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Use It or Lose It: Grappling with Classification of Post-Petition Sale Proceeds under Chapter Seven Bankruptcy for Consumer Debtors in the Lone Star State.

Danielle Nicole Rushing

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RECENT DEVELOPMENT

USE IT OR LOSE IT: GRAPPLING WITH CLASSIFICATION OF POST-PETITION SALE PROCEEDS UNDER CHAPTER SEVEN BANKRUPTCY FOR CONSUMER DEBTORS IN THE LONE STAR STATE

DANIELLE NICOLE RUSHING*

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I. INTRODUCTION

“You may go to Hell, but I will go to Texas!” has been a debtor’s cry for over a century due to the state’s favorable debt protection laws.¹ Texas affords consumer debtors some of the most generous state bankruptcy exemptions in the United States.² Among these is the homestead exemption that dates back to the days of the Republic,³ when Texas became the first nation to adopt such a protection.⁴ This exemption, which is currently enshrined in the Texas Constitution and the Texas Property Code, permits consumer debtors to exempt a homestead of unlimited value from forced sale, subject to certain enumerated exceptions.⁵ Consumer–debtor protection may be further strengthened by recent case law from the United States Bankruptcy Court for the Western District of Texas.

The homestead exemption and the potential sale of homesteads were recently litigated in Texas.⁶ Bankruptcy courts throughout the state are

1. David “Davy” Crockett made this infamous remark in the mid-1830s, inspiring generations that followed him to flock to the great State of Texas. *David Crockett*, TEX. HERITAGE SOC’Y, <http://www.texasheritagesociety.org/David-Crockett-Quote.html> (last visited May 16, 2016) (detailing the history of Davy Crockett’s infamous Lone Star State quote). Debtors continue to follow Crockett’s advice and flock to Texas for its debtor-friendly laws.

2. See John O’Connor, *Chapter 7 Bankruptcy in Texas: What You Need to Know*, NAT’L BANKR. F. (Feb. 27, 2014), <http://www.natlbankruptcy.com/chapter-7-bankruptcy> (stating Texas provides consumer debtors with liberal bankruptcy exemptions).

3. David J. Willis, *Homestead Protections in Texas*, <http://www.lonestarlandlaw.com/Texas-Homestead.html#> (last visited May 16, 2016).

4. See Joseph Milton Nance, *Republic of Texas*, TEX. ST. HIST. ASS’N, <https://tshaonline.org/handbook/online/articles/mzr02> (last visited May 16, 2016) (detailing the homestead legislation passed in 1839 by the Congress of the Republic of Texas).

5. See TEX. CONST. art. XVI, § 50(a) (allowing for the exemption of one homestead, minus listed exceptions); TEX. PROP. CODE ANN. § 41.001 (West 2014) (illustrating one homestead exemption is permitted per Texas resident and is subject to the enumerated exceptions); see also *In re McCombs*, 659 F.3d 503, 507 (5th Cir. 2011) (“Texas state law provides for homestead protection with an acreage limit but no dollar limit.”); *In re D’Avila*, 498 B.R. 150, 153 (Bankr. W.D. Tex. 2013) (“The law exempts homesteads from seizure or encumbrance in all but a narrow range of circumstances, and caps homesteads in size but not in value.”); *Homestead Exemptions Across the States*, TEX. POL. PROJECT, https://texaspolitics.utexas.edu/archive/html/cons/features/0406_01/homestead.html# (last visited May 16, 2016) (listing an unlimited homestead exemption for residents in the Texas).

6. See generally *Frost v. Viegelahn (In re Frost)*, 744 F.3d 384 (5th Cir. 2014) (determining the characterization of property in the bankruptcy estate based on the date of the sale of exempted

grappling with how to characterize the proceeds from the sale of an exempted homestead once a consumer debtor has filed a Chapter Seven bankruptcy petition.⁷ Specifically, the courts are faced with the question of whether a debtor may personally retain the funds from the sale of a homestead or whether a Chapter Seven Trustee should receive the sale proceeds on behalf of a debtor's bankruptcy estate for the payment of creditors who properly filed proof of claims.

This Recent Development discusses the Texas homestead exemption as applied in Chapter Seven bankruptcy cases filed by consumer debtors. Particularly, the Recent Development focuses on the hotly contested issue regarding fund characterization of sale proceeds from an exempted homestead claimed by a consumer debtor seeking bankruptcy relief under Chapter Seven of the Bankruptcy Code. Additionally, the Recent Development highlights the case law conflict in Texas, concentrating on the recent case law out of the Southern and Western Districts and illustrates why the state truly is a consumer-debtor's paradise.

II. TEXAS: A DEBTOR'S PARADISE

"When it comes to protecting your assets from creditors, you [cannot] live in a better state than Texas."⁸ Texas's reputation as a debtor-friendly state stems largely from the state's constitution.⁹ The liberal exemptions afforded under state law, when compared to federal exemptions, make Texas a haven for consumer debtors.¹⁰

assets); *Lowe v. DeBerry* (*In re DeBerry*), No. 15-05054, 2015 WL 6528024 (Bankr. W.D. Tex. Oct. 28, 2015) (litigating whether the debtor or bankruptcy estate received the proceeds of the sale of the exempted homestead if not reinvested within the six-month statutory time frame); *In re D'Avila*, 498 B.R. 150 (contesting the characterization of the sale of the homestead proceeds in the Austin division of the Western District of Texas).

7. See generally *In re Frost*, 744 F.3d at 385 (deciding the bankruptcy estate received the proceeds of the sale of the exempted homestead); *In re DeBerry*, No. 15-05054, 2015 WL 6528024, at *4 (Bankr. W.D. Tex. Oct. 28, 2015) (stating the debtor shall be entitled to receive the post-petition sale proceeds of the exempted homestead); *In re D'Avila*, 498 B.R. at 153 (declaring the trustee has no authority over the post-petition sale proceeds of the debtor's previously exempted homestead).

8. Pamela Yip, *Texas Law Puts Protective Umbrella over Debtors*, DALL. NEWS (Aug. 18, 2012, 10:24 AM), <http://www.dallasnews.com/business/personal-finance/headlines/20120817-texas-law-puts-protective-umbrella-over-debtors.ece>.

9. See *In re D'Avila*, 498 B.R. at 153 ("Strong protection of the homestead dates back to the first Texas Constitution of 1845." (citing *England v. F.D.I.C.* (*In re England*), 975 F.2d 1168, 1172, 1174-75 (5th Cir. 1992))).

10. See *id.* ("Texas law provides broad protection for homesteads.").

A. Debtor Homestead

Both rural and urban homesteads are eligible to be claimed in Texas.¹¹ The Texas Property Code permits residents to claim up to ten acres as an urban homestead, while up to two hundred acres can be claimed as a rural homestead.¹² A Texas resident claims a homestead by showing “overt acts of homestead usage and the intention on the part of the owner to claim the land as a homestead.”¹³ Mere ownership of property does not qualify as a homestead.¹⁴

The Texas Constitution and the Texas Property Code both provide a homestead is sheltered from a forced sale except for valid encumbrances fixed to the homestead, including tax liens, purchase money liens, owelty of partition, reverse mortgages, home equity liens, refinance loans, mechanic's and materialsman's liens, and liens on mobile homes.¹⁵ Historically, a Texas resident was not permitted to exempt the proceeds from the sale of a homestead.¹⁶ To remedy that situation, the legislature passed a law in 1897 to provide an exemption to the proceeds from the sale of a homestead.¹⁷

Currently, the Texas Proceeds Rule affords Texas residents protection of the proceeds from the sale of a homestead for six months from the date of sale.¹⁸ Should an owner choose not to reinvest the funds on another homestead within the time allotted under the Texas Proceeds Rule, the exemption is lost.¹⁹ For a consumer debtor to exempt a homestead from creditors in a bankruptcy proceeding, a debtor must provide a homestead

11. TEX. PROP. CODE ANN. § 41.002 (West 2014).

12. *Id.* § 41.002(a), (b).

13. *Lifemark Corp. v. Merritt*, 655 S.W.2d 310, 314 (Tex. App.—Houston [14th Dist.] 1983, writ ref'd n.r.e.).

14. *See Sanchez v. Telles*, 960 S.W.2d 762, 770 (Tex. App.—El Paso 1997, pet. denied) (“[M]ere ownership alone is insufficient to constitute premises of a homestead.” (citing *Silvers v. Welch*, 91 S.W.2d 686, 688 (1936))).

15. *See* TEX. CONST. art. XVI, § 50(a) (enumerating the exceptions to the homestead exemption for Texas residents); *see also* Willis, *supra* note 3 (providing the eight exceptions to the unlimited homestead exemption in the Texas).

16. *See In re D'Avila*, 498 B.R. 150, 153 (Bankr. W.D. Tex. 2013) (indicating a Texan's homestead protection was abolished upon voluntary sale or exchange (citing *In re England*, 975 F.2d 1168, 1174 (5th Cir. 1992))).

17. *Id.*

18. TEX. PROP. CODE ANN. § 41.001(c); *see also In re D'Avila*, 498 B.R. at 153 (“Now, in addition to the homestead itself, Texas protects the proceeds of a homestead sale—but only for a limited time.”).

19. *See In re D'Avila*, 498 B.R. at 153 (requiring the homestead owner to reinvest the sale proceeds within six months of the sale of the homestead to protect his or her exemption of the homestead sale proceeds).

property description on a specified schedule at the time of filing the bankruptcy petition.²⁰

B. *Post-petition Homestead Sale*

Once the exemptions are granted in a debtor's bankruptcy petition, "the debtor can sell or dispose of exempt property, or even encumber property with post-petition debts, without involving the bankruptcy court or the bankruptcy estate."²¹ Exempt property belongs solely to a debtor, who is free to keep or sell any exempted items.²² "In the same vein, if [a] debtor sells his homestead and reinvests some, but not all, of the proceeds in a new homestead, any surplus proceeds lose their exempt status and revert to the estate . . ."²³ As a result, it is difficult for a trustee and the bankruptcy court to determine the size of a bankruptcy estate.²⁴ Courts throughout Texas struggle to apply the Texas Proceeds Rule in combination with the exemption provisions of the Bankruptcy Code due to the competing public policies for creditors and debtors.

III. CHAPTER SEVEN BANKRUPTCY

Congress has the authority to establish bankruptcy laws under Article I, Section 8 of the United States Constitution.²⁵ Under this authority, Congress passed the Bankruptcy Code in 1978.²⁶ The Bankruptcy Code, formally known as Title 11 of the United States Code, governs most aspects of bankruptcy law throughout the nation.²⁷ Congress has passed

20. *See id.* (declaring the necessary date for the debtor to properly claim a homestead in a bankruptcy proceeding is the date of filing the bankruptcy petition (citing *Zibman v. Tow* (*In re Zibman*), 268 F.3d 298, 302 (5th Cir. 2001))).

21. *Id.*

22. *See id.* (stating the debtor retains ownership over approved exempt property).

23. *Cage v. Smith* (*In re Smith*), 514 B.R. 838, 844 (Bankr. S.D. Tex. 2014) (citing *England v. F.D.I.C.* (*In re England*), 975 F.2d 1168, 1174–75 (5th Cir. 1992)).

24. *See id.* (detailing the difficulty of quantifying the "size of the bankruptcy estate and the extent of the debtor's post-bankruptcy assets").

25. *See* U.S. CONST. art. I, § 8, cl. 4 (providing Congress has the power "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States"); *see also* *Process: Bankruptcy Basics*, U.S. CTS., <http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/process-bankruptcy-basics> (last visited May 16, 2016) (discussing the congressional power of enacting uniform bankruptcy laws throughout the nation).

26. *See* *Process: Bankruptcy Basics*, *supra* note 25 (providing details on the enactment of the Bankruptcy Code).

27. *Id.* Even though the Bankruptcy Code governs the law on bankruptcy cases, bankruptcy courts and practitioners adhere to the Federal Rules of Bankruptcy Procedure for procedural parts of bankruptcy law. *Id.* Bankruptcy practitioners are also required to abide by the local rules of their respective district's bankruptcy court. *Id.*

several amendments to the Bankruptcy Code, most notably the Bankruptcy Abuse and Prevention and Consumer Protection Act (BAPCPA) of 2005.²⁸

A. Debtor Liquidation

Filing for Chapter Seven bankruptcy is designed to be a “fresh start” for consumer debtors.²⁹ The goal of filing a Chapter Seven bankruptcy petition is realized by the liquidation of a debtor’s bankruptcy estate.³⁰ Simply stated, a debtor’s assets are sold to cover payment of his debts.³¹

28. Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, Pub. L. No. 109-8, 199 Stat. 23 (codified as amended throughout 11 U.S.C.). The most sweeping change in BAPCPA is the imposition of the “means test” for consumer debtors seeking bankruptcy relief. *See Process: Bankruptcy Basics*, *supra* note 25 (detailing the addition of the “means test” to BAPCPA). The “means test” determines whether a consumer debtor is eligible for Chapter Seven relief. *Id.*; *see also* O’Connor, *supra* note 2 (discussing an overview of the required means test). Since the passing of BAPCPA, the means test is codified in Section 707(b)(2) of the Bankruptcy Code. *See Bankruptcy Basics Glossary*, U.S. CTS., <http://www.uscourts.gov/educational-resources/educational-activities/bankruptcy-basics-glossary> (last visited May 16, 2015) (“Section 707(b)(2) of the Bankruptcy Code applies a ‘means test’ to determine whether an individual debtor’s [C]hapter 7 filing is presumed to be an abuse of the Bankruptcy Code requiring dismissal or conversion of the case (generally to chapter 13).”). If deemed ineligible for Chapter Seven liquidation relief, the consumer debtor is forced into debt reorganization under Chapter Thirteen of the Bankruptcy Code. *See Process: Bankruptcy Basics*, *supra* note 25 (“Chapter 13 is also used by consumer debtors who do not qualify for [C]hapter 7 relief under the means test.”). Several factors determine whether the debtor is forced into Chapter Thirteen relief or whether Chapter Seven eligibility is granted. *See generally id.* (stating the importance of the means test in determining debtor eligibility for Chapter Seven relief). Most notably, the debtor’s monthly income is compared to the median income for his county of residence according to the number of persons in his household. *See Chapter 7 Means Test Calculation*, U.S. CTS., <http://www.uscourts.gov/forms/means-test-forms/chapter-7-means-test-calculation> (last visited May 16, 2016) (providing instructions and guidance on the calculation of the means test for consumer debtors seeking Chapter Seven relief); *see also* O’Connor, *supra* note 2 (detailing the importance of the debtor’s monthly income in determining whether the debtor passes the means test and qualifies for Chapter Seven relief). “If such a debtor’s income is in excess of certain thresholds, the debtor may not be eligible for [C]hapter 7 relief.” *Process: Bankruptcy Basics*, *supra* note 25.

29. *See Bankruptcy*, U.S. CTS., <http://www.uscourts.gov/services-forms/bankruptcy> (last visited May 16, 2016) (stating bankruptcy is helpful to debtors who cannot afford the payment of personal debts and seek liquidation relief for a fresh start); *see also Process: Bankruptcy Basics*, *supra* note 25 (“A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial ‘fresh start’ from burdensome debts.”); *Bankruptcy Cases*, U.S. CTS., <http://www.uscourts.gov/about-federal-courts/types-cases/bankruptcy-cases> (last visited May 16, 2016) (“Federal courts, in their exclusive jurisdiction over bankruptcy cases, give people and businesses a fresh start when they can no longer pay their debts.”); *Chapter 7 Bankruptcy Provides You with a Fresh Start*, CHARLES JUNTIKKA & ASSOC., <http://cjalaw.com/chapter-7-bankruptcy-a-fresh-start> (last visited May 16, 2016) (providing debtors who file under Chapter Seven bankruptcy liquidate the debtors’ bankruptcy estate and start fresh).

30. *See Bankruptcy Basics Glossary*, *supra* note 28 (defining the purpose of chapter seven bankruptcy).

31. *See generally* O’Connor, *supra* note 2 (providing basic details on the effect of filing Chapter

However, if a debtor's bankruptcy estate contains little to no non-exempt assets, no liquidation can occur; these cases are typically referred to as "no-asset case[s]."³² One major benefit to eligibility under Chapter Seven relief is the quick turnaround for liquidation of the debtor's bankruptcy estate.³³ Another key aspect of debtor protection provided by filing for bankruptcy is the imposition of the automatic stay.³⁴ The automatic stay protects debtors from creditors by imposing a court-ordered "injunction that automatically stops lawsuits, foreclosures, garnishments, and all collection activity against the debtor the moment a bankruptcy petition is filed."³⁵ As long as the automatic stay is in place, debtors are protected from a creditor's efforts to bring suit, garnish wages, and harass for payments of a debt.³⁶

B. *Bankruptcy Estate*

A debtor's non-exempt assets and any other non-exempt property owned at the time of the petition's filing constitute the bankruptcy estate.³⁷ Upon the creation of a bankruptcy estate, a Chapter Seven Trustee is appointed to oversee a debtor's bankruptcy estate.³⁸ For timing

Seven bankruptcy as a consumer debtor).

32. *Bankruptcy Basics Glossary*, *supra* note 28; *Process: Bankruptcy Basics*, *supra* note 25. If a debtor's bankruptcy estate contains relatively little to no non-exempt assets, unsecured creditors that filed a proof of claim against the debtor will not receive payout from the estate. *Bankruptcy Basics: Process*, *supra* note 25.

33. *See Process: Bankruptcy Basics*, *supra* note 25 ("The debtor normally receives a discharge just a few months after the petition is filed.").

34. *See Bankruptcy Basics Glossary*, *supra* note 28 (discussing the importance of the automatic stay).

35. *See id.* (defining the purpose of the necessary automatic stay for the protection of consumer debtors throughout the United States).

36. *Bankruptcy Cases*, *supra* note 29. Even though debtors are protected through the automatic stay, a creditor can file a motion to lift the automatic stay with the bankruptcy court. *See Bankruptcy Basics Glossary*, *supra* note 28 (defining the motion to lift the automatic stay as "a request by a creditor to allow the creditor to take action against the debtor or the debtor's property that would otherwise be prohibited by the automatic stay").

37. *See Process: Bankruptcy Basics*, *supra* note 25 (discussing debtor's assets which constitute the bankruptcy estate at the time of filing the debtor's Chapter Seven petition).

38. *See id.* (providing for trustee oversight once debtor's bankruptcy estate is formed at the time of filing the Chapter Seven petition); *Trustees & Administrators*, U.S. CTS., <http://www.uscourts.gov/services-forms/bankruptcy/trustees-and-administrators> (last visited May 16, 2016) ("When a bankruptcy case is filed, the United States trustee assigns an impartial case trustee to administer the case and liquidate the debtor's nonexempt assets."). Each trustee appointed to a debtor's case is a representative of the United States Trustee Program, which is a component of the United States Department of Justice. *Trustees & Administrators*, *supra*. Specifically, each bankruptcy district in the United States employs United States Trustees, Assistant United States Trustees, and chapter-specific trustees for efficiency and effective administration of the debtor's bankruptcy estate. *See id.* (stating the role of the appointed trustee in a bankruptcy proceeding).

purposes, the “snapshot” principle³⁹ is used to “determin[e] the extent of the bankruptcy estate and the scope of the exemptions.”⁴⁰ Unless items are exempted pursuant to the applicable statute, a debtor’s bankruptcy estate will be depleted and all debts discharged under a Chapter Seven filing.⁴¹ The Chapter Seven Trustee’s fiduciary duty to a bankruptcy estate terminates upon the closing of a debtor’s case—not at the time debtor receives a discharge.⁴²

IV. CASE LAW CONFLICT IN THE LONE STAR STATE

A. *Examining Fifth Circuit Rulings*

In 2001, the United States Court of Appeals for the Fifth Circuit ruled on the application of the Texas Proceeds Rule in bankruptcy in *In re Zibman*.⁴³ The debtor, Zibman, exercised his right as a homestead owner and sold the property before filing his bankruptcy petition seeking Chapter Seven relief.⁴⁴ The Fifth Circuit focused on the timing of the homestead sale.⁴⁵ *In re Zibman* established the “snapshot” provision, providing “any exemptions claims are determined by the facts and the law as they exist on the date of filing of the bankruptcy petition.”⁴⁶ The Fifth Circuit determined Zibman’s homestead exemption remained contingent upon his timely reinvestment of the homestead sale proceeds pursuant to the Texas Proceeds Rule.⁴⁷ Even though Zibman sold his homestead pre-petition, he failed to reinvest the homestead sale proceeds from the sale of his exempted homestead within the time frame allowed under the Texas

39. See *In re D’Avila*, 498 B.R. 150, 153 (Bankr. W.D. Tex. 2013) (“Soon after a bankruptcy filing, exemptions are usually determined once and for all, having been ‘determined by the facts and law as they exist on the date of filing the bankruptcy petition.’” (quoting *In re Zibman*, 268 F.3d 298, 302 (5th Cir. 2001))).

40. *Id.* (alteration in original).

41. See *Process: Bankruptcy Basics*, *supra* note 25 (providing a general overview of the Chapter Seven bankruptcy process).

42. *In re Smith*, 514 B.R. 838, 850 (Bankr. S.D. Tex. 2014).

43. *In re Zibman*, 268 F.3d 298 (5th Cir. 2001).

44. See *In re DeBerry*, No. 15-05054, 2015 WL 6528024, at *2 (Bankr. W.D. Tex. Oct. 28, 2015) (providing background information on the Fifth Circuit’s decision in *In re Zibman*).

45. See *id.* (providing the focus of the Fifth Circuit’s ruling in *In re Zibman* is on the timing of the sale of the proceeds and whether the funds are appropriately reinvested within the time period allowed under the Texas Proceeds Rule).

46. *Id.*

47. See *id.* (stating the determining factor of whether the debtor in *In re Zibman* kept his proceeds from the sale of his exempted homestead was the timely reinvestment of the proceeds into another homestead within the state of Texas (citing *In re Zibman*, 268 F.3d at 305)).

Proceeds Rule.⁴⁸ Zibman's untimely reinvestment of the proceeds from the sale of his homestead cost him exemption characterization of the funds.⁴⁹ In Texas, a consumer debtor seeking Chapter Seven bankruptcy relief must timely reinvest the proceeds from a sale of the exempted homestead on the acquisition of another Texas homestead to retain fund characterization as exempted property.⁵⁰ Should a debtor, like Zibman, fail to timely reinvest the sale proceeds according to the Texas Proceeds Rule, the exemption characterization of the funds is lost, becoming subject to recovery by a Chapter Seven Trustee for payment to creditors in the bankruptcy proceeding.⁵¹

Over a decade later, the Fifth Circuit revisited the application of the Texas Proceeds Rule in bankruptcy for a second time in *In re Morgan*.⁵² The debtor, Morgan, sought Chapter Seven bankruptcy relief in Texas.⁵³ Unlike *In re Zibman*, the debtor in *In re Morgan* claimed his homestead as exempt property after the date of filing his Chapter Seven bankruptcy petition.⁵⁴ According to *In re Zibman*, the "snapshot" of Morgan's bankruptcy estate would include only the exemptions claimed on the date of filing his petition.⁵⁵ The Fifth Circuit found the debtor's exemption of his homestead post-petition constituted property included in the bankruptcy estate.⁵⁶ Morgan's amendment of his exemptions in his Chapter Seven bankruptcy petition comprised only the proceeds of his post-petition homestead sale.⁵⁷ Following *In re Zibman*, the Fifth Circuit found Morgan's exemption claim was "contingent upon [his] reinvestment

48. *See id.* (detailing the debtor in *In re Zibman* did not reinvest the proceeds from the sale of his exempted homestead within the six months allowed by Texas law).

49. *See id.* ("Thus, the homestead proceeds lost their exempt character when not timely reinvested." (citing *In re Zibman*, 268 F.3d 298, 305 (5th Cir. 2001))).

50. *Id.*

51. *Id.*

52. *In re Morgan*, 481 F. App'x 183 (5th Cir. 2012); *see also In re DeBerry*, 2015 WL 6528024, at *3 ("[In 2012,] the Fifth Circuit subsequently examined the application of the Texas Proceeds Rule." (citing *In re Morgan*, 481 F. App'x at 185)). Even though *In re Morgan* is unpublished and does not provide precedential value, the Fifth Circuit's ruling can—and has been—influential in deciding the characterization of funds from the sale of exempted homesteads by consumer debtors in Texas bankruptcy courts.

53. *In re DeBerry*, 2015 WL 6528024, at *3 (citing *In re Morgan*, 481 F. App'x at 185).

54. *See id.* (providing the debtor exempted his homestead after filing his Chapter Seven bankruptcy petition).

55. *See id.* at *2 (illustrating the timeline of exemptions to the bankruptcy state under the "snapshot rule" (citing *In re Zibman*, 268 F.3d 298, 302 (5th Cir. 2001))).

56. *See id.* at *3 (declaring the post-petition homestead exemption claim by the debtor resulted in the property being included in the debtor's bankruptcy estate).

57. *Id.*

under the Texas Proceeds Rule.”⁵⁸ Since Morgan failed to timely reinvest the proceeds of his exempted homestead sale in accordance with the Texas Proceeds Rule, the proceeds lost exemption status.⁵⁹

Most recently in 2014, the Fifth Circuit considered the characterization of proceeds from post-certification sale of a consumer debtor's exempted homestead in *In re Frost*.⁶⁰ Unlike the debtors in *In re Morgan* and *In re Zibman*, Frost sought Chapter Thirteen⁶¹ relief under the Bankruptcy Code in Texas.⁶² The debtor exempted his homestead at the time of filing his bankruptcy petition and, ultimately, sold the homestead and received post-petition proceeds.⁶³ Frost did not reinvest his proceeds within the six months allowed by the Texas Proceeds Rule.⁶⁴ Frost's failure to reinvest his proceeds within six months from the date of sale resulted in the bankruptcy estate capturing the proceeds for payment to creditors.⁶⁵ Thus, Frost challenged the bankruptcy and district courts' rulings that the proceeds lost exempt status and were included in the bankruptcy estate.⁶⁶ The Fifth Circuit noted the sale of the homestead changes the exemption character from “homestead” to “proceeds,” triggering the six-month time

58. *See id.* (requiring the debtor in *In re Morgan* to reinvest the proceeds based on the previous ruling of *In re Zibman* (citing *In re Morgan*, 481 F. App'x 183, 186–67 (5th Cir. 2012))).

59. *See id.* (providing Morgan's proceeds no longer were protected as exempted property due to his failure to adhere to the timely reinvestment requirement of the Texas Proceeds Rule).

60. *In re Frost*, 744 F.3d 384 (5th Cir. 2014).

61. Chapter Thirteen relief is often sought by consumer debtors wishing to remain in possession of their assets. *Process: Bankruptcy Basics*, *supra* note 25. Additionally, debtors that do not qualify for Chapter Seven relief under the means test are often forced into Chapter Thirteen bankruptcy. *Id.* “Chapter 13 is often preferable to [C]hapter 7 because it enables the debtor to keep a valuable asset, such as a house, and because it allows the debtor to propose a ‘plan’ to repay creditors over time—usually three to five years.” *Id.* Unlike Chapter Seven relief, Chapter Thirteen does not provide debtors with an immediate debt discharge. *Id.* Once the bankruptcy court confirms the debtor's Chapter Thirteen plan, the debtor must make payments and complete the plan to receive discharge. *Id.* Debtors receive a broader scope of discharged debts under Chapter Thirteen when compared to Chapter Seven debt dischargeability. *Id.*

62. Brief for Appellant at 11, *In re Frost*, 744 F.3d 384 (5th Cir. 2014) (No. 12-50811), 2012 WL 5464325, at *2. Interestingly enough, the distinction of the debtor filing bankruptcy under Chapter Thirteen is not mentioned in the Fifth Circuit's opinion. *See generally In re Frost*, 744 F.3d 384 (finding the post-petition sale proceeds from a debtor's exempted homestead reverted to the bankruptcy estate while failing to address the relevant chapter relief sought under the Bankruptcy Code). Notably, Frost does not include Chapter Thirteen statutory provisions in arguments before the lower courts or the Fifth Circuit. *See id.* (failing to include Chapter Thirteen provisions in debtor's arguments for protection of non-reinvested homestead sale proceeds).

63. *In re Frost*, 744 F.3d at 385–86. “During the pendency of his Chapter 13 case, the debtor sold this property and used some of the proceeds for purposes other than purchasing a new homestead.” *In re Smith*, 514 B.R. 838, 844 (Bankr. S.D. Tex. 2014).

64. *In re Frost*, 744 F.3d at 386–87.

65. *Id.* at 387.

66. *Id.* at 385–86.

frame for reinvestment under the Texas Proceeds Rule.⁶⁷ The Fifth Circuit held the debtor's "interest in his homestead changed from an unconditionally exempted interest in the real property itself to a conditionally exempted interest in the monetized proceeds from the sale of that property."⁶⁸ Thus, Frost's failure to reinvest the proceeds within the six months "removed [the proceeds] from the protection of Texas bankruptcy law and [thus the proceeds were] no longer exempt from the estate."⁶⁹

Taken together, the Fifth Circuit's rulings in *In re Frost*, *In re Morgan*, and *In re Zibman* provide guidance to bankruptcy courts in Texas. The "snapshot" principle established in *In re Zibman* clarifies the timing requirement for a debtor's claimed exemptions and property included in the debtor's bankruptcy estate. Both *In re Frost* and *In re Morgan* stress the importance of timely adherence to the Texas Proceeds Rule for reinvestment of sale proceeds for a debtor to maintain proceeds exemption status. All three cases require a consumer debtor to strictly adhere to the Texas Proceeds Rule's reinvestment time period for investing in a new Texas homestead to retain exemption status for the proceeds of a sale of a debtor's claimed homestead listed in the bankruptcy petition on the date of filing.⁷⁰ Therefore, debtors seeking Chapter Seven or Chapter Thirteen relief under the Bankruptcy Code can be subject to the Texas Proceeds Rule and potentially lose exemption status proceeds from the sale of an exempted homestead.

B. *Examining In re D'Avila*⁷¹

While *In re Zibman* and *In re Morgan* guide Texas bankruptcy courts on the timing requirement for claiming exemptions in a consumer-debtor

67. *Id.* at 387. The Fifth Circuit notes that the Texas homestead exemption is of particular importance in *In re Frost* because it "exempts the homestead property itself as an interest in *real* property without a monetary limit." *Id.* at 389. Frost attempts to analogize his case to two cases from Massachusetts and Georgia. *Id.* The Fifth Circuit found Frost's analogies unpersuasive because both Massachusetts and Georgia's homestead exemption is based on a monetary limit, while Texas's exemption is unlimited. *Id.*

68. *Id.* at 389.

69. *Id.* at 387. The Fifth Circuit clarifies the importance of 11 U.S.C. § 522(c) with respect to the sale of an exempted homestead in *In re Frost*. *Id.* at 388. The court stated its precedent focuses on two essential elements: (i) the sale of the homestead that voids the homestead exemption and (ii) the failure to reinvest the proceeds from the sale of the exempted homestead voids the proceeds exemption. *Id.* Of particular note, the court stated the timing of the sale of the exemption homestead was not determinative. *Id.*

70. *In re DeBerry*, No. 15-05054, 2015 WL 6528024, at *2-3 (Bankr. W.D. Tex. Oct. 28, 2015).

71. *In re D'Avila*, 498 B.R. 150 (Bankr. W.D. Tex. 2013).

Chapter Seven filing, the bankruptcy courts in the Western District faced a new problem in 2014 that remained unanswered by the Fifth Circuit: How are proceeds from a post-petition sale of a debtor's exempted homestead properly characterized? *In re D'Avila* involved a consumer debtor seeking Chapter Seven relief in the Western District of Texas.⁷² Within this case, the debtor, D'Avila, properly claimed her homestead under the Texas Constitution⁷³ and the Texas Property Code⁷⁴ as exempt property in her Chapter Seven bankruptcy petition, electing the use of state exemptions pursuant to 11 U.S.C. § 522(b)(3).⁷⁵ The homestead, though exempted, was included in D'Avila's bankruptcy estate upon filing her petition with the bankruptcy court.⁷⁶

D'Avila elected to contract with her spouse before filing her bankruptcy petition to sell the exempted homestead for \$340,000.00.⁷⁷ When she tried to sell the property, D'Avila received an objection to the sale proceeds of the exempted homestead by the Chapter Seven Trustee.⁷⁸ The Chapter Seven Trustee objected to the sale of the proceeds of the exempted homestead because of the six-month reinvestment rule in Texas,⁷⁹ which is codified in the Texas Property Code § 41.001(c).⁸⁰ The trustee's basis for objecting to the sale of D'Avila's exempted homestead rested on the need for an extension to the objection deadline for creditors to determine whether reinvestment of the sale proceeds occurred within the statutory six-month time period.⁸¹ If D'Avila chose not to reinvest the sale proceeds within the six-month reinvestment period, the trustee claimed the funds could "be subject to recovery by the estate in order to

72. *See id.* at 152 (providing background on the chapter seven bankruptcy filing by D'Avila, a consumer debtor).

73. *See* TEX. CONST. art. XVI, § 50(a) ("The homestead of a family, or of a single adult person, shall be, and is hereby protected from forced sale, for the payment of all debts . . .").

74. *See* TEX. PROP. CODE ANN. § 41.001(a) (West 2014) ("A homestead and one or more lots used for a place of burial of the dead are exempt from seizure for the claims of creditors except for encumbrances properly fixed on homestead property.").

75. *See In re D'Avila*, 498 B.R. at 151 (detailing the debtor's exemption of her homestead when filing her bankruptcy petition).

76. *See id.* at 152 (stating the debtor's exempted homestead was a part of the debtor's bankruptcy estate).

77. *Id.*

78. *See id.* ("[T]he Chapter 7 Trustee . . . advances a limited but significant objection to the [debtor's] Application to Sell [their homestead].").

79. *Id.* at 152–53.

80. *See* PROP. § 41.001(c) ("The homestead claimant's proceeds of a sale of a homestead are not subject to seizure for a creditor's claim for six months after the date of sale.").

81. *See In re D'Avila*, 498 B.R. at 152–53 (detailing the basis of the Chapter Seven Trustee's objection to Debtor's sale of exempted homestead).

pay the creditors of the estate.”⁸² The Honorable Tony M. Davis⁸³ decided whether D’Avila or the Chapter Seven Trustee should receive the proceeds from the sale of the exempted homestead if the proceeds were not reinvested in the six-month statutory time period.⁸⁴

Unlike *In re Zibman*, D’Avila exempted the homestead itself at the time of filing the Chapter Seven bankruptcy petition.⁸⁵ Because the homestead itself was exempted at the time of petition and not the proceeds of a homestead sale, the relevant law was the homestead exemption under the Texas Constitution and the Texas Property Code.⁸⁶ Texas homestead exemption law provides no time limitation; whereas the Texas Proceeds Rule requires the reinvestment of proceeds within six months of the date of filing the bankruptcy petition.⁸⁷ Due to the grave differences between *In re D’Avila*, *In re Zibman*, and *In re Morgan*, there is no Fifth Circuit precedent for the exact issue contested in *In re D’Avila*.⁸⁸

In resolving the issue, the bankruptcy court found the Texas Proceeds Rule was not implicated because, in the petition, D’Avila exempted the homestead itself and not the proceeds from the sale of an exempted homestead.⁸⁹ “The debtor who exempts the actual homestead need not seek the benefit of the Texas Proceeds Rule, and thus need not bear its burden.”⁹⁰ Concluding D’Avila was not subject to the Texas Proceeds Rule, the bankruptcy court found she retained ownership of the post-petition proceeds from the sale of her previously exempted homestead at the time of filing her Chapter Seven petition.⁹¹ Therefore, the Chapter Seven Trustee had no authority to include the proceeds from the post-petition sale of the exempted homestead in the debtor’s bankruptcy estate for payment of debts to creditors.⁹²

82. *See id.* (providing trustee’s argument that any proceeds not reinvested within the six-month time frame can be subject to the bankruptcy estate for payout to the debtor’s creditors).

83. *See Judge Davis*, U.S. BANKR. CT.: W. DIST. TEX., <http://www.txwb.uscourts.gov/node/125> (last visited May 16, 2016) (providing details on The Honorable Tony M. Davis, United States Bankruptcy Judge for the Western District of Texas).

84. *In re D’Avila*, 498 B.R. at 151, 153.

85. *See id.* at 152 (detailing the exemption of the homestead at the time of filing the bankruptcy petition).

86. *Id.* at 157.

87. *Id.*

88. *Id.* at 157–158.

89. *Id.* at 159.

90. *Id.*

91. *Id.* at 159–60.

92. *Id.*

C. *Examining In re DeBerry*⁹³

Like *In re D'Avila*, *In re DeBerry* involved a consumer debtor seeking Chapter Seven relief in the Western District of Texas.⁹⁴ DeBerry listed a homestead as exempt property on his petition schedules.⁹⁵ After filing his bankruptcy petition, DeBerry sought court approval to sell his homestead.⁹⁶ The Honorable Craig A. Gargotta⁹⁷ granted DeBerry's motion and authorized the sale of his homestead.⁹⁸

Unlike *In re D'Avila*, DeBerry did not reinvest his proceeds from the sale of his exempted homestead within the six months provided under the Texas Proceeds Rule.⁹⁹ The failure to reinvest the proceeds within the prescribed six-month period forced the court to decide "whether the [p]roceeds became part of the bankruptcy estate after [the] [d]ebtor failed to reinvest them in a new Texas homestead."¹⁰⁰

Following *In re D'Avila*, the bankruptcy court did not include the post-petition sale proceeds in DeBerry's bankruptcy estate.¹⁰¹ "[W]hen a Texas homestead itself is held as of the petition date and as of the date exemption is claimed, the Texas Proceeds Rule is not implicated and the proceeds are not subject to later recovery by the bankruptcy estate."¹⁰² DeBerry claimed his homestead in his Chapter Seven petition at the date of filing; therefore, the court found the exemption was for the homestead itself and not proceeds of the sale of the exempted homestead.¹⁰³ Because the homestead was exempted and not the proceeds, the "snapshot" of the bankruptcy estate included the homestead of unlimited value.¹⁰⁴ DeBerry received approval of the homestead exemption by the

93. *In re DeBerry*, No. 15-05054, 2015 WL 6528024 (Bankr. W.D. Tex. Oct. 28, 2015).

94. *See id.* at *1 (detailing the debtor's filing for Chapter Seven bankruptcy relief).

95. *See id.* (providing the debtor included his homestead as exempted property on the date of filing his Chapter Seven bankruptcy petition).

96. *See id.* (stating the debtor requested court approval for the sale of his exempted homestead property after filing for Chapter Seven bankruptcy relief).

97. *See Judge Gargotta*, U.S. BANKR. CT.: W. DIST. OF TEX., <http://www.txwb.uscourts.gov/node/126> (last visited May 16, 2016) (providing details on The Honorable Craig A. Gargotta, United States Bankruptcy Judge for the Western District of Texas).

98. *See In re DeBerry*, 2015 WL 6528024, at *1 (granting the debtor's motion to sell exempted homestead property post-petition).

99. *See id.* (stating there was an agreement by the debtor and the Chapter Seven Trustee that the debtor's post-petition sale proceeds from the exempted homestead were not reinvested in another homestead within the statutorily prescribed period).

100. *Id.* at *2.

101. *Id.* at *3.

102. *Id.* (citing *In re D'Avila*, 498 B.R. 150, 159 (Bankr. W.D. Tex. 2013)).

103. *Id.* at *3-4.

104. *Id.* at *3.

bankruptcy court and was permitted to retain or sell the homestead post-petition.¹⁰⁵ The proceeds from the sale of DeBerry's exempted homestead were obtained after the petition was filed, and the court found the proceeds should not be included in the bankruptcy estate for recovery by the Chapter Seven Trustee.¹⁰⁶ Based on its finding, the court declared the debtor owned the proceeds of the post-petition sale of the exempted homestead, and the proceeds were thus untouchable by the Chapter Seven Trustee for payment of debts to creditors.¹⁰⁷

D. *Examining In re Smith*¹⁰⁸

Unlike *In re D'Avila* and *In re DeBerry*, *In re Smith* involves a debtor seeking Chapter Seven relief in the Southern District of Texas.¹⁰⁹ Smith, the debtor, filed his bankruptcy petition before properly exempting his homestead in 2012.¹¹⁰ Smith's case is considered "an 'asset case' in which the Trustee will liquidate non-exempt assets and make distributions to creditors."¹¹¹ In April 2013, Smith received a discharge of debt from the bankruptcy court.¹¹² Subsequent to receiving his discharge, the debtor sold his homestead in June 2013; after payment of costs and expenses relating to the homestead's sale; Smith received over \$813,935.77 in sale proceeds.¹¹³ Subject to the Texas Proceeds Rule, Smith failed to timely reinvest the post-petition sale proceeds.¹¹⁴ Due to Smith's failure to timely reinvest the sale proceeds, the Chapter Seven Trustee objected to the debtor keeping the proceeds and sought turnover of the \$813,935.77 in proceeds "on the basis that the [p]roceeds [were] non-exempt and therefore property of the [d]ebtor's Chapter 7 estate."¹¹⁵

Arguing the applicability of the then-recently decided *In re Frost*, the Chapter Seven Trustee filed a motion with the bankruptcy court requiring the debtor to turnover the post-petition homestead sale proceeds to the trustee as part of the bankruptcy estate.¹¹⁶ On the other hand, Smith

105. *Id.*

106. *Id.* at *3-4.

107. *See id.* (finding the debtor retained ownership of the post-petition proceeds from the sale of debtor's homestead).

108. *In re Smith*, 514 B.R. 838 (Bankr. S.D. Tex. 2014).

109. *Id.* at 838, 841.

110. *Id.* at 841.

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.* at 840.

argued *Frost* was inapplicable to his case “because Chapter 7 lacks a companion provision” to Section 1306(a)(1) of the Bankruptcy Code.¹¹⁷ *Frost*'s failure to mention Section 1306(a)(1) of the Code or Chapter Thirteen relief bolstered the Chapter Seven Trustee's argument.¹¹⁸ Because *Frost* was not decided based on Chapter Thirteen provisions, the bankruptcy court found the Chapter Thirteen case of *In re Frost* was applicable to Smith's Chapter Seven case.¹¹⁹

Under *In re Zibman*'s “snapshot” principle, the debtor's bankruptcy estate included “all proceeds from any future sale of the [p]roperty that the [d]ebtor did not use within six months of the sale to purchase a new homestead.”¹²⁰ Smith failed to timely reinvest the proceeds in a new Texas homestead; therefore, the proceeds were included in the bankruptcy estate for the payment of creditors.¹²¹

Additionally, Smith argued the receipt of discharge prior to the sale of the exempted homestead should have shielded him from the application of the Texas Proceeds Rule.¹²² The bankruptcy court stated, “[A]lthough the [d]ebtor has received his discharge, the Chapter 7 case itself has not been closed.”¹²³ Here, the court noted the Chapter Seven Trustee continued to recover the debtor's non-exempt assets on behalf of the bankruptcy estate for the payment of creditors.¹²⁴ The trustee's fiduciary duty to recover all non-exempt assets continues until a bankruptcy case is closed—not when a debtor receives discharge.¹²⁵ “Once a Chapter 7 case is closed, any property that the trustee has not administered at the time of closing is abandoned to the debtor under §554(c) [of the Code].”¹²⁶

Noting the six-month time frame under the Texas Proceeds Rule, the bankruptcy court commented that Smith could have received the entire amount of proceeds had the case closed before the expiration of the six months.¹²⁷ Judge Bohm stated the “key date is **not** the discharge date, but rather the date that the case is closed.”¹²⁸

117. *Id.* at 848.

118. *In re Smith*, 514 B.R. 838, 845 (Bankr. S.D. Tex. 2014).

119. *Id.* at 840.

120. *Id.* at 848.

121. *Id.* at 850.

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.* The bankruptcy court noted the case will close “only after the Trustee has recovered and liquidated all non-exempt assets and made distributions to creditors.” *Id.*

126. *Id.*

127. *Id.* at 851.

128. *In re Smith*, 514 B.R. 838, 851 (Bankr. S.D. Tex. 2014).

Unlike *In re D'Avila* and *In re DeBerry*, Smith's proceeds became property of the bankruptcy estate six months after the date of the sale of his exempted homestead.¹²⁹ On the 181st day after selling the homestead, the title to the proceeds transfers automatically to the Chapter Seven Trustee on behalf of the bankruptcy estate.¹³⁰ Smith was no longer entitled to the proceeds, and he possessed a duty to hand over the \$813,935.77 to the Chapter Seven Trustee.¹³¹ Thus, Smith's proceeds lost exempt status and went to pay creditor claims.¹³²

V. CONCLUSION

Freedom and protection of the people—particularly as debtors—was central to this nation's founding.¹³³ The drafters of the United States Constitution envisioned debtor protection when providing Congress with the authority to establish uniform bankruptcy laws throughout the states.¹³⁴

Texas is known throughout the fifty states for its unrivaled, liberal protection of debtors.¹³⁵ If you are considering filing bankruptcy as a consumer debtor, y'all come on over to the great State of Texas! If you serve as counsel for consumer debtors, your clients are well protected under current federal and state bankruptcy laws. As seen throughout this Recent Development, the protections and exemptions afforded to Texan debtors are generous and deeply rooted in Texas's history.

A major goal of Chapter Seven bankruptcy is to provide debtors with a fresh start.¹³⁶ Consumer debtors, particularly those filing under Chapter Seven of the Bankruptcy Code in Texas, will generally be considered "judgment proof" due to the generous exemptions afforded by state law. For those consumer debtors owning, claiming, and exempting a homestead, the characterization of the proceeds of a potential post-petition sale is of great importance.

Timing in relation to the Texas Proceeds Rule is an issue for Texas bankruptcy courts, and debtors should contemplate such sale prior to

129. *Id.*

130. *Id.*

131. *Id.* at 852.

132. *Id.* at 851.

133. See U.S. CONST. art. I, § 8, cl. 4 (enumerating congressional authority over establishing bankruptcy laws).

134. *Id.*

135. See generally Yip, *supra* note 8 (discussing the extreme protection of debtors in the Texas).

136. *Bankruptcy*, *supra* note 29; *Process: Bankruptcy Basics*, *supra* note 25; *Bankruptcy Cases*, *supra* note 29; *Chapter 7 Bankruptcy Provides You with a Fresh Start*, *supra* note 29.

filing because, depending on *when* the home is sold, it may be property of the bankruptcy estate. “[I]t is the controlling exemption statute at the time of filing, not the exempted character of the property, that undergirds the ‘snapshot rule.’”¹³⁷

Due to the increase in the volume of litigation in bankruptcy courts in Texas regarding the issue of how to characterize post-petition sale proceeds of a Chapter Seven consumer-debtor’s homestead, the Fifth Circuit Court of Appeals could be faced with determining this issue. Until the Fifth Circuit settles this dispute, Chapter Seven consumer debtors in Texas run the risk of losing protection of post-petition proceeds from the sale of a homestead if the proceeds are not reinvested in another Texas homestead within the six-month time period afforded by the Texas Proceeds Rule. However, in the districts adopting the approach set forth by the Western District in *In re D’Avila* and *In re DeBerry*, consumer debtors are likely to continue to be afforded protection of the post-petition proceeds of their homesteads.

137. *In re Smith*, 514 B.R. at 848 (citing *In re Zibman*, 268 F.3d 298, 301–02 (5th Cir. 2001) (emphasis omitted)).