



SO ORDERED.

SIGNED this 25 day of February, 2005.

Dale L. Somers

Dale L. Somers
UNITED STATES BANKRUPTCY JUDGE

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS**

In Re:

**ALAN D. SAGER and
TONYA G. SAGER,**

DEBTORS.

**CASE NO. 03-13626-DLS
CHAPTER 7**

BANKWEST OF KANSAS,

PLAINTIFF,

v.

ADV. NO. 03-5308

**ALAN D. SAGER and
TONYA G. SAGER,**

DEFENDANT.

**MEMORANDUM DENYING MOTION OF
BANKWEST OF KANSAS FOR SUMMARY JUDGMENT**

This is a proceeding in which a creditor, Bankwest of Kansas (hereinafter "Bank"), seeks an order denying in part the Debtors' homestead exemption. The Bank appears by William B.

Sorensen, Jr. of Morris, Laing, Evans, Brock & Kennedy, Cht. The Debtors, Alan D. Sager and Tonya G. Sager, appear by Sarah L. Newell, Klenda, Mitchell, Austerman & Zuercher, LLC.

The Bank is an undersecured creditor. It seeks to recover a portion of its unsecured claim by challenging the Debtors' prepetition use of proceeds from the sale of collateral to reduce their obligation on their note secured by their homestead. The Bank presented its position by two separate sets of pleadings. First, the Bank filed a Limited Objection to Homestead Exemption in the main bankruptcy proceeding.¹ Second, the Bank commenced an adversary proceeding by filing a Complaint to Establish Constructive Trust on Homestead and to Determine Dischargeability of Debt². After discovery, the Bank filed the Plaintiff's Motion for Summary Judgment and a supporting memorandum,³ addressing only the homestead issue and asserting that the dischargeability issue will become moot if the Court were to rule in its favor by granting a constructive trust on the homestead. The Debtors filed Defendants' Objection to Plaintiff's Motion for Summary Judgment and Memorandum in Support

¹ Limited Objection to Homestead Exemption, Case No. 03-13626 (Doc. 15).

² Complaint to Establish Constructive Trust on Homestead and to Determine Dischargeability of Debt, Adversary No. 03-5308 (Doc. 1) .

³ Plaintiff's Motion for Summary Judgment, Adversary No. 03-5308 (Doc. 14) and Memorandum in Support of Plaintiff's Motion for Summary Judgment, Adversary No. 03-5308 (Doc.15). Although neither the motion nor memorandum is entered in the docket of the main case, the Court considers the motion for summary judgment to also address the limited objection to the homestead exemption.

Thereof.⁴ The Bank filed a reply brief.⁵ This is a core proceeding⁶ over which the Court has jurisdiction.⁷ The Court is ready to rule.

The Plaintiff Bank seeks an order partially disallowing the Debtors' homestead exemption or the imposition of an equitable lien on the Debtors' homestead in the amount of a payment made on the debt securing the homestead shortly before the Debtors filed for relief. The Bank contends that the monies paid were the proceeds from the sale of collateral in which the Bank had a security interest, such that the Bank has a "peculiar equity" in the homestead. The Debtors oppose the Bank's contentions. They contend that the Bank has no "peculiar equity," that the "peculiar equity" rule applies only when the homestead is acquired or purchased with the proceeds of collateral,⁸ and that the bankruptcy relief requested would improperly grant the Bank enhanced rights solely because the Debtors had applied the collateral proceeds to a debt secured by their homestead.

The matter is before the Court on the Bank's motion for summary judgment. Pursuant

⁴ Defendants' Objection to Plaintiff's Motion for Summary Judgment and Memorandum in Support Thereof, Adversary No. 03-03-5308 (Doc. 38).

⁵ Reply Memorandum in Support of Plaintiff's Motion for Summary Judgment, Adversary No. 03-5308 (Doc. 37).

⁶ 28 U.S.C.A. § 157 (b)(2)(K).

⁷ 28 U.S.C.A. § 1334.

⁸ Because the Court resolves the applicability of the "peculiar equity" exception to the Debtors' right to convert nonexempt assets to exempt assets on other grounds, it does not address the Debtors' contention that the exception applies only to acquisitions of a homestead and not to subsequent paydowns on the debt secured by the homestead.

to Fed. R. Civ. P. 56(c)⁹, the Court is directed to enter judgment in favor of the movant “if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.”¹⁰ Here, the Debtors did not controvert the Bank’s statement of uncontroverted facts.¹¹ The issues presented are therefore questions of law based upon uncontroverted facts. The Court is required to enter judgment in favor of the Bank if, based upon the facts as stated by the Bank, it is entitled to judgment as a matter of law.

The uncontroverted facts are as follows:

1. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(l) & (K), and the Court has jurisdiction over the subject matter and the parties hereto under 28 U.S.C. §§ 157 & 1334, and Rules of Practice of the United States District Court for the District of Kansas, Rule 83.8.4.
2. At all material times, and in particular from and after January 1, 2001, the Debtors have been indebted to Bankwest on outstanding loan obligations.
3. At all material times, Bankwest held a security interest in all of the Debtors' equipment, including a 2000 Jet Grain Trailer, VIN 5ING42207YH000441 ("Jet Trailer").
4. Bankwest's security interest in the Jet Trailer was duly perfected under the laws

⁹ Fed. R. Civ. P. 56 is made applicable in adversary proceedings pursuant to Fed. R. Bankr. P. 7056.

¹⁰ Fed. R. Civ. P. 56(c).

¹¹ Although the Debtors’ brief does not include a paragraph by paragraph response to the Bank’s statement of uncontroverted facts (which the Court interprets to mean that the facts as stated by Bank are uncontroverted), in the body of their brief Debtors do object to Statement of Facts, ¶ 11 on the basis that it is a legal conclusion rather than a factual statement. The legal issues included in ¶ 11 are discussed below.

of the State of Kansas.

5. During the summer of 2001, the Jet Trailer was wrecked; the insurance company declared the trailer totaled, and on October 29, 2001, said company issued to Sager a Check for \$14,126.02 ("Insurance Proceeds").

6. The Insurance Proceeds constituted cash proceeds of the Jet Trailer, in which Bankwest held a perfected interest.

7. At all material times, Sager maintained checking account no. 722952 at Bankwest, in the name of "Alan Sager d/b/a Sager Farm Trucking" ("Bank Account").

8. Sager deposited the Insurance Proceeds in the Bank Account on November 29, 2001.

9. Between November 29, 2001 and May 2, 2002, the balance in the Bank Account did not drop below \$14,631.64.

10. On or about May 2, 2002, Sager purchased a trailer to replace the Jet Trailer from Colby Ag Center for \$15,000.00 ("New Trailer").

11. The New Trailer represented non-cash proceeds of the Jet Trailer in which Bankwest held a perfected security interest; in addition, the New Trailer was subject to Bankwest's blanket lien on equipment.

12. On May 12, 2003, the Debtors purchased the following described real property located in Thomas County, Kansas, to-wit:

All of Lot Six (6), Block Four (4), Pleasant Valley Addition to the City of Colby, Kansas, as shown by the recorded plat thereof, commonly known as 955 East 6th, Colby, Kansas ("Homestead");

from Michael and Patricia Sprenkel.

13. The Debtors' purchase of the Homestead was financed with a purchase money loan from the Joan R. Kready Trust No. 1 in the amount of \$89,000; said mortgage was dated May 13, 2003, and filed with the Thomas County Register of Deeds on May 14, 2003, in Book 158, at page 625.

14. In June 2003, the Debtors sold the New Trailer to McDougal Sager Grain for \$14,500.00, and paid said proceeds to the John R. Kready Trust No. 1 in reduction of the balance due on the mortgage loan secured by the Homestead.

15. This bankruptcy case was commenced when the Debtors filed a joint voluntary petition under Chapter 7 of the Bankruptcy Code on July 7, 2003 ("Filing Date").

16. The Homestead was claimed as exempt on Schedule C in this case; Bankwest filed a timely objection to said exemption, incorporating the claims herein.

17. As of the Filing Date, the Debtors' indebtedness to Bankwest was evidenced by a promissory note dated July 11, 2001, in the original principal amount of \$500,000, and subject to an Extension and Amendment dated March 19, 2002, and a second promissory note dated May 29, 2002, in the original principal amount of \$200,000.

18. The aggregate balance due as of the Filing Date on the promissory notes described in the preceding paragraph was \$623,818.85 ("Bankruptcy Claim").

19. The collateral securing the Bankruptcy Claim has an aggregate market value that is substantially less than said claim.

The Court is being asked to determine the extent of the Debtors' homestead

exemption. Since Kansas has opted out of the federal exemptions,¹² the extent of the Debtors' homestead exemption is determined by Kansas law.¹³ The Bank relies upon *Metz v. Williams*,¹⁴ which addresses the conversion of nonexempt assets into a homestead as follows:

An insolvent debtor may successfully assert a claim of exemption as to a homestead purchased with proceeds of nonexempt property, *where there is no peculiar equities in favor of existing creditors*, even although said purchase be made for the very purpose of acquiring property that should constitute a homestead, and as such be beyond the reach of creditors.¹⁵

The Bank claims that as the holder of a security interest in the proceeds from the sale of collateral which were used to pay down the debt on the homestead, it has a "peculiar equity" in the homestead. The Bank seeks the alternative remedies of a partial denial of the exemption or imposition of an equitable lien.¹⁶

It is well-established under Kansas law, as well as bankruptcy law, that a debtor will be permitted to convert nonexempt property into exempt property before filing bankruptcy to take full advantage of the exemptions permitted. "The right to convert non-exempt assets into exempt assets is well settled in Kansas."¹⁷ The Tenth Circuit Court of Appeals, when applying federal bankruptcy law,

¹² K. S.A. 60–2312(a).

¹³ *Jenkins v. Hodes (In re Hodes)*, 287 B.R. 561, 566 (D. Kan. 2002), citing *Kretzinger v. First State Bank of Waynoka (In re Kretzinger)*, 103 F. 3d 943, 945 (10th Cir. 1996).

¹⁴ 149 Kan. 647, 88 P.2d 1093 (1939).

¹⁵ *Id.*, 149 Kan. at 651 quoting *McConnell v. Wolcott*, 70 Kan. 375, 383, 78 Pac. 848 (1904) (emphasis supplied).

¹⁶ See *In re McGinnis*, 306 B.R. 279, 285 (Bankr. W.D. Mo. 2004).

¹⁷ *In re Hodes*, 287 B.R. at 568, quoting *Douglas County Bank v. Fine (In re Fine)*, 89 B.R. 167,174 (Bankr. D. Kan. 1998) (citing *Metz v. Williams*, 149 Kan. 647, 88 P. 2d 1093 (1939)); see

has stated that “the conversion of nonexempt to exempt property for the purpose of placing property out of the reach of creditors, without more, will not deprive the debtor of the exemption to which he otherwise would be entitled.”¹⁸ The legislative history accompanying the Bankruptcy Reform Act of 1978 fully supports this conclusion. It states as follows:

As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.¹⁹

The question before the Court is therefore the extent and nature of the Kansas “peculiar equity” limitation upon the right to convert assets. As examined below, the Kansas Supreme Court has applied the limitation in only one case decided in 1882 and has not subsequently addressed details of the exception. Because there is no decision of the Kansas Supreme Court or the Kansas Court of Appeals directly answering the issue presented, it is the obligation of this Court to attempt to predict what the Kansas Supreme Court would rule if it were presented with the question of the applicability of the exemption under the facts of this case.²⁰ The Bank claims the homestead exemption should be denied in part or an equitable lien imposed on homestead based upon the Debtors’ admission that shortly before filing for bankruptcy relief they applied the proceeds from the sale of the New Trailer to the partial satisfaction of the debt securing the purchase price of the homestead. A three part analysis is

also *McConnell v. Wolcott*, 70 Kan. 375, 78 Pac. 848 (1904).

¹⁸ *Marine Midland Business Loans, Inc. v. Carey (In re Carey)*, 938 F. 2d 1073, 1076 (10th Cir. 1991), quoting *Norwest Bank Neb., N.A. v. Tveten*, 848 F. 2d 871, 873–74 (8th Cir. 1998).

¹⁹ H. R. Rep. No.90-595 at 361 (1977); S. Rep. No. 90-989 at 76 (1978).

²⁰ *Morris v. The CIT Group (In re Charles)*, 323 F.3d 841, 842-43 (10th Cir. 2003).

required. First, the Court will determine the precise interest of the Bank in the monies that were used to pay down the debt. Second, the Court will examine the “peculiar equity” exception. Third, the Court will apply the exception to the facts of this case.

The uncontroverted facts establish the following: (1) To secure debt to the Bank, the Bank held a perfected security interest in a Jet Trailer that was wrecked during the summer of 2001. (2) The Debtors received \$14,126.02 in insurance proceeds and on November 29, 2001 deposited them in a checking account at the Bank. (3) Between November 29, 2001 and May 2, 2002, the balance in that account did not drop below \$14,631.64. (4) On or about May 2, 2002, Debtors purchased a trailer (“New Trailer”) for \$15,000. (The facts do not address whether the New Trailer was purchased with funds from the account at the Bank, but knowledge of this fact is not necessary to the Court’s analysis.) (5) The New Trailer was subject to the Bank’s blanket lien on equipment. (6) On May 12, 2003, the Debtors purchased the homestead property. (7) The Debtors’ purchase of the homestead was financed with a purchase money loan and secured by a properly recorded mortgage. (8) In June, 2003 the Debtors sold the New Trailer for \$14,500 and applied the proceeds to reduce the purchase money loan secured by the homestead. (9) The Debtors filed for relief under Chapter 7 on July 7, 2003.

The Court concludes that in June 2003 the Bank held an unperfected security interest in the cash proceeds from the sale of the New Trailer. For the following reasons, as a matter of law the transactions regarding the Jet Trailer did not result in a perfected security interest in the New Trailer on the date of its sale in June 2003. Assuming that the Bank did not waive its interest (a matter not addressed by the uncontroverted facts), when the insurance proceeds from the Jet Trailer were

received by the Debtors, they were subject to the Bank's perfected security interest, because the proceeds were identifiable.²¹ When proceeds are not goods, the secured party may identify them by any method of tracing that is permitted under law outside Article 9.²² Under Kansas law, when cash proceeds from the disposition of collateral are deposited into the debtor's bank accounts, courts when tracing funds apply the lowest intermediate balance rule which presumes that general payments are first made from general funds and a security interest in proceeds is eroded only to the extent that the account balance falls below the amount of proceeds deposited.²³ The uncontroverted facts establish that the cash proceeds were identifiable. Assuming no waiver by the Bank, its perfected security interest in the identifiable cash proceeds continued as long as they were identifiable and did not expire after the 21 day period which cuts off the interest as to other forms of proceeds.²⁴ If the New Trailer was purchased with funds drawn from the account holding the indentifiable proceeds of the Jet Trailer in which the Bank had a perfected security interest, the Bank initially had an automatically perfected security interest in the New Trailer.²⁵ However, such automatic perfection would have ceased 21 days after the security interest attached.²⁶ Revised article 9 "makes the general rule of continued perfection inapplicable to proceeds acquired with cash proceeds, leaving perfection of a security interest in those

²¹ K.S.A. 2002 Supp. 84-9-315 (a)(2) and (c).

²² K.S.A. 2002 Supp. 84-9-315(b)(2).

²³ *Bank of Kansas v. Hutchinson Health Services, Inc.*, 12 Kan. App. 2d 87, 735 P. 2d 256 (1987) pet rev. denied June 18, 1987.

²⁴ K.S.A. 2002 Supp. 84-9-315(d)(2).

²⁵ K.S.A. 2002 Supp. 84-9-315(c).

²⁶ K.S.A. 2002 Supp. 84-9-315(d)(1).

proceeds to the generally applicable perfection rules. . . .²⁷ The New Trailer was a titled vehicle, the only method to perfect a security interest in a titled vehicle was through the Department of Revenue,²⁸ and there is no evidence that the Bank's lien was perfected through the Department of Revenue. The Bank's security interest in the New Trailer if perfected when it was acquired, became unperfected on May 23, 2002, which was 21 days after its purchase on May 2, 2002, and before its sale in June 2003. Therefore, when New Trailer was sold in June, 2003 the Bank did not hold a perfected security interest in the proceeds of sale under the theory that the New Trailer was the proceeds of the cash proceeds of the Jet Trailer, in which the Bank did have a perfected security interest. Resolution of the "gaps" in the uncontroverted facts identified above, even if resolved in favor of the Bank, would not change this conclusion.

Further, the Bank's pre-existing perfected security interest in equipment did not perfect its interest in the proceeds from the sale of the New Trailer. When the Debtors acquired the New Trailer, it was covered by the previously executed security agreement granting a lien in any after-acquired equipment. However, the Bank's interest in the after-acquired New Trailer was not perfected by any previously filed financing statement covering equipment. The only applicable means of perfection was compliance with the procedures in the Certificate of Title statutes,²⁹ which did not occur. The Bank's security interest in the New Trailer was unperfected, and therefore its security interest in the proceeds from the sale of the New Trailer was also unperfected. The Court therefore concludes that as a matter of law the Bank held an unperfected security interest in the proceeds from the sale of the

²⁷ K.S.A. 2002 Supp. 84-9-315, official UCC cmt. ¶ 5.

²⁸ K.S.A. 2002 Supp. 84-9-311(a)(2).

²⁹ *Id.*

New Trailer.

Next, the Court must construe the Kansas “peculiar equity” exception to a debtor’s ability to convert nonexempt assets to an exempt homestead. The Kansas case relied upon by the Bank is *Metz v. Williams*.³⁰ Although *Metz* stated the rule, the Court denied the judgment creditor relief under the “peculiar equity” exception because the requirements of the rule were not satisfied. In *Metz*, the creditor obtained judgment against the debtor husband in April, 1935 and registered it in Lyon County. The debtor on November 15, 1935, received a settlement in a personal injury case and transferred the proceeds to his wife with directions to invest them in Lyon County real estate which was then used as a homestead. The judgment creditor filed a motion to subject the homestead to the lien of its judgment, but the trial court held the property was exempt. On appeal, the creditor contended that it was fraud on the debtor’s creditors for him to invest the money in real estate in either his own name or his wife’s name and claim it as an exempt homestead. After examining prior Kansas cases addressing the fraudulent conversion of exempt assets into a homestead, the Court affirmed the trial court’s preservation of the exemption, finding “there was no showing of any kind that peculiar equities existed in favor of [the judgment creditor]; the funds were not the result of anything originally procured from him nor did he have any lien thereon, when the homestead was purchased.”³¹

The two Bankruptcy decisions cited by the Bank, *In re Mueller*³² and *In re Barash*,³³ also did not apply the “peculiar equity” rule for the benefit of creditors. *Mueller* concerned only the

³⁰ 149 Kan. 647, 88 P. 2d 1093 (1939).

³¹ *Id.* at 651.

³² 867 F.2d 568 (10th Cir. 1989).

³³ 69 B.R. 231 (Bankr. D. Kan. 1984).

exemption of life insurance purchased with nonexempt assets on the eve of filing bankruptcy. The court held the rule inapplicable because it had been superseded by the life insurance exemption statute. In *Barash*, the trustee and two creditors objected to the debtor's exemptions consisting of his homestead, one automobile, and two life insurance policies which had been purchased, at least in part, with nonexempt assets several months before filing for relief. Judge Pusateri rejected the objecting parties' contention that it is unlawful to convert nonexempt assets into exempt property, but recognized the "peculiar equity" exception. The court described the exception as follows:

The exception recognized in Kansas is that a debtor may not place property out of the reach of a creditor when the creditor has a "peculiar equity" in the assets converted to non-exempt property. A "peculiar equity" has been defined as the situation in which funds were originally procured from the creditor or the creditor had a lien on them when the exempt property was purchased.

The objecting parties ... cite several bankruptcy cases in support of their position. In each of the cases, however, the court found evidence of actual fraud other than the mere fact of the conversion of nonexempt to exempt assets....

... Actual fraud by a debtor in purchasing exempt assets has been narrowly defined in Kansas case law and this Court believes is bound by the decisions. The debtors actions do not fit the Kansas definition of fraud.³⁴

Because none of the assets claimed to be exempt were obtained with "funds procured from or secured to a creditor" and that there was "no showing of actual intent to defraud," the court held that the objecting creditors had failed to sustain their burden of proof.³⁵ In this case, the Bank, although tracing funds to the purchase of the exempt homestead, does not allege actual intent to defraud and would not be entitled to relief if this Court were to follow the analysis of *Barash*.

³⁴ *Id.*, 69 B.R. at 232-233(citations omitted).

³⁵ *Id.*, 69 B.R. at 233.

The earliest opinion of the Kansas Supreme Court located by this Court recognizing the limitation upon the conversion of non-exempt assets to a homestead is *Long v. Murphy*.³⁶ Interestingly, it is the only case found by this Court where the rule was applied to deny the homestead exemption. The case arose upon a motion to discharge real property, claimed by the wife of the judgment debtor to be her homestead, from levy in favor of the husband's creditors. It was alleged that the debtor had concealed assets and that he had assigned and disposed of his property with intent to defraud, hinder, and delay his creditors. The trial court sustained the judgment debtor's wife's objection to the attachment of the homestead, and creditors appealed. The land had been acquired, at least in part, in exchange for the debtor's transfer of a stock of merchandise in a mercantile business at a time when the debtor was unable to meet his obligations. To satisfy one claimant, the debtor had conditionally transferred the merchandise to him. Soon after the transfer, the debtor sold the same merchandise to another, in partial exchange for the real property claimed as a homestead. The Court found that the transfer of the land was fraudulent as to existing creditors and stated:

We do not think that a debtor being absolutely insolvent, and having creditors pressing him for the payment of their claims, and fully cognizant of his inability to pay such debts, can, *to defraud his creditors*, transfer possession of goods purchased by him upon credit and take in exchange therefor land, either in his own name or in the name of his wife, and then claim the same as an exempt homestead against such existing creditors. "A party cannot turn that which is granted him for the comfort of himself and family, into an instrument of fraud."³⁷

³⁶ 27 Kan. 375 (1882).

³⁷ *Id.* at 380, quoting *Pratt v. Burr*, 5 Biss. 36; *Thompson on Homesteads* §§ 305-310 (emphasis supplied). The above statement of the exception in *Long v. Murphy* does not track precisely with the facts of the case, as the opinion does not include a finding that the stock of merchandise had been purchased on credit. Also, the statement ignores the finding of actual intent to hinder and delay creditors.

Long has been frequently cited when creditors seek to attach an interest in a homestead for the payment of debts. However, this Court's research has found no case where the conversion of exempt assets into a homestead was set aside because of a creditor's "peculiar equity" or where the exception was analyzed. *Tootle v. Stine*³⁸ rejected the attempt of a creditor, who in April 17, 1880 had sold inventory to the husband on credit, to reach the homestead purchased with proceeds from the bulk sale of inventory on July 17, 1880. The financed inventory had been commingled with other inventory purchased by the debtor's wife, and the creditor did not show that any part of the goods sold by the creditor to the debtor were used to purchase the homestead. Similarly, in *Long v. Hopper*³⁹ the Court found that the debtor was entitled to an exemption for mules acquired in partial exchange for the bulk sale of grocery goods which had been purchased on credit 30, 60 and 90 days before the exchange. Even though the sale was to the debtor's father-in-law, the Court failed to hold that the disposition of the stock of groceries was fraudulent. In *McConnell v. Wolcott*⁴⁰ the homestead purchased with proceeds from a draft held by the debtor at the time of institution of proceedings in aid of execution was exempt, because the creditor had no special claim to the draft. "The fact that the exchange may have been made for the very purpose of acquiring exempt property does not alter the rule,"⁴¹ generally allowing the conversion of nonexempt property. None of these cases citing *Long v. Murphy* support application of the exception in favor of the Bank where, although nonexempt assets in which the Bank had an interest

³⁸ 31 Kan. 66, 1 Pac. 279 (1883).

³⁹ 54 Kan. 572, 38 Pac. 809 (1895).

⁴⁰ 70 Kan. 375, 78 Pac. 848 (1904).

⁴¹ *Id.*, 70 Kan. at 383.

have been traced to the homestead, there is no allegation of actual fraud.

Federal courts discussing the “peculiar equity” exception likewise have not relied upon it to defeat an exemption. In two opinions where the Kansas life insurance exemption was challenged, the courts’ statements of the rule, which could be read to support the Bank’s position, are mere dicta. District Judge Kelly in a case challenging the debtor’s claim of exemption of a life insurance policy purchased with nonexempt assets, characterized the “peculiar equity” rule as an exception which “was judicially developed for application where a creditor challenged the conversion of nonexempt assets into exempt assets as a ‘fraudulent conveyance.’”⁴² The court held that this judicial rule did not apply to life insurance because of a 1984 amendment of the life insurance exemption statute. The United States Court of Appeals for the Tenth Circuit affirmed Judge Kelly’s finding that the exemption did not apply and, in dicta, characterized the exception as arising “when the debtor obtained the non-exempt property by fraud or when the property was subject to a lien.”⁴³

In two other bankruptcy cases, the courts found the exception inapplicable and construed it to require both tracing and actual fraud. As discussed above, Bankruptcy Judge Pusateri in *Barash* considered the exemption when the trustee and two creditors objected to the debtor’s claimed exemptions consisting of his homestead, one automobile, and two insurance policies.⁴⁴ He discussed the Kansas exception but found it inapplicable because the creditors failed to show actual intent to defraud and did not trace assets in which they had an interest to the property claimed as exempt. The

⁴² *In re Mueller*, 71 B.R. 165, 167 (Bankr. D. Kan. 1987).

⁴³ *Mueller v. Redmond (In re Mueller)*, 867 F. 2d 568, 569 (10th Cir. 1989).

⁴⁴ *In re Barash*, 69 B.R. at 232.

Bankruptcy Court for the Western District of Missouri characterized the “peculiar equity” rule as a “jurisprudential exception” which is “little more than the recognition that when funds equitably belonging to a third-party are used to purchase a homestead, that third party has a right in the homestead itself *ab initio*.”⁴⁵ However, when applying the rule the court required both tracing and fraud. It rejected the trustee’s challenge to the debtors’ Kansas homestead rights because the trustee failed to establish fraud and to demonstrate a special interest in the cash used by the debtors to purchase the homestead.

The Bankruptcy Code, although generally permitting conversion of assets prepetition, also includes vehicles to prevent abuse of that process. A conversion of nonexempt assets may be set aside because made with intent to hinder, delay or defraud creditors sufficient to render the transfer voidable under 11 U.S.C. § 548(a)(1). One of the factors identified as relevant to the finding of fraud is “(u)se of the proceeds of secured property or acquisition of new funds to acquire exempt property.”⁴⁶ In addition, the debtor’s conduct with respect to collateral may be cause to object to discharge under 11 U.S.C. § 727(a)(2).⁴⁷ The issue of fraudulent conversion of nonexempt assets into an exempt homestead is frequently litigated in Florida, which like Kansas, has an unlimited homestead exemption. An illustrative case is *European American Bank v. Lapse (In re Lapse)*.⁴⁸ European American Bank, which held a partially satisfied judgment against the debtor in excess of \$1 million, sought a determination that the deficiency was not dischargeable and that the debtor’s homestead exemption

⁴⁵ *In re McGinnis*, 306 B.R. at 287.

⁴⁶ 2 Norton Bankruptcy Law and Practice 2d § 46:30 (Norton, auth & ed.-in-chief 1997).

⁴⁷ 3 Norton Bankruptcy Law and Practice 2d at § 74:8.

⁴⁸ 254 B.R. 501 (Bankr. S. D. Fla.2000).

should be denied. The court denied discharge based upon several alternative code sections and further held that the debtor's homestead exemption would be denied to the extent that proceeds from the creditor's perfected security interest in accounts could be directly traced to the homestead's acquisition.

The court stated:

Notwithstanding [the debtor's] claims to the contrary, he did not innocently convert his non-exempt asset to an exempt homestead on the eve of bankruptcy. [The debtor] converted [the creditor's] directly traceable collateral to a homestead in his name. This conduct can be distinguished from those cases where the courts consider whether or not a transfer from non-exempt property to exempt property, standing alone, is a fraudulent transfer that may give rise to the remedy of the imposition of an equitable lien . [The debtor] used traceable proceeds from prior fraudulent transfers to acquire a homestead with the actual intent to hinder, delay and defraud [the creditor].⁴⁹

In this case, where the Court is asked to construe and apply the “peculiar equity” exception to the permissible practice of converting nonexempt assets into a homestead, the Kansas public policy of protection of the homestead exemption must be considered. In Kansas, the homestead exemption is liberally construed to safeguard its humanitarian, social, and economic purposes.⁵⁰ The situations under which a homestead can be subject to forced sale are provided by the constitution⁵¹ and statute.⁵² They are limited to sale for taxes, for the payment of obligations contracted for the purchase of

⁴⁹ *Id.* at 508.

⁵⁰ *State, ex rel. v. Mitchell*, 194 Kan 463, Syl ¶ 5, 399 P.2d 556, 558 (1965).

⁵¹ Kan. Const. art.15 § 9.

⁵² K.S.A. 60-2301.

the premises, or for the erection of improvements.⁵³ Neither the legislature nor the courts have the power to create new exceptions to the exemption.⁵⁴ The exceptions do not include tracing of proceeds of collateral.⁵⁵ Further, Kansas courts protect the homestead by narrowly construing the exceptions. For example, the provision that the homestead shall not be exempt from the payment of a debt contracted for its purchase does not include a debt created by borrowing money from a third person where there is no specific agreement that the money so borrowed is to be used for the purchase of the homestead, even though some of the loan proceeds can could be directly traced to that purpose.⁵⁶

Although, as urged by the Bank, the Kansas Supreme Court’s recitation of the “peculiar equity” exception could be understood to mean that the homestead exemption should be denied if a creditor can trace proceeds of the collateral to the homestead, without more, this Court concludes that such a construction would be rejected by the Kansas Supreme Court, if the issue were presented to it. As discussed above, the “peculiar equity” exception to the permitted conversion of assets was developed and later discussed in cases where the validity of the homestead was challenged based upon the debtor’s fraudulent intent to hinder or delay creditors. The exception was the basis for setting aside a homestead in only one case, *Long v. Murphy*, decided in 1883, where there was substantial evidence

⁵³ *Id.*

⁵⁴ *State. ex rel. Baun v. A Tract of Land*, 251 Kan. 685, 840 P.2d 453 (1992).

⁵⁵ Commentators on the Kansas homestead exemption identified the Court’s rationale in *Long v. Murphy*, discussed above, to be “that the defendant did not acquire an exempt homestead, as the court did not purport to create or recognize an exception to the general rule that creditors cannot seek collection of their claims from an exempt homestead.” Roger L. Theis & Karl R. Swartz, *Kansas Homestead Law*, 65 Kan. B.J. 20,26 (1996).

⁵⁶ *Dreese v. Myers*, 52 Kan. 126, 34 Pac. 349 (1893).

of fraudulent intent. The Court construes the Kansas “peculiar equity” exception to the rule allowing conversion of exempt assets to a homestead to require a showing of fraudulent intent and the tracing of nonexempt assets in which an objecting creditor held an interest to the exempt property. In other words, the interest of the creditor challenging the exemption in the funds used to acquire the homestead must be shown in addition to the usual requirements of a fraudulent transfer. This Court understands the requirement of a “peculiar equity” to be in effect a limited grant of standing to object to the conversion of nonexempt assets to exempt assets which the Kansas Court imposed over 120 years ago to strike the balance between permissible exemption planning and fraud upon existing creditors. This analysis is supported by Kansas public policy, which vigorously defends the homestead exemption and recognizes that not all conversions of nonexempt assets to exempt assets are fraudulent as to existing creditors. The innocent conversion of the proceeds of collateral into an exempt asset, in the absence of evidence of fraudulent intent, would be inconsistent with long- standing public policy. Further, if faced with the issue, this Court predicts that the Kansas Supreme would adopt a narrow definition of “peculiar equity.”

Moreover, in the bankruptcy context, to allow an unperfected secured creditor in the absence of showing of fraud similar to that required to either deny a discharge or set aside the transfer, would result in upsetting established rules of priority among creditors. When the tracing is of the proceeds from an unperfected security interest, the granting of an equitable lien in the homestead in favor of the creditor would convert what would otherwise be an unsecured claim into a secured claim to which the creditor would not be otherwise be entitled. In bankruptcy, a creditor’s unsecured security interest in proceeds is subject to avoidance pursuant to 11 U.S.C. § 544.. The Kansas “peculiar equity” exception to the conversion of nonexempt to exempt assets should not be construed to upset the well-

established priorities of the Bankruptcy Code.

Finally, turning to the facts of this case, the Court holds that the Bank is not entitled to the benefits of the Kansas “peculiar equity” exception to the permissible conversion of nonexempt assets to exempt assets. Although the uncontroverted facts have established that the proceeds of the Bank’s unperfected security interest in the New Trailer were applied to reduce the Debtors’ purchase money loan secured by the homestead, there has been no showing that the Debtors even knew that the funds were subject to the Bank’s security interest or engaged in fraudulent conduct to defraud their creditors. The absence of facts to support a finding of actual fraud requires the Court to deny the Bank’s motion for summary judgment seeking the remedy of a partial denial of the homestead.

As to the remedy of constructive trust, District Judge Belot has summarized Kansas law as follows:

A constructive trust arises where a person by fraud, actual or constructive, or by any form of unconscionable conduct or shall affix, has obtained or hold title to property which in equity and good conscience she ought not to possess or which justly belongs to another.

Fraud, actual or constructive, is an essential element of proving a constructive trust. Constructive fraud is a breach of a legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others or violate a confidence. Absent actual fraud, there must also be a breach of a confidential relationship.⁵⁷

The Bank provides that no authority which convinces this Court that under Kansas law a constructive trust should be imposed under the circumstances revealed by the uncontroverted facts. Because imposition of a constructive trust would be in direct contravention of the Debtors’ right to convert

⁵⁷ *Caplinger v. Lundgren*, 905 F. Supp. 876 (D. Kan.1995) (citations omitted).

nonexempt to exempt assets, the concerns of the Court expressed above with respect to the application of the “special equity” rule are relevant to the constructive trust question. The absence of evidence that the Bank took steps to protect its collateral and to assure the turn over of proceeds also makes the Court reluctant to impose the equitable remedy of a constructive trust. The Court therefore finds that the Bank has not made sufficient showing to be entitled to a constructive trust which would disrupt the established priorities of bankruptcy administration.⁵⁸

For the foregoing reasons the Motion for Summary Judgment on the homestead issue filed by plaintiff, Bankwest of Kansas, is hereby denied. This memorandum shall be entered in both the main bankruptcy case with reference to Doc. 15 and in the adversary proceeding.

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⁵⁸ The imposition of a constructive trust by a bankruptcy court, when the debtor has not been determined to be a constructive trustee by a nonbankruptcy court prepetition, is problematical. *In re Leitner*, 236 B.R. 420 (Bankr. D. Kan. 1999).