

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WISCONSIN
COURT MINUTES

CHAPTER 13
DATE: March 24, 2014
JUDGE: Margaret Dee McGarity
CASE NO.: 12-21920-MDM
DEBTOR: Lawrence and Lorine Hartung
NATURE OF HEARING: 1. Preliminary hearing on the debtors' objection to Universal Restoration Services, Inc.'s motion for relief from the automatic stay.
2. Court's decision on Universal Restoration Services, Inc.'s objection to debtor's motion to avoid judicial lien.
APPEARANCES: Dayten Hanson, Attorney for Debtors
Bradley Arnold, Attorney for Universal Restoration Services, Inc.
Rebecca Garcia for Chapter 13 Trustee
COURTROOM DEPUTY: Carolyn A. Belunas
TIME: 1:00 pm - 1:34 pm

Debtors' objection to Universal Restoration Services, Inc.'s motion for relief from the automatic stay. Because the judicial lien on the homestead is avoidable (see below), the motion for relief from the automatic stay was denied, without prejudice. Mr. Hanson will submit an order.

Court's decision on Universal Restoration Services, Inc.'s objection to debtor's motion to avoid judicial lien on debtors' homestead. The debtors filed a chapter 13 petition on February 22, 2012. On April 20, 2012, the automatic stay was lifted to allow Universal Restoration Services to continue with state court litigation against the debtors. That litigation had previously resulted in a prepetition jury verdict in favor Universal on February 3, 2012, three weeks before the debtors filed for bankruptcy. After the automatic stay was lifted and post-trial motions were heard, on July 9, 2012, the state court awarded Universal an amended judgment against the debtors in the amount of \$164,130.07, plus interest, costs and disbursements. The state court found that the debtors received the insurance proceeds "as trustees to hold such money for the sole benefit of Universal Restoration Services, Inc. which was and is the beneficial owner of such property." The court further found that the debtors' use of such funds for personal reasons (including payments toward their mortgage and personal property for the house) "constitute[d] a breach of their fiduciary duty to Universal." (Amended Judgment Order, June 9, 2012, Racine County Circuit Court Case No. 10-CV-1308). The Amended Judgment Order also held that the "equitable lien by agreement is ordered to attach to and is impressed upon the American Security Insurance Company funds tendered to Defendants in the amount of \$107,534.06 and upon the real and personal property owned by Defendants located at 3125 W. Mile Road, Caledonia, Wisconsin 53108."

Subsequently, the appellate court found that the trial court did not erroneously exercise its discretion when it imposed the constructive trust on the insurance proceeds because all of the elements necessary to impose a constructive trust were present:

A "constructive trust will be imposed only in limited circumstances" where (1) the legal title is "held by someone who in equity and good conscience should not be entitled to (its) beneficial enjoyment" and (2) where title was "obtained by means of actual or constructive fraud, duress, abuse of a confidential relationship, mistake, commission of a wrong, or by any form of unconscionable conduct." *Wilharms v. Wilharms*, 93 Wis. 2d 671, 678-79, 287 N.W.2d 779 (1980).

(Decision ¶ 15, July 10, 2013, Wisconsin Court of Appeals Case No. 2012AP2207). The appellate decision and order are final and nonappealable. On January 17, 2014, this Court determined that Universal was entitled to summary judgment and the obligation was excepted from discharge under

sections 523(a)(4) and 1328(a)(2). That ruling is currently under appeal.

Universal alleges that it holds a judicial lien against the debtors' homestead property by virtue of the state court judgment. The debtors have claimed their property exempt under Wis. Stat. § 815.20 in the amount of \$75,000.00. The value of the real estate as of the date of filing was \$192,742.00 and the property is subject to liens and encumbrances – not including Universal's judgment lien – in the nature of mortgages, judgment liens, and tax liens in the aggregate amount of \$132,591.28.

Arguments. The debtors moved to avoid Universal's judicial lien pursuant to section 522(f)(1)(A), claiming said judicial lien impaired an exemption of the debtors because the sum of the lien and all other liens on the property, and the amount of the exemption that the debtors could claim if there were no liens against the property, exceeded the value that the debtors' interest in the property would have in the absence of any liens under section 522(f)(2)(A). A debtor can avoid a judgment lien pursuant to federal law, not state law, even though the underlying judgment is nondischargeable. See *In re Allen*, 217 B.R. 945, 948 (Bankr. M.D. Fla. 1998). At the preliminary hearing on this matter, the debtors also pointed out that the time to oppose the debtors' claim of exemption has passed.

Universal contends the state court imposed a trust on the debtors' real and personal property due to a specific finding of the debtors' breach of fiduciary duty to Universal and wrongful appropriation of property by the debtors directly traceable to the debtors' residence and personal property located there. The debtors are not entitled to the homestead exemption under Wis. Stat. § 815.20. *Paulman v. Pemberton*, 2001 WI App 164, 246 Wis.2d 909, 633 N.W.2d 715; *Warsco v. Oshkosh Savs. & Trust Co.*, 190 Wis. 87, 88-89, 96, 208 N.W. 886 (1926). Additionally, at the preliminary hearing, Universal argued it did not oppose the debtors' exemption within 30 days of the conclusion of the meeting of creditors because the state court had not issued its amended judgment until June 9, 2012, and that order was appealed. The appellate court did not uphold the trial court's imposition of the trust until July 10, 2013.

Discussion. Section 522(f) provides, in pertinent part:

[T]he debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is –
(A) a judicial lien[.]

11 U.S.C. § 522(f)(1)(A). A lien "impairs" an exemption for purposes of § 522(f) to the extent that the sum of the lien, all other liens on the property, and the amount of the exemption that the debtor could claim if there were no liens on the property, "exceeds the value that the debtor's interest in the property would have in the absence of any liens." 11 U.S.C. § 522(f)(2)(A). The value of the debtor's property at the time of filing and the amounts of the liens on the property are not disputed.

Under federal law, property that is properly exempted under section 522 is immunized against liability for prebankruptcy debts, subject only to a few exceptions. Those exceptions include: (1) debt from certain taxes and customs duties, (2) debt related to domestic support obligations, (3) liens that cannot be avoided or voided, including tax liens, and (4) debts for a breach of fiduciary duty to a federal depository institution. See 11 U.S.C. § 522(c)(1)-(3). The debtors are correct that the nondischargeable nature of the obligation, in of itself, does not preclude the debtors from avoiding the lien. *In re Allen*, 217 B.R. 945, 948 (Bankr. M.D. Fla. 1998). Additionally, the Bankruptcy Code does not give courts equitable power to deny exemptions based on a debtor's bad conduct. See *Law v. Siegel*, ___ S.Ct. ___, 2014 WL 813702 at *6 (March 4, 2014). Nevertheless, "when a debtor claims a state-created exemption, the exemption's scope is determined by state law, which may provide that certain types of debtor misconduct warrant denial of the exemption." *Id.* The debtors have claimed an exemption of \$75,000.00 in the subject real property under Wis. Stat. § 815.20. Thus, according to the recent directive of the Supreme Court, this Court must look to state law to determine whether or not the debtors are entitled to the exemption.

Wisconsin Stat. § 815.20 states, in part:

An exempt homestead as defined in s. 990.01(14) selected by a resident owner and occupied by him or her shall be exempt from execution, from the lien of every judgment, and from liability for the debts of the owner to the amount of \$75,000, except mortgages, laborers', mechanics', and purchase money liens and taxes and except as otherwise provided. The exemption shall not be impaired by temporary removal with the intention to reoccupy the premises as a homestead nor by the sale of the homestead, but shall extend to the proceeds derived from the sale to an amount not exceeding \$75,000, while held, with the intention to procure another homestead with the proceeds, for 2 years. The exemption extends to land owned by husband and wife jointly or in common or as marital property, and each spouse may claim a homestead exemption of not more than \$75,000. The exemption extends to the interest therein of tenants in common, having a homestead thereon with the consent of the cotenants, and to any estate less than a fee.

Wis. Stat. § 815.20(1).

Under state law, an asset may be denied exempt status if the asset was procured, concealed, or transferred with the intention of defrauding creditors. Wis. Stat. § 815.18(10). In the case of *Paulman v. Pemberton*, 2001 WI App 164, the defendant had purchased a home with funds that had been converted from his mother's trust. The plaintiff – the defendant's sister – argued the homestead did not apply by operation of Wis. Stat. § 815.18. The Wisconsin Court of Appeals noted that while the state's homestead exemption is to be "liberally construed," the exemption did not apply to instances where the exemption had been acquired by "conversion, theft, or other wrongful appropriation." *Id.* at ¶¶ 11, 16. As a consequence of the defendant's misuse of his fiduciary authority to convert assets to his own benefit, the appeals court found the homestead exemption was inapplicable. *Id.* at ¶¶ 16, 17.

The *Paulman* court cited the long-standing case of *Warsco v. Oshkosh Sav. & Trust Co.*, 190 Wis. 87, 88-89, 96, 208 N.W. 886 (1926), in which the supreme court upheld the trial court's imposition of a lien on homestead property in which converted trust funds were invested. Interpreting the predecessor statute to Wis. Stat. § 815.20, the court recognized that while the exemption statute "must be conceded as broad and inclusive," the exemption did not apply where the judgment was based on the conversion of funds directly traceable to the homestead. *Warsco*, 190 Wis. at 91-92. The supreme court reasoned:

[I]t was never contemplated nor intended that a homestead shall be created and maintained with stolen or embezzled property, or by the wrongful appropriation of property rightly belonging to others. If this were so, the statute exempting a homestead, instead of promoting the public welfare, would operate as an immoral and baneful influence, undermining and destroying the fundamental principles of government.

Id. at 93-94, 208 N.W. 886, cited in *Paulman*, 2001 WI App 164, ¶ 12. Thus, under Wisconsin law, "where a person benefits from a wrongful act, the homestead exemption statute may have to surrender to other stated public policy." *Paulman*, 2001 WI App 164, ¶ 15, quoting *State v. Dziuba*, 148 Wis.2d 108 115, 435 N.W.2d 258 (1989).

As distinguished from the above cases, the state court in this instance never specifically traced the insurance proceeds held in trust for Universal to the creation or maintenance of the debtors' homestead at the time it imposed the trust. To the extent that the funds are not traced to the debtors' homestead, the judicial lien on the homestead is avoidable. Any lien with respect to the debtors' personal property is not at issue at this time.

The debtors further argue that because Universal did not file a timely objection to its exemption, the homestead became exempt by default. Universal claims it did not oppose the debtors' exemption within the statutory time limit because the state court's postpetition amended judgment was appealed and the appellate court did not uphold the imposition of the trust until July 10, 2013.

When a debtor files a bankruptcy petition, all of the debtor's assets become property of the bankruptcy estate, 11 U.S.C. § 541, subject to the debtor's right to reclaim certain property as exempt under 11

U.S.C. § 522. See *Taylor v. Freeland & Kronz*, 503 U.S. 638, 642, 112 S.Ct. 1644 (1992). A property becomes exempt by operation of law when no objections are filed. See 11 U.S.C. § 522(l). Subject to exceptions not relevant here, the Federal Rules of Bankruptcy Procedure require interested parties to object to a debtor's claimed exemptions within 30 days after the conclusion of the creditors' meeting. See Fed. R. Bankr. P. 4003(b). If an interested party fails to object within the time allowed, a claimed exemption will exclude the subject property from the estate. *Schwab v. Reilly*, 560 U.S. 770, 775-76, 130 S.Ct. 2652 (2010).

Several courts have considered and reached contrary holdings on whether or not exemption by default under section 522(l) applies in the context of lien avoidance. Fortunately, the Seventh Circuit has addressed this issue in *In re Schoonover*, 331 F.3d 575 (7th Cir. 2003). The court distinguished the rules applicable to lienholders and general unsecured creditors:

After May 12, 2001 [30 days from the concluded meeting of creditors], no unsecured creditor could have asserted any right to payment from the funds on deposit at the Bank of Herrin. But Karr had a judicial lien, and though this may not have given him a security interest in the accounts it did give him a valuable entitlement: to wait out the bankruptcy and enforce the lien at its conclusion, unless the debtor asked the bankruptcy court for relief. "[A] creditor's right to foreclose on [a lien] survives or passes through the bankruptcy." *Johnson v. Home State Bank*, 501 U.S. 78, 83, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991). Although general unsecured creditors must take the initiative by objecting, lienholders may wait for notice under § 522(f). Once they receive notice, lienholders litigate on the schedule appropriate to a proceeding under § 522(f), not the schedule for general creditors.

Taylor [v. Freeland & Kronz] did not get its 30-day limit from the Bankruptcy Code: all § 522(l) says is that creditors who want dibs on assets claimed as exempt must object, which Karr eventually did. The deadline came from Rule 4003(b), which deals with objections by general creditors. Motions under § 522(f) to avoid liens fall under Rule 4003(d), not Rule 4003(b) – and Rule 4003(d) does not set a 30-day schedule but instead provides that "[a] proceeding by the debtor to avoid a lien or other transfer of property exempt under § 522(f) of the Code shall be by motion in accordance with Rule 9014." In turn, Rule 9014 leaves deadline-setting to the bankruptcy judge. The upshot is that lienholders have more time than general unsecured creditors, a dispensation essential if lienholders are to enjoy any chance to watch the proceedings from afar and enforce their liens later. Just as § 522(l) and Rule 4003(b) put the onus of timely objection on general unsecured creditors, so § 522(f) and Rules 4003(d) and 9014 put the onus of contesting a lien on debtors; the clock for lienholders runs from the motion under § 522(f) and not from the meeting of unsecured creditors.

331 F.3d at 578. As previously noted by Judge Martin:

The express language of § 522(f) allows a debtor to avoid liens on property which "would be exempt" rather than property which "has been deemed exempt" as the debtor suggests. Congress could have easily chosen to allow debtors to avoid liens "which have been found to be exempt" (or some similar phrase), but chose not to do so. The debtor must reestablish exemptability when seeking to avoid a lien.

In re Page, 171 B.R. 349, 352 (Bankr. W.D. Wis. 1994) (citations omitted).

Based upon the above analysis, a judicial lien creditor may file an objection to the debtors' claim of homestead exemption after the Rule 4003(b) deadline has passed if its lien is challenged by the debtor. Nevertheless, because this Court has found the lien avoidable, any objection by Universal to the debtors' homestead exemption would be unwarranted at this time.

Mr. Hanson will submit an order.