However, the procedure violated the Federal Fraudulent Transfer Act (11 U.S.C.A., Section 727). The judge denied *Reed* a discharge in bankruptcy.

As to the second issue, Texas case law holds that wrongfully obtained funds, in some instances, may be protected by applying them to a homestead. Timing is important, however.

Homesteads may not be used as havens for wrongfully obtained funds if the money was obtained prior to acquiring a homestead. Illegally obtained funds may be used to repair or remodel an established homestead. Two Texas cases illustrate these rules.

In *First State Bank v. Zelesky*, *Zelesky* embezzled \$15,000 from the bank where he worked and purchased a home [262 S.W. 190 (1924)]. Later the bank was able to sell the home to regain the loss.

When funds are embezzled or taken by fraud, Texas courts impose a constructive trust. The embezzler has legal title that is subordinate to the bank's superior equitable title both for the funds and any property acquired therewith. Here, *Zelesky's* interest in the embezzled funds and later in the homestead was inferior to the bank's claim. *Zelesky* never owned both legal and equitable title to the home.

In *Curtis Sharp Custom Homes, Inc. v. Glover*, *Glover* embezzled \$70,000 from her employer (701 S.W. 2d 24 [1985]). She used \$5,000 to pay for improvements on her existing home. The employer sought to sell the home to retrieve the \$5,000. The court denied the sale because it would violate the Texas Constitution, Section 50, Article 50.

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