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Florida Homestead Traps

Think twice before flying south to exploit favorable homestead and bankruptcy laws. Case law and proposed bankruptcy reforms may clip a few wings

By **Barry A. Nelson**, founding shareholder, and **Kevin E. Packman**, associate, Nelson & Levine, P.A., North Miami Beach, Fla.

People should think carefully before deciding to move to Florida to take advantage of the state's favorable asset protection laws. Attorneys and advisors need to have some understanding of the potential traps clients may fall into as they try to benefit from the Florida homestead exemption.

Creditors have been successful in forcing the sale of a homestead, with the sales proceeds allocated between the debtor homeowner and his creditors as well as in attaching a homestead through a lien.

To uproot a family during a time of financial stress is difficult, but to do so only to discover the anticipated benefits are nonexistent is devastating. So carefully plan and consider all risks before making the move to this so-called "debtor's haven."

CASES

To benefit from Florida's homestead exemption from creditors' claims, the owner must satisfy three conditions: (1) residency requirements—the owner must reside in Florida; (2) ownership requirements—the Florida homestead should be titled in an individual capacity or as tenants-by-the-entirety for husband and wife, not through a trust, corporation, partnership or limited liability company[1]; and (3) acreage limitations.

But even when clients satisfy the ownership and residency requirements, danger still lurks.[2] Courts have directed the sale of Florida homesteads when:

- the residence was situated on more than the constitutionally-protected lot size;
- funds used to purchase the home were traced to fraud;
- a tax lien, regardless of whether owned by one spouse or both, was owed to the Internal Revenue Service; and
- a federal agency had statutory authority to seek restitution by placing a lien on a homestead.

ACREAGE LIMITATIONS

Florida's constitutional protection is generally limited to homesteads consisting of no more than half an acre if located within a municipality and 160 acres if located outside a municipality. The constitution provides that, if the property is later included in a municipality, the acreage limitation may not be reduced without the owner's consent.

If a municipal residence is situated on more than half an acre, the consequences can be dramatic. Before the U.S. Supreme Court denied certiorari in *Englander v. Mills*[3] in 1997, the extent to which homestead protection was available for residences on more than a half-acre was uncertain.

The debtor in *Englander* owned a home on approximately one acre within a municipality and local zoning regulations prevented the property from being legally subdivided. The debtor claimed a homestead exemption for the portion of the property that surrounded the non-exempt portion, eliminating any reasonable access to the non-exempt portion and rendering it valueless. The bankruptcy court, in reaching its conclusion that the homestead designation sought for a portion of the property was improper, stated that the debtor's "attempt at homestead exemption 'gerrymandering' was clearly in bad faith."[4] Accordingly, the bankruptcy court ordered a judicial sale of the homestead and granted the debtor an exemption for the portion of the proceeds to be derived from the sale of the property equal to the value of a half-acre.[5]

The debtor appealed to the U.S. Court of Appeals for the Eleventh Circuit, which upheld the lower court, finding: "The issue on appeal is whether the bankruptcy court [could] order the sale of a claimed homestead property, which exceeds the area limitation under the homestead provision and [could not] be practically or legally subdivided, and then order an apportionment of the proceeds."[6] The appellate court reasoned that a sale and apportionment of the sales proceeds is an equitable solution that provides the appropriate recognition of the debtor's homestead yet affords creditors some satisfaction of their claims.[7]

Quraeshi v. Dzikowski,[8] decided in 2002, is the first reported case addressing how assets should be apportioned when the property exceeds half an acre within a municipality, and cannot be partitioned into a homestead-exempt half-acre (on which the debtor would presumably continue to reside) and a remaining, non-exempt portion. In *Quraeshi*, the debtor claimed as exempt his 2.69 acre homestead located within a municipality. The bankruptcy trustee overseeing his case filed an objection to the debtor's claim of exemption on the grounds that the Florida Constitution, Article X, Section 4, states that a homestead cannot exceed a half-acre in a municipality. The parties agreed that the residence was indivisible.

The trustee's objection was sustained. It was found that a half-acre would equate to 19 percent of the total acreage; thus the debtor was entitled to 19 percent of the sale's proceeds. The home was sold for $760,000 and, after paying off first and second mortgages and closing expenses, $216,000 remained. The debtor's position was that he should receive 19 percent of gross proceeds of $760,000, rather than of net proceeds of $216,000.

The court, finding no case law on point from either the Florida courts or the Eleventh Circuit, looked to the Florida Constitution for guidance. "Based on the language of the homestead provision," the court said, "it would seem that a debtor's homestead exemption would extend to a pro rata portion of the net proceeds of a sale of a debtor's property, based on his acreage share of the property sold, rather than on a pro rata portion of the gross sales price."[9] As a result, the court determined that the gross sales proceeds had to be used to pay off any liens

Florida puts strict limits on the amount of acreage that will qualify for a homestead.

before any portion of the proceeds could be considered debtor's homestead. The debtor was entitled to 19 percent of the net proceeds based upon the ratio of a half an acre to the actual size of the homestead property of 2.69 acres. In other words, the debtor was entitled to 19 percent of $216,000, a mere $41,040.

The *Quraeshi* decision also precludes debtors from claiming the value of the actual residence (that is to say, with fixed improvements) on the exempt half-acre should be apportioned to them while the value of the land in excess of the half-acre should be apportioned on a pro rata basis. Of course, such an allocation would be far more advantageous to debtors.

FRAUD

Beginning with the 1925 case of *Jones v. Carpenter*,[10] in which the Florida Supreme Court ruled the homestead exemption "cannot be employed as a shield and defense after fraudulently imposing on others," Florida courts have stated in *dicta* that the homestead exemption should not be used as an instrument of fraud upon creditors.[11] Nonetheless, when presented with opportunities to limit the application of the exemption for debtors who'd purchased residences with what appears to have been actual intent to defraud creditors, the state's highest court has refused to do so.

A Florida homestead purchased with funds traced to fraud may be subject to an equitable lien based on unjust enrichment.

In *Havoco of America, Ltd. v. Hill*,[12] judgment was entered against the debtor, a resident of Tennessee, on Dec. 19, 1990. The enforceability of the judgment was delayed until Jan. 2, 1991. With full knowledge of the judgment, the debtor purchased a Florida home on Dec. 30, 1990, using non-exempt funds that would have been available to the known creditor, intentionally converting them into Florida homestead property. The Florida Supreme Court, while stating that the equitable lien as imposed in *Jones* was still a viable remedy for creditors, reasoned that the debtor must engage in some fraudulent or otherwise egregious act, which in this particular case was not proven by the creditor.[13] Consequently, the court in *Havoco* determined that the debtor's conversion of funds to avoid a creditor was not one of the exceptions to the homestead exemption under the Florida Constitution, and as such refused to extend equitable principles.[14]

Those considering a move to Florida in light of *Havoco* should beware there is a limit to Florida's tolerance. Subsequent bankruptcy court decisions have distinguished *Havoco* when homesteads were purchased with funds traced to fraud. To prevent unjust enrichment, the court in *Synod of S. Atl. Presbyterian Church v. Magpusao*[15] authorized an equitable lien imposed on a homestead purchased with embezzled funds. Similarly, in *In re Thiel*[16] an equitable lien was imposed on homestead property when the fraudulent conduct was behind the funds used to pay off a mortgage on homestead property. The distinction is based on the source of the funds used to buy the home. For example, a physician who purchases a home on the eve of a bankruptcy filing with savings from his employment may benefit from the homestead exemption under *Havoco*, whereas a chief executive officer charged with stealing from his company would be subject to an equitable lien if he used the stolen money to buy the homestead.

By affirming the bankruptcy court, the Eleventh Circuit in *Financial Federated*[17] clarified when the equitable lien remedy should be available. The bankruptcy court authorized a trustee to impose an equitable lien and constructive trust on the proceeds from the sale of a homestead property

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on the grounds that most, if not all, of the funds used to purchase the property could be traced directly to fraud.[18] The *Financial Federated* court stated that because the funds used to pay for the residence were fraudulently obtained, it would decide the case based upon the *Jones* holding, which remains the law in Florida.[19] The court added that "the imposition of [the] equitable lien in favor of [the Trustee] is necessary to prevent defendants from using the homestead exemption as an instrument of fraud and to prevent the defendant's unjust enrichment at the expense of the defrauded investors. An equitable lien will allow a means for [the Trustee] to recover at least a portion of the fraudulently obtained funds."[20]

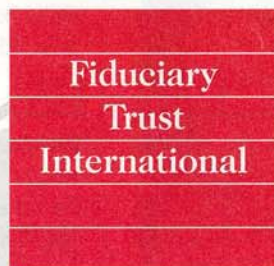
In arriving at its judgment and dismissing several of the debtors' arguments, the *Financial Federated* court observed that Florida case law took a hard line against anyone benefiting from fraudulent activity, regardless of whether the benefactor was innocent of fraud. Accordingly, Florida courts have traced the funds in question to determine whether they derived from fraud.[21] Bottom line: when funds used to purchase a homestead (or pay down a mortgage on a homestead) are traced to fraudulent activity, whether for a residence owned by the debtor or by others; an equitable lien may be imposed to prevent unjust enrichment.[22]

Advisors need to be concerned about their own liability when helping clients who are on the eve of bankruptcy. In *Freeman v. First Union National Bank*,[23] the Florida Supreme Court reviewed this question of state law certified by the Eleventh Circuit: Does the Florida Uniform Fraudulent Transfer Act (FUFTA) create a cause of action for damages in favor of a creditor against an aider or abettor to a fraudulent transaction? The case stemmed from a suit brought against First Union by victims of a Ponzi scheme. The victims alleged that despite First Union's knowledge of litigation instituted against one of its clients, the bank continued to permit the client to transfer millions of dollars offshore, even after an injunction was issued. After reviewing FUFTA, the Florida Supreme Court concluded that it "was not intended to serve as a vehicle by which a creditor may bring a suit against a non-transferee party for monetary damages arising from the non-transferee party's alleged aiding-abetting of a fraudulent money transfer."[24]

But in the 2003 case of *Morganroth*,[25] the U.S. Court of Appeals for the Third Circuit remanded to the district court in New Jersey on the question of whether the defendants, who were attorneys, knowingly and intentionally participated in a client's unlawful conduct to hinder, delay and/or fraudulently obstruct the enforcement of a judgment. The appeals court said such a finding would satisfy a claim for creditor fraud against the lawyer under New Jersey law. Advisors should find out whether their states have causes of action similar to New Jersey's, as *Morganroth* is not an isolated case. It should also be noted, however, that *Freeman* did not effectively close the door on all causes of action against an advisor in Florida. The court noted: "We caution that our answer to the certified question in this case is confined to the context of FUFTA. We do not address whether relief is available [to the victims] under any other theory of liability or cause of action."[26]

FEDERAL TAX LIENS

Federal tax law in some circumstances preempts Florida's homestead exemption. In the 1998 decision on *In re McFadyen*,[27] the bankruptcy court held that a federal tax lien was enforceable against homestead property. The court stated that "the homestead exemption does not erect a barrier around a taxpayer's home sturdy enough to keep out the Commissioner of the Internal



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Revenue."[28] However, due to concern that seizure of a taxpayer's principal residence is particularly disruptive for the taxpayer and the taxpayer's family, Congress held that a taxpayer's principal residence may be seized to satisfy a taxpayer's tax liability only as a last resort; it is exempt from levy unless a judge or magistrate of a U.S. district court approves the levy in writing.[29]

Similarly, a federal court in 1991 held that a federal forfeiture statute preempts Florida's homestead exemption.[30] Then in 2003, the bankruptcy court in *Dahlman v. United States*[31] held that the United States properly placed a lien on homestead property owned as tenants-by-the-entirety. Before the husband's bankruptcy proceeding and the legitimacy of the liens had been determined, a court order permitted the homestead property to be sold and the proceeds held in a trust account, referencing the tenancy-by-the-entireties. The husband and wife were each independently found guilty of conspiracy to commit bank fraud and required to pay fines as well as restitution. The husband's lien was in excess of $4 million, and he filed for bankruptcy protection. Liens were placed on the homestead property pursuant to the Anti-Terrorism and Effective Death Penalty Act of 1996 that authorizes "a lien in favor of the United States on all property and rights to property of the person fined as if the liability of the person were a liability for a tax assessed under the Internal Revenue Code of 1986."[32] The court, after determining that the liens were proper, granted a motion for summary judgment as to the validity of the lien in favor of the government against the debtor's interest in the homestead owned as tenants-by-the-entirety. The court denied the motion with respect to the extent of the lien so the value of debtor's interest in the property could be determined.

> Those forum shopping for favorable bankruptcy exemptions must consider the potential impact of federal bankruptcy reform.

BANKRUPTCY REFORM

Any discussion regarding Florida's favorable bankruptcy exemptions must consider the potential impact federal bankruptcy reform would have on the ability of individuals to claim such exemptions. On January 28, 2004, the House of Representatives passed the Bankruptcy Abuse Prevention and Consumer Protection Bill of 2003, H.R. 975 by a 265 to 99 margin.[33] The Senate has yet to act on the bill and in light of the political climate it appears unlikely to do so in the immediate future. The bill is virtually identical, however, to the compromised version of H.R. Bill 333 that the Senate passed in the fall of 2002, but which the House did not.[34] The bottom line is bankruptcy reform would create significant limitations for those forum shopping for state bankruptcy exemptions before declaring bankruptcy.

Under existing bankruptcy laws, to obtain the benefits of Florida's creditor protection exemptions, debtors must be Florida residents or domiciliaries for the greater portion of 180 days before filing for federal bankruptcy protection.[35] To benefit from Florida's unlimited homestead exemption, the proposed law would require debtors to reside in Florida for at least 40 months before declaring bankruptcy.[36] If the 40-month requirement is not met, the proposed law generally would limit the homestead protection to just $125,000—unless the debtor was a family farmer.[37] If a debtor used assets to purchase the Florida homestead with the intent to hinder, delay or defraud a creditor, the law would require the debtor to have resided in Florida for at least 10 years before filing for bankruptcy.[38]

The Bankruptcy Reform Bill does not appear to provide a grandfathering for people who may have moved to Florida shortly before reform is enacted. As a result, the 40-month requirement likely would be applied

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to anyone who'd recently moved to Florida. Consequently, any decision to move to Florida to take advantage of its exemptions and/or homestead protection should be reviewed carefully in light of potential bankruptcy reform. When reform is implemented, the availability of Florida's exemptions will be significantly curtailed. ∎

Endnotes

1. *Crews v. Bosonetto* (In re Bosonetto), 271 B.R. 403 (Bankr. M.D. Fla. 2001); however in *Callava v. Feinberg*, 864 So. 2d 429 (Fla. Dist. Ct. App. 3d Dist. 2003) the court permitted homestead protection for a Florida residence titled in the name of a trust. Nevertheless, in light of *Bosonetto*, the safest alternative is to avoid trust ownership of a Florida homestead.
2. See *In re John Richards Homes Building Co., L.L.C.*, 298 B.R. 591 (Bankr. E.D. Mich. 2003) for an excellent example of how a Michigan debtor, who contracted for and closed on a $2.8 million Florida residence within two weeks of a $6.4 million judgment, was not entitled to claim a Florida homestead exemption, in part, due to a finding that the Florida residence was not the debtor's homestead.
3. *Englander v. Mills (In re Englander)*, 520 U.S. 1186 (1997).
4. *In re Englander*, 156 B.R. 862, 864 (Bankr. M.D.Fla. 1997).
5. *Ibid* at 870.
6. 95 F.3d 1028, 1030 (11th Cir. 1996).
7. *Ibid* at 1032.
8. *Quraeshi v. Dzikowski (In re Quraeshi)*, 289 B.R. 240 (Bankr. S.D.Fla. 2002).
9. *Ibid* at 244.
10. *Jones v. Carpenter*, 90 Fla. 407 (Fla. 1925).
11. *Simpson v. Simpson*, 123 So. 2d 289, 294 (Fla. Dist. Ct. App. 2d Dist. 1960); *Frase v. Branch*, 362 So. 2d 317, 319 (Fla. Dist. Ct. App. 2d Dist. 1978)("great care should be taken to prevent homestead laws from becoming instruments of fraud, an imposition on creditors, or a means to escape honest debts"); *Englander*, 95 F.3d at 1031 ("the homestead exemption law is intended to be a shield, not a sword, and should not be applied as to make it an instrument of fraud or as an imposition upon creditors.")
12. *Havoco of America, Ltd. v. Hill*, 790 So. 2d 1018 (Fla. 2001).
13. *Ibid* at 1027.
14. *Ibid* at 1028.
15. *Synod of S. Atl. Presbyterian Church v. Magpusao (In re Magpusao)*, 265 B.R. 492 (Bankr. M.D.Fla. 2001).
16. *In re Thiel*, 275 B.R. 633 (Bankr. M.D.Fla. 2001).
17. *Levy v. Kozyak (In re Fin. Federated Title & Trust)*, 347 F.3d 880 (11th Cir. 2003).
18. 273 B.R. 706 (Bankr. S.D.Fla. 2001).
19. *Ibid* at 719.
20. *Ibid.*
21. See *Babbit Electronics, Inc. v. Dynascan Corp.*, 915 F. Supp 335 (Bankr. S.D.Fla. 1995)(holding that a judgment creditor could obtain an equitable lien on the house of a debtor's daughter and son-in-law on the grounds that debtor satisfied their mortgage with fraudulently obtained funds); and *Palm Beach Savings & Loan Association, F.S.A. v. Fishbein*, 619 So. 2d 267 (Fla. 1993)(holding that notwithstanding the spouse's innocence, an equitable lien was imposed on homestead property based on an unjust enrichment and subrogation theory).
22. On Feb. 13, 2004 in a questionable extension of *Havoco* , the court in *Dzikowski v. Chaunsey (In re Chaunsey)*, 308 B.R. 97 (Bankr. S.D.Fla. 2004), denied a debtor's discharge in bankruptcy and imposed an equitable lien on debtors homestead attributable to a prepayment (from funds received in a personal injury lawsuit) of the debtor's mortgage 13 days before a Chapter 7 bankruptcy filing.
23. *Freeman v. First Union Nat'l Bank*, 865 So. 2d 1272 (Fla. 2004).
24. 865 So. 2d at 1277.
25. *Morganroth & Morganroth v. Norris, McLaughlin & Marcus, P.C.*, 331 F.3d 406 (3rd Cir. 2003).
26. *Freeman*, 865 So. 2d at 1275 n4.
27. *In re McFadyen*, 216 B.R. 1006 (Bankr. M.D.Fla. 1998).
28. *Ibid* at 1009, quoting *Thompson v. Adams*, 685 F. Supp. 842, 846 (M.D.Fla. 1988) quoting *U.S. v. Estes*, 450 F.2d 62, 65 (5th Cir. 1971).
29. See 26 U.S.C.S. F.S. § 6334(a)(13)(B) and (e) (2003); see also, the Taxpayer's Bill of Rights incorporated in the IRS Restructuring and Reform Act of 1998 effective July 22, 1998.
30. *United States v. One Single Family Residence Without Buildings Located at 212 Airport Rd. South, et. al.*, 771 F. Supp. 1214 (S.D.Fla. 1991).
31. *Dahlman v. United States (In re Dahlman)*, 304 B.R. 892 (Bankr. M.D.Fla. 2003).
32. *Ibid* at 893.
33. It should be noted, however, that Congress has been considering ways to overhaul the nation's bankruptcy laws since 1997. In 2001, separate reform bills were passed by the Senate and the House with one key area of dispute being the unlimited homestead exemption permitted by several states including Florida and Texas. After President Bush threatened to veto any legislation that provided a cap on the value of a homestead in April 2002, the two sides came together to work through competing matters.
34. H.R. 333 was defeated by religious conservatives in the House who objected to Section 330, which prohibited abortion activities from discharging their debts incurred in connection with protest activities. Consequently, the bill omits Section 330.
35. 11 U.S.C. Section 522(b)(2)(A),(B).
36. 11 U.S.C. Section 322.
37. *Ibid.*
38. 11 U.S.C. Section 308.

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