

PROPERTY EXEMPTIONS

Protecting property so each person can be a productive member of society has been the foundation of exemption laws. The concept that certain property will be immune from creditor attachment is not unique to American law, and in fact, has deep roots.²⁰⁵ The policy reasons are basic. Debtors cannot go to the workplace without clothes, nor can they perform their jobs without tools of their trades.²⁰⁶ Exemptions preserve citizens' ability and incentive to earn and pay taxes. Protecting future wages ensures that individuals retain their incentives to continue working, to work longer hours or under more adverse conditions, and to be productive, tax-paying members of society. Similarly, exemptions are intended to promote savings. Laws exempt some retirement funds to encourage all citizens to make adequate provisions rather than becoming public charges in their post-employment years. Laws also shield disability payments so the government need not increase its grants to provide a basic standard of living for its disabled citizens. Finally, property exemptions protect items of nominal value that may not be necessary to earn a living, but would do little to satisfy obligations to creditors. For example, used clothes or household goods have little resale value for creditors that seized and sold them. Additionally, wedding bands, family heirlooms and photographs may be highly valued by their owners, but have no resale value at all. However, a creditor's threat to seize this property can lead a family to liquidate other assets, borrow from other people, or use any other means to find to

²⁰⁵ The historical antecedents of this approach are well established. According to one commentator, Roman law provided property exemptions to maintain an adequate tax flow: "The public interest was thought to be serviced by those early exemptions because destitute persons were unlikely to pay taxes or produce wealth that could be taxed." William J. Woodward, Jr., *Exemptions, Opting Out, and Bankruptcy Reform*, 43 OHIO ST. L. J. 335, 337 (1982). Vern Countryman, *Bankruptcy and the Individual Debtor -- And A Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U.L.REV. 309 (1983) (tracing history of exemption laws from Roman law onward). See also Joseph McKnight, *Protection of the Family Home from Seizure By Creditors: The Sources and Evolution of a Legal Principle*, 86 S.W. HIST. L. Q. 364 (1983) (Tracing history of Texas exemptions). The homestead exemption signified family preservation. *The Nebraska Homestead*, 3 NEB. BULL. NO. 2 112 (1924).

²⁰⁶ Early exemptions for personal property protected plows and cattle. In a society of farmers, craftspeople, artisans, and other entrepreneurs, exempting farm machinery and hand tools protected debtors' future earning capacity. As more people became wage earners, exemption laws dealt less with equipment and more with future wages.

protect these items from creditors. To curb this leverage, exemptions often protect this personal property.²⁰⁷

Exemptions take on a heightened role in the bankruptcy system as the bankruptcy laws reconcile the competing interests of creditors, something recognized in the federal exemptions of the three short-lived statutes predating the Bankruptcy Act of 1898 federal bankruptcy exemptions. The Bankruptcy Act of 1800 established exemptions for necessary apparel, bedding, and a percentage of the estate keyed to the amount of creditor distributions.²⁰⁸ The Bankruptcy Act of 1841 offered a wider range of exemptions: it protected more clothing, household goods, and other “necessaries” worth up to \$300. The Bankruptcy Act of 1867 exempted even more items within these categories of property, and also reflected contemporary events by exempting military arms, uniforms, and equipment. Significantly, the 1867 Act permitted debtors to avail themselves of the state law exemptions as well, so that debtors could protect a wider range of property. Altogether, federal bankruptcy laws were in force fewer than 20 years of the Nineteenth Century, and for the remainder, state collection laws filled the gaps to protect essential property from creditor process.²⁰⁹

Unlike its predecessors, the Bankruptcy Act of 1898 did not establish a set of bankruptcy exemptions. It relied instead on state exemptions to protect debtors’ property.²¹⁰ Thus, the right to retain property in a federal bankruptcy proceeding depended on the exemption laws of each of the states. Critics charged that the law failed to meet the Constitutional mandate for “uniform laws of bankruptcy.”²¹¹ In

²⁰⁷ See, e.g., Ala. Code § 6-10-6 (1996) (exempting family portraits or pictures). See also *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996) (Easterbook, J. concurring) (bankruptcy court does not honor all leverage that parties would have at state law); ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 3-8 (3d ed. 1996) (illustrating leverage in debtor-creditor process).

²⁰⁸ Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 15 n. 74 (1995).

²⁰⁹ See Paul Goodman, *The Emergence of Homestead Exemption in the United States: Accommodation and Resistance to the Market Revolution, 1840-1880*, 80 J. AM. HIST. 470 (Sept. 1993) (recounting history of state homestead exemptions).

²¹⁰ Nonbankruptcy federal exemptions also were available. For a list of currently applicable nonbankruptcy federal exemptions, see 14 COLLIER ON BANKRUPTCY Fed-1 - Fed-16 (Lawrence P. King et al eds., 15th ed. 1996).

²¹¹ U.S. CONST. art. I, sec. 8, cl. 4.

Hanover National Bank v. Moyses,²¹² the United States Supreme Court upheld the constitutionality of the 1898 Act and declared that the scheme yielded “geographical uniformity” by ensuring that all citizens in a certain area received equal treatment under the law.²¹³ Yet, geographical uniformity did not change the fact that creditors of financially identical debtors would receive very different distributions in bankruptcy depending on where those debtors happened to live.

As the Bankruptcy Act weathered the evolution of debtor-creditor relations throughout the Twentieth Century, the goals of the consumer bankruptcy system matured and diverged more sharply from those of state law creditor collection statutes. Although exemptions should not be unnecessarily generous, grossly insufficient state exemptions were inconsistent with rehabilitating failing families and encouraging work and self-sufficiency. The problems of relying on state laws were compounded by the fact that many state exemption laws had become so outdated in the types of property they exempted that they were laughable in a modern economy.

Mindful of these concerns, in its 1973 Report, the Commission on the Bankruptcy Laws of the United States proposed that Congress enact a set of uniform federal exemptions.²¹⁴ To that end, the 1970 Commission provided a draft statute with exemptions that conceivably would be appropriate for bankruptcy purposes when the claims of creditors were being discharged. The bankruptcy system would no longer have to rely on the excessively generous exemptions of some states or the exceedingly miserly exemptions of others. The 1970 Commission also aimed to reduce wasteful litigation over whether certain pieces of property fit the state exemptions, which dissipated any available assets on lawyers’ fees and court costs that might otherwise be distributed to the creditors.

Taking a slightly different approach, the National Conference of Bankruptcy Judges (“NCBJ”) recommended that Congress enact a slate of federal bankruptcy exemptions but proposed that all debtors be permitted to choose between federal and

²¹² 186 U.S. 181 (1902). This case was brought by a creditor challenging the constitutionality of the system, noting its apparent lack of uniformity despite the constitutional mandate to establish “uniform laws of bankruptcy.”

²¹³ The court’s reasoning partly was derived from two decisions upholding the constitutionality of the 1867 Act. *In re Beckerford*, 3 F. Cas. 26 (C.C.D. Mo. 1870) (state exemptions variety did not compromise uniformity requirement, for creditors in any state only were entitled to receive distribution from available portion of debtors’ assets); *In re Deckert*, 7 F. Cas. 334 (C.C.E.D. Va. 1874) (rejecting attack to law on basis of geographical diversity). *Hanover*, in turn, has been used for subsequent challenges to the 1978 Code.

²¹⁴ REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. 93-137, part I, 170 (1973).

their state exemptions.²¹⁵ The NCBJ Proposal would have guaranteed a base exemption for all debtors – the proposed federal exemptions – while it would have permitted debtors to claim larger exemptions if they lived in states with more generous exemptions.

Congress considered these proposals during the debates over what became the 1978 Code. The House endorsed the NCBJ exemption approach. The Senate, however, advocated the retention of exclusive use of state exemptions, incorporating both the high and the low state exemption levels into the federal system. Late in the process, Congress adopted a provision that offered a slate of federal exemptions but also allowed states to “opt out.” Through the opt out mechanism, a state could preclude its own residents from using federal exemptions when they filed for bankruptcy.²¹⁶ If a state did not opt out, those residents could elect either the state or the federal exemptions, as the House and NCBJ approach proposed. Two thirds of the states opted out of the federal system, permitting their citizens access only to state exemptions, while the residents of the remaining states had access both to federal and state exemptions. Subsequent amendments to section 522 have clarified some issues and adjusted the dollar amounts of the federal exemptions,²¹⁷ but the fundamental structure of the exemptions system has not changed since enactment of the Code.

Although little public debate centered on this part of the new Code when initially enacted, the exemption provisions subsequently have provoked much commentary and have yielded a large body of conflicting case law. Litigants have attacked the provision as lacking Constitutionally mandated uniformity, as providing an impermissibly broad power delegation to state legislatures, and as a violation of the Supremacy Clause, but the opt-out clause has survived such challenges.²¹⁸

²¹⁵ H.R. Rep. No. 94-32 (1975); S. 235, 94th Cong., 1st Sess. (1975).

²¹⁶ Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?* 70 N.Y.U. L. REV. 235, 254 (1995).

²¹⁷ Several matters were clarified in the Bankruptcy Amendments and Federal Judges Act of 1984. For example, it resolved that debtors filing jointly could not “stack” federal and state exemptions by having one filer pick the state exemptions while the other picked the federal exemptions. In addition, Congress reduced the size of the “spillover” exemption. The 1994 Amendments doubled the amounts of the federal exemptions, essentially raising the exemption “floor” in the non-opt-out states. Bankruptcy Reform Act of 1994, P.L. No. 103-394, 108 Stat. 4107, 4111 § 108.

²¹⁸ See, e.g., *In re Storer*, 58 F.3d 1125 (6th Cir. 1995) (opt out does not violate 5th Amendment due process or equal protection rights), cert. denied, 116 S.Ct. 520 (1995); *In re Sullivan*, 680 F.2d 1131 (7th Cir.) (rejecting impermissible delegation argument), cert. denied, 459 U.S. 992 (1982). But see Judith Schenck Koffler, *The Bankruptcy Clause and Exemption Laws: A Reexamination of the Doctrine of Geographic Uniformity*, 58 N.Y.U.L. REV. 22 (1983).

1.2.1 Elimination of Opt Out

A consumer debtor who has filed a petition for relief under the Bankruptcy Code should be allowed to exempt property as provided in section 522 of the Code. Subsection (b)(1) and (2) of section 522 should be repealed.

Exemption policy is a fundamental component of consumer bankruptcy.²¹⁹ Exemptions, along with the discharge, are so central to bankruptcy that they cannot be waived in advance of a bankruptcy filing.²²⁰ However, current exemption policy is channeled away from bankruptcy policy-makers toward a variety of state legislatures.²²¹ The result of the opt-out is a complex exemption system in which variation is the norm. In the states that have opted out, the federal exemptions in section 522(d) are completely abrogated, leaving state legislatures to determine how much property debtors can keep when they file for federal bankruptcy protection and discharge their debts.²²² In “debtor’s choice” states that have not opted out, debtors can choose the set of exemptions that best insulates the greatest amount of property from the reach of their creditors. Yet, bankruptcy law purports to control the claiming, safeguarding, and sometimes entitlement to exemptions; this partial delegation produces confusion when state and federal law are seemingly irreconcilable.²²³

It arguably would be reasonable to use state law exemptions if they reflected regional variations in cost of living or property use, but they do not. A comparison of state homestead exemptions and the relative cost of living reveals that state homestead

²¹⁹ See, e.g., Vern Countryman, *For a New Exemption Policy in Bankruptcy*, 14 RUTGERS L. REV. 678 (1960); Frank R. Kennedy, *Limitation of Exemptions in Bankruptcy*, 45 IOWA L. REV. 445 (1960).

²²⁰ See Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985). “[I]n order to justify nonwaivability, it must be shown that individuals systematically misjudge (or ignore) their own interests and that this bias leads them to consume too much and save too little. I will also argue that societal intervention in the decisions of individuals to consume credit may be justified by the negative effects that those decisions may have on third parties.” *Id.* at 1405. Some states permit their citizens to waive exemptions. See, e.g., Ga. Code Ann. § 44-13-41 (1997).

²²¹ Lawrence Ponoroff, *Exemption Limitations: A Tale of Two Solutions*, 71 AM. BANKR. L.J. 221 (1997); Hon William Houston Brown, *Political and Ethical Considerations of Exemption Limitations: The “Opt-Out” as Child of the First and Parent of the Second*, 71 AM. BANKR. L.J. 149 (1997).

²²² For information on states that have opted out, refer to the annex to this Chapter.

²²³ See *In re Davis*, 105 F.3d 1017 (5th Cir. 1997) (Bankruptcy Code exception to scope of exemption superseded state homestead protection from levy).

exemptions do not reflect a relative cost of living assessment. For example, in 1991, Rhode Island had the fifth highest median home value in the country and yet had a homestead exemption of zero; conversely, Iowa had the third lowest home value in the nation and had an unlimited homestead exemption.²²⁴ No regional cost variation explains why California has very generous exemption laws while New York does not. The lack of rationale extends to personal property as well. For example, compare three states in which a reasonable car might be equally necessary to commute to work: Kansas permits its citizens to exempt up to \$20,000 in a vehicle while Missouri exempts only \$1,000, and, until recently, Nebraska had no automobile exemption at all. Nebraska debtors now may exempt \$2,000 in a motor vehicle, but only if the car is used as a tool of the trade, or to commute to and from work.²²⁵

Although different intrastate values and historical artifact may be perfectly appropriate factors to determine exemptions in the context of state collection laws, they create difficulties when integrated with a national statute that contains a delicate balance between all parties in a collective proceeding. Debtors with roughly equivalent economic profiles and similar property are receiving vastly dissimilar treatment through the federal bankruptcy system, and correspondingly their creditors do as well. A debtor who cannot save a car, a home, and household furniture under one state's exemption laws may look across the state line to see a similar debtor saving all of those items and more.²²⁶ In addition, although there has been significant revision in state exemption statutes since 1978, state exemption laws are sometimes a collection of archaic remains.²²⁷ Moreover, some states require a debtor to file a deed of exemption

²²⁴ U.S. Department of Commerce, Bureau of the Census, 1990 Housing Highlights Financial Facts, Table 1 State and Regional Ranking by Median Home Value: 1970-1990 (June 1992).

²²⁵ 1997 Nebraska Laws L.B. 372 (act to amend section 25-1556); Neb. Rev. Stat. § 25-1556 (1997). Previously, parties had to litigate whether equity in an automobile could be exempted as a tool of the trade or within the \$1500 wildcard exemption. See Oliver B. Pollak & David G. Hicks, 'Please Sir, I Want Some More,' - *Loopholes, Austerity and the Cost of Living - Nebraska Exemption Policy Revisited*, 73 NEB. L. REV. 298, 312 (1994). Note, *Bankruptcy Exemptions: A Full Circle back to the Act of 1800?* 53 CORNELL L. REV. 663, 669 (1967-68) (discussing exemptions for fishing and oyster equipment and unpaid milk proceeds).

²²⁶ See KAREN GROSS, FAILURE AND FORGIVENESS; REBALANCING THE BANKRUPTCY SYSTEM 46-49 (1997) (providing examples of how debtors and creditors experience different outcomes under bankruptcy law depending on which state system is operative).

²²⁷ See generally, James B. Haines, Jr., *Section 522's Opt-Out Clause: Debtors' Bankruptcy Exemptions in a Sorry State*, 1983 ARK. ST. L.J. 1, 10.

in advance of a bankruptcy filing in order to exempt certain property, a requirement that can become a trap for the poorly informed debtor.²²⁸

In deferring to state law exemptions, the current system also multiplies the opportunities for forum shopping and prebankruptcy asset conversion. It does not, however, establish whether state or federal laws should control questions concerning the propriety of prebankruptcy planning, yielding tremendous litigation for debtors and creditors.²²⁹ According to most commentators, Congress intended that the system permit debtors to maximize the use of exemptions,²³⁰ but the case law has not yielded coherent rules on what constitutes appropriate pre-bankruptcy planning. This sometimes leads to decisions holding that debtors have overreached in their efforts to maximize the value of their exemptions.²³¹ As a consequence, some debtors

²²⁸ See 1 GINSBERG & MARTIN ON BANKRUPTCY § 6.01[D](3), 6-9 (Robert E. Ginsberg et al eds. 1997) (citations omitted); *In re Wing*, 55 B.R. 91 (Bankr. D. Colo. 1985) (permitting dismissal and refiling to comply with homestead deed filing requirement). The 1970 Commission also was concerned about the loss of state exemptions through mistake or inadvertence. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. 93-137, at 171 (1973).

²²⁹ See, e.g., Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. REV. 235 (1995); Alan N. Resnick, *Prudent Planning or Fraudulent Transfer? The Use of Nonexempt Assets to Purchase or Improve Exempt Property on the Eve of Bankruptcy*, 31 RUTGERS L. REV. 615 (1978).

²³⁰ See, e.g., Lynn M. LoPucki, *The Death of Liability*, 106 YALE L. J. 1, 32 (1996) (“Congress was concerned with equity between those already judgment proof and those who sought to become so on the eve of bankruptcy”). The legislative history of the Bankruptcy Reform Act of 1978 suggests that prebankruptcy asset conversion was not intended to be prohibited, for it was not fraudulent for a debtor to make full use of exemptions to which he is entitled under the law. H.R. REP. NO. 95-595 (1977). However, this type of prebankruptcy planning has not been met with uniform acceptance and has been the subject of much litigation and discussion. Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. REV. 235 (1995). It also is problematic for lawyers who do not want to advise their clients to commit fraud, but also have the responsibility to protect their clients to the extent the law provides.

²³¹ See *In re Reed*, 700 F.2d 986 (5th Cir. 1983) (affirming lower court’s denial of discharge under section 727 for transferring property less than two weeks before bankruptcy to maximize homestead exemption); *In re Smiley*, 864 F.2d 562 (7th Cir. 1989) (denying discharge after debtor originally residing in Illinois encumbered assets to buy home in state with unlimited homestead exemption, even though court already had limited debtors’ homestead to \$7,500, the Illinois exemption). *In re Tveten*, 848 F.2d 871 (8th Cir. 1988) (applying Minnesota exemption law, denying discharge to doctor with \$19 million in debts for prebankruptcy planning), *rehearing denied, en banc*, 1988 U.S. App. Lexis. 11321 (8th Cir. 1988). Judge Arnold’s dissent in *Tveten* criticized the majority’s attempt to legislate where the legislature had not: “A debtor’s right to make full use of statutory exemptions is fundamental to bankruptcy law.” *Id.* at 887. *But see In re Johnson*, 880 F.2d 78 (8th Cir. 1989) (under similar facts to *Tveten*, upheld district court and bankruptcy

unwittingly risk losing their entitlement to exemptions, seeing transactions unwound, or losing their discharges altogether, while others engage in similar behavior and successfully protect substantial sums of property.²³²

The opportunities for prebankruptcy planning created by the exemption opt-out have called the integrity of the bankruptcy system into question, particularly in the context of a small handful of high-visibility debtors. People with no other familiarity with the bankruptcy system can cite celebrities who have shielded millions of dollars in an expensive homestead in certain states, a behavior that erroneously is attributed to federal law, even though the federal exemptions would not have allowed this shielding to occur.²³³ Unlimited homesteads have led to national ridicule and the efforts of some less needy and better represented families to find literal and figurative shelter in generous states.²³⁴

The bankruptcy system was designed to deal with the consequences of financial failure and to reorganize the honest but unfortunate debtor, a fundamental tenet that should be reflected in a national bankruptcy policy. Until the bankruptcy system sets its own carefully balanced exemption policy, the integrity of the system remains at risk, with serious repercussions for all debtors and creditors.

court's approval of discharge); *In re Hanson*, 848 F.2d 866 (8th Cir. 1988) (applying North Dakota exemption law, finding that debtor's prebankruptcy planning was not fraudulent behavior); *In re Sholdan*, 108 F.3d 886 (8th Cir. 1997) (finding that debtor intended to hinder and delay by prebankruptcy conversion are not sufficient under Minnesota law without evidence that debtor intended to defraud); see also *In re Coplan*, 156 B.R. 88 (Bankr. M.D. Fla. 1993) (after debtor transferred homestead from Wisconsin to Florida, permitted debtor to take only Wisconsin exemption amount).

²³² Memorandum from Jonathan Gruber, Deputy Assistant Secretary (Economic Policy), Department of the Treasury to Fran Allegra, Deputy Associate Attorney General, Department of Justice, Subject: "Treasury Comments on Bankruptcy Commission Position on Asset Exemption Levels," (June 16, 1997) (arbitrary distinctions between exemptions in different categories of goods leads to distortion in asset allocation; inequities arising from favoring savings in one form over another).

²³³ See, e.g., Peter S. Canellos, *Sheltered from Bankruptcy; Fla. Home Exemption Gives Debtors a Haven*, BOSTON GLOBE, Apr. 22, 1997, at A1; Sandra Ward, *Bailing Out: Bankruptcy, Once a Disgrace, Has Become As American as the Fourth of July*, BARRON'S, June 17, 1996, at 17; David Barstow, *In Florida, Simpson May Find a Financial Haven*, ST. PETERSBURG TIMES, Oct. 19, 1995, at 1A ("Were Simpson to move to Florida and file for bankruptcy, creditors couldn't touch his home, no matter how lavish, bankruptcy lawyers say. Conceivably, Simpson could sell Brentwood, sell his New York apartment, sell his Bentley and sink his money into a spread of up to 160 acres of prime Florida real estate, declare bankruptcy a week later, and all of it would be untouchable").

²³⁴ See, e.g., Larry Rohter, *Rich Debtors Find Shelter Under a Populist Florida Law*, N.Y. TIMES, July 25, 1993, at 1.

The Commission recommends the elimination of the provision in section 522 that permits states to opt out of bankruptcy exemptions. State exemption law would be fully applicable to individuals who deal with their creditors under state law and for the creditors who pursue their rights through state law. Yet, for debtors who seek the protection and unique attributes of federal law, such as the automatic stay and the discharge, the implicit bargain is different. To receive federal protection, a debtor should be willing to give up all property in excess of a federally-determined amount. At the same time, each debtor who declares bankruptcy would be guaranteed protection of the same amount of property, and creditors would be entitled to the excess, regardless of where the debtor resides. Beginning with a premise of national uniformity, the exemption rules can be crafted in light of the particular policies and special features of bankruptcy law and collective bankruptcy proceedings.

1.2.2 *Homestead Property*

The debtor should be able to exempt the debtor's aggregate interest as a fee owner, a joint tenant, or a tenant by the entirety, in real property or personal property that the debtor or a dependent of the debtor uses as a residence in the amount determined by the laws of the state in which the debtor resides, but not less than \$20,000 and not more than \$100,000. Subsection (m) of section 522 should be revised to reflect that all exemptions except for the homestead exemption shall apply separately to each debtor in a joint case.

Throughout the Twentieth Century, governmental entities have created incentives and supported various programs to help families become homeowners. For most Americans, a home not only provides physical family shelter but it is also the most significant and valuable financial asset they will own.²³⁵ American families hold a substantial proportion of their net worth in their homes. A homeowner is likely to remain a homeowner through retirement; the vast majority of Americans over the age of fifty live in their own homes.²³⁶

For many Americans, home equity is a form of long-term savings and an informal retirement plan. To the extent that families make this long-term investment

²³⁵ U.S. Department of Commerce, Bureau of the Census, 1990 Housing Highlights Financial Facts, Table 1 State and Regional Ranking by Median Home Value: 1970-1990 (June 1992).

²³⁶ Data from the Consumer Bankruptcy Project, Phase II, 1991, reported in TERESA A. SULLIVAN, ELIZABETH WARREN, JAY LAWRENCE WESTBROOK, *THE FRAGILE MIDDLE CLASS* (forthcoming). See also TERESA SULLIVAN, ELIZABETH WARREN, AND JAY LAWRENCE WESTBROOK, *AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA* (1989).

to provide for future needs rather than spending their incomes on consumable goods, governmental policy generally favors that choice.

Nonetheless, home ownership, in itself, is neither an insurance policy against financial distress nor a badge of solvency. Homeowners tend to be more financially secure than renters, but they are not immune from economic troubles or the need for bankruptcy. Rather, homeowners represent almost one half of bankruptcy filers.²³⁷ The great majority of homes owned by debtors in bankruptcy are encumbered by at least one mortgage, and often two or three mortgages or liens are attached to the property.

States traditionally have held a particularly strong interest in the homestead rights. Some states, such as Florida, Texas, and Oklahoma, provide homestead protection in their state constitutions. Some states find homesteads to be so important that they will protect homesteads of any value, even those worth more than a million dollars. Yet, other states recognize no homestead at all, including Maryland, New Jersey, Pennsylvania and Rhode Island. Others have only nominal homestead exemptions, and the remainder fall somewhere in between.²³⁸

To promote debtor rehabilitation and to advance other governmental policies, there is adequate cause to establish preemptive bankruptcy homestead exemption policies. However, the Commission recommends providing limited incorporation of states' longstanding interest in setting the parameters of homestead protection. Providing debtors with no homestead exemption at all is flatly inconsistent with the fresh start goal of the bankruptcy system, the numerous federal policies promoting home ownership (*e.g.*, federally insured mortgages, tax deductibility of interest on home mortgages), and the prevalent and widely-accepted use of the home as a long-term savings plan. At the same time, permitting unlimited homestead exemptions plainly violates bankruptcy's goal to liquidate and ratably distribute assets among the creditors when a debtor seeks a discharge from outstanding debts.

To reconcile state law interest in the homestead with bankruptcy policy considerations, the Commission's Proposal recommends that state law determine the amount of the homestead exemption within a permissible range and determine the character of property to which a homestead exemption would attach (*e.g.*, a mobile home). However, the federal floor would apply regardless of whether the debtor filed a deed of exemption in advance, required by some states, which can be a trap for the

²³⁷ *Id.*

²³⁸ A list of state homestead exemptions is annexed to this Chapter.

unwary.²³⁹ The floor-and-ceiling approach is a compromise that preserves some of the state variation while it narrows the range of differences to eliminate the most serious concerns about unprotected and overprotected homeowners.

Setting the Floor. A variety of factors are relevant in determining the appropriate floor, such as the number of states with exemptions at that level, a comparison of the proposed floor with the current federal exemption, and policy reasons for protecting the homestead. A homestead exemption protects only the debtor's equity in a home. Notwithstanding the fact that home values might be quite high, most debtors have encumbered their homes with large mortgages, so that the amount of equity needed to exempt and keep the home is quite modest.²⁴⁰ Most homeowners in bankruptcy will not have equity that meets or exceeds the \$20,000 floor that the Commission is recommending. On the other hand, setting the floor any lower would discriminate against elderly homeowners and frustrate their savings efforts, because they are more likely to have built up a greater portion of equity than their younger counterparts who have greater earning potential ahead.²⁴¹ The floor must reflect the fact that the homestead is both a physical shelter and a long-term savings device. In addition, in states that have low homestead exemptions, some debtors with equity that slightly exceeds the exemption may be encouraged by Chapter 7 trustees or other parties to further encumber the property with mortgages to prevent liquidation. This practice benefits neither the debtor, who emerges from bankruptcy with greater encumbrance, nor the debtor's prepetition unsecured creditors, who still get nothing. Thus, it is sensible to set the floor sufficiently high to curb this practice.

Some states vary their exemptions by marital status, number of occupants or dependents, age of debtors, and location of homestead. To simplify the comparison of the proposed floors with the presently applicable exemptions, this discussion will presume that the debtors are jointly-filing spouses under 60 years of age with two dependent children and reside in a non-rural area.

²³⁹ See 1 GINSBERG & MARTIN ON BANKRUPTCY § 6.01[D](3), 6-9 (Robert E. Ginsberg et al. eds. 1997) (citations omitted). *In re Wing*, 55 B.R. 91 (Bankr. D. Colo. 1985) (permitting dismissal and refile to comply with homestead deed filing requirement). The 1970 Commission also was concerned about the loss of state exemptions through mistake or inadvertence. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. 93-137, at 171 (1973).

²⁴⁰ According to one empirical study, the median home equity is \$5,500. TERESA A. SULLIVAN, ELIZABETH WARREN, JAY LAWRENCE WESTBROOK, *THE FRAGILE MIDDLE CLASS* (forthcoming).

²⁴¹ At least one debtors' attorney has noted that many senior citizens who have worked hard to pay down their mortgages end up losing their homes under current exemption policy. See, e.g., Letter from Steven J. Abelson, attorney in Freehold N.J. (May 9, 1997).

The first draft of the Commission's Proposal recommended a \$40,000 floor.²⁴² Approximately nineteen states have exemptions of \$40,000 or more for a family of four, and it would increase the exemption for the remainder. This floor would provide \$10,000 more in potential homestead protection for joint filers and \$25,000 more for single filers than the current federal exemption. Some people suggested that exempting \$40,000 of equity is an insufficient floor for rural areas and high cost of living areas,²⁴³ while others thought that it was unnecessarily generous and too drastic a change from the homestead exemptions used currently in many states.²⁴⁴ With respect to \$30,000, for the aforementioned family of four, twenty-five states have homestead exemptions at or above this number. This floor also comports with the federal homestead exemption currently available for joint filers. In addition, five states and the District of Columbia have very low state homestead exemptions and have not opted out of the federal exemptions. Thus, assuming that homeowner debtors in these states generally choose the federal exemptions, this functionally brings the number of states with bankruptcy homestead exemptions at or above \$30,000 to thirty-one.

Thirty-two states, including states that permit their citizens to use the federal exemptions, have homestead exemptions at or above \$20,000 for joint debtors with two dependents in a non-rural region. A federal floor of \$20,000 effectively would *reduce* the available bankruptcy homestead exemption for debtors in five states and the District of Columbia that provide little or no homestead exemption but presently permit the family of four to use the \$30,000 federal homestead exemption. Thus, joint filers would get less protection than they currently receive under the federal exemptions. In addition, a number of states provide homestead exemptions of \$10,000 or \$15,000; in those states, establishing a \$20,000 floor would constitute a less radical change to current law but would be consistent with the policy considerations behind this Proposal.

The Commission ultimately adopted the \$20,000 floor as being the least drastic change while ensuring that families forced to avail themselves of bankruptcy protection

²⁴² When the Commission commenced its discussions of a specific exemption Proposals, the Commission was working with a \$40,000 floor, but expressed interest in exploring options to find the most justifiable level in light of the aforementioned considerations. Three possible alternatives—\$40,000, \$30,000, and \$25,000—initially were explored and the Commission first adopted a \$30,000 floor. Upon later reconsideration, the Commission voted to recommend a \$20,000 floor.

²⁴³ See, e.g., Letter from Kenneth E. Salomon, Salomon Enterprises, Loxahatchee, Florida (\$40,000 is too low a floor).

²⁴⁴ See Letter from Celia Woodham, Director of Compliance, Chartway Federal Credit Union, Apr. 4, 1997; Letter from Frank M. Hensley, President, Pioneer Western Investment Assoc., Inc., July 28, 1997; Letter from Robert H. Waldshmidt, Howell & Fisher (Mar. 28, 1997) (speaking for Chapter 7 trustees).

can retain a reasonable amount of equity in their homes. It would narrow the wide gap in treatment of economically similar debtors in states with disparate views of the homestead and would bring their treatment into accordance with the bankruptcy system's view of the role of the homestead in the reorganization of a debtor. The exemption floor reflects the use of the home as a savings and retirement plan and should make bankruptcy policy consistent with other federal policies promoting home ownership.

Because imposing a federal floor would raise the homestead exemption in some states, some have expressed concern that this change might encourage more families to file for bankruptcy or to file for Chapter 7 rather than Chapter 13.²⁴⁵ Empirical evidence refutes this assertion. Economists, statisticians, and legal scholars repeatedly have found that larger property exemptions or debtor-favoring bankruptcy laws have not caused increases in bankruptcy filings, nor is there persuasive evidence showing that exemptions affect debtors' choices between Chapter 7 and Chapter 13.²⁴⁶ Corroborating the majority of private studies, an Administrative Office of the U.S. Courts Working Paper has indicated that states with generous exemptions often have higher proportions of Chapter 13 filings than states with more meager exemptions.²⁴⁷ Conversely, states with very low exemptions do not necessarily have Chapter 13 filing

²⁴⁵ See Letter from John D. Leahy, Chief Executive Officer, Cinfed Employees Federal Credit Union, Cincinnati, Ohio (April 1, 1997); Letter from Robert H. Waldshmidt, Howell & Fisher, Nashville, TN (March 28, 1997).

²⁴⁶ See, e.g., Michael Bork and Susan Tuck, Administrative Office of the U.S. Courts, Bankruptcy Statistical Trends; Chapter 13; Adjustment of Debts of an Individual with Regular Income (Working Paper 1) (Jan. 1994) (while some argue that low exemptions will encourage more debtors to choose Chapter 13 and vice versa, statistics show no correlation between state homestead exemptions and number of Chapter 13s filed); TERESA A. SULLIVAN, ELIZABETH WARREN, JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS; BANKRUPTCY AND CONSUMER CREDIT IN AMERICA (1989); Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984-1987*, 22 U. RICH. L. REV. 303, 316-17 (1988); William J. Woodward and William S. Woodward, *Exemptions as an Incentive to Voluntary Bankruptcy: An Empirical Study*, 88 COM. L. J. 309 (1983). See also Ian Domowitz and Thomas L. Eovaldi, *The Impact of the Bankruptcy Reform Act of 1978 on Consumer Bankruptcy*, 36 J. L. & ECON. 803, 805 (1993) ("Code cannot be established as the cause of any major increase in the number of nonbusiness bankruptcies"); Kim J. Kowalewski, *Personal Bankruptcy: Theory and Evidence*, FED. R. BANK OF CLEV. ECON. REV. 1-29 (1982); Charles A. Luckett "Personal Bankruptcy" (1988); Jagdeep S. Bhandari & Lawrence A. Weiss, *The Increasing Bankruptcy Filing Rate: A Historical Analysis*, National Conference of Bankruptcy Judges (1993). But see Richard L. Peterson and Kiyomi Aoki, *Bankruptcy Filings Before and After Implementation of the Bankruptcy Reform Law*, J.E. & BUS. 95-105 (1984).

²⁴⁷ Michael Bork and Susan Tuck, Administrative Office of the U.S. Courts, Bankruptcy Statistical Trends; Chapter 13; Adjustment of Debts of an Individual with Regular Income (Working Paper 1) (Jan. 1994).

rates above the national average.²⁴⁸ In addition, the proportion of Chapter 13 cases filed varies tremendously within some states with multiple districts, which suggests that differences in state-wide exemption laws do not explain the chapter choice.²⁴⁹

Setting the Ceiling. Quite a few states allow debtors to exempt over \$100,000 in home equity or impose no monetary cap on the homestead.²⁵⁰ The recommended \$100,000 ceiling would restrict the homestead exemption in some states, freeing more property for creditors in cases involving high-asset consumer debtors. Individuals with ample means still might use homesteads to judgment-proof themselves outside of bankruptcy, but they would forfeit this ability once they sought the benefits of federal bankruptcy relief.

Although some have argued that a \$100,000 cap on homestead exemptions is too high, the cap is consistent with legislation introduced in the U.S. Senate during the 104th and 105th Congress and is lower than the proposed cap of \$500,000 in Senate Bill 1559 that passed in the Senate and was referred to the House Committee on the Judiciary in 1996.²⁵¹

To be clear, setting a cap at \$100,000 does not mean that debtors in all states can keep this much equity. The Commission's Proposal to impose a \$100,000 cap would be an issue in only the few states that have homestead exemptions higher than \$100,000 or unlimited in amount. Capping exemptions has no effect on the majority of state homestead exemptions that are lower than \$100,000.

Homestead Exemption Based on Households. In some states, a standard homestead exemption applies equally to debtors whether single or married. Other states provide a per-person exemption or offer enhanced exemptions for people who are married. The present set of federal exemptions provides each individual debtor a homestead exemption of \$15,000, but gives \$30,000 to a married couple filing jointly.

The Commission proposes that the floor and ceiling should apply equally to all households, regardless of whether a debtor files singly or jointly. The need for a homestead may be based more on the formation of a household than on whether one or two adults live in the home. Single parents or widows or widowers may need a

²⁴⁸ *Id.*

²⁴⁹ *Id.* at 8.

²⁵⁰ See homestead exemption chart at end of this Chapter.

²⁵¹ Bankruptcy Abuse Reform Act of 1995, S. 769; Bankruptcy Technical Corrections Act of 1996, S. 1559, § 28.

homestead exemption that is as large as if they lived with spouses.²⁵² The property exemption would apply to the interest of either the single debtor or the married couple without distinction. The Proposal would not change the states' ability to enhance the amount of an exemption based on family size within the federal floor and ceiling. However, debtors could not "stack" exemptions beyond the otherwise available amount by filing separately. For example, if a husband and wife filed separately in a state with a \$20,000 homestead exemption, each could claim a \$20,000 exemption in the homestead, but the calculation of the exemption, coming immediately after applicable mortgages, would protect the same \$20,000 in value in the home. Neither bankruptcy defers to or accounts for the other bankruptcy, and thus the exemption should be the same as if the couple filed jointly.

The Commission's floor and ceiling Proposal also would apply regardless of the form in which debtors hold the property, and thus would apply to property held in tenancy by the entirety. When spouses hold property in a tenancy by the entirety, as is permitted in about half of the states, spouses have joint ownership of an undivided interest in property. In most states, this means that property held in tenancy by the entirety cannot be transferred or encumbered by one spouse individually. However, tenancies by the entireties are not completely sheltered from the bankruptcy process even if only one spouse files for bankruptcy.²⁵³ As an initial matter, it now is generally accepted that a singly-filing debtor's interest in tenancy by the entirety property is part of the debtor's bankruptcy estate under section 541(a).²⁵⁴ The property is not automatically subject to administration because of the protection offered by some state law exemptions,²⁵⁵ but most state laws do not protect entireties property from levy by

²⁵² In some cases applying state law, widows get no protection at all. *See In re Henry*, 91-41972 (Bankr. D. Neb. Jan. 15, 1996), *cited in* Oliver B. Pollak & David G. Hicks, 'Please Sir, I Want Some More,' - *Loopholes, Austerity and the Cost of Living - Nebraska Exemption Policy Revisited*, 73 NEB. L. REV. 298, 330 n.218 (1994).

²⁵³ *See, e.g.*, 11 U.S.C. § 363(h) (1997) (permitting sale of property held in tenancy by the entirety under certain circumstances).

²⁵⁴ 11 U.S.C. § 541(a). *See, e.g., In re Paepow*, 972 F.2d 730 (7th Cir. 1992); *In re Garner*, 952 F.2d 232 (8th Cir 1991); *In re Grosslight*, 757 F.2d 773, 775 (6th Cir.1985); *Napotnik v. Equibank & Parkvale Sav. Ass'n*, 679 F.2d 316 (3d Cir. 1982). Under the Bankruptcy Act of 1898, a debtor's interest in property held in tenancy by the entirety did not come into the bankruptcy estate because the debtor was not capable of transferring or encumbering the property independently. 11 U.S.C. § 110(a)(5) (1970) (repealed 1979). *See generally* Hon. Frank W. Koger & Thomas N. Lane, "The Fiction is Fractured: Bankruptcy Breaks Entireties," 48 J. Mo. B. 507 (1992). Thus, under the 1898 Act, a married couple could shield property from joint creditors by having one spouse file singly.

²⁵⁵ A debtor who chooses to use state law exemptions may attempt to exempt his interest in a tenancy by the entirety to the extent that such interest is exempt from process under applicable state law. 11 U.S.C. § 522(b)(2)(B) (1994). *See In re Edmonston*, 107 F.3d 74, 75 (1st Cir. 1997)

joint creditors.²⁵⁶ Thus, the presence of joint creditors in the bankruptcy case may permit the trustee to administer the property.²⁵⁷ Because the Commission declined to provide greater bankruptcy exemptions to married people than to unmarried people, the proposed homestead exemption would not distinguish between property held by the entirety, joint tenancy, or other forms. If a married person opts for bankruptcy protection and owns property in tenancy by the entirety, that debtor would be treated as a joint tenant under the Commission's Proposal. The property would be part of the bankruptcy estate, half of the equity would be reserved for the nondebtor spouse in the event of liquidation, and the debtor would be entitled to the homestead exemption provided by state law, within the federal floor and ceiling. The trustee would administer assets equally for joint and non-joint creditors. Similarly, in the few states that permit property other than real property to be held in tenancy by the entirety,²⁵⁸ the proposed federal exemptions could be applied to the debtor's portion of the property.

Application of Indexing. Due to the ravages of inflation, any exemption limits can become outdated if not reviewed periodically. Based on the Consumer Price Index, there was 115% inflation between 1978 and 1994, but no adjustment of exemptions. To deal with this imbalance, Congress added section 104 to provide for adjustment of dollar amounts throughout the Bankruptcy Code.²⁵⁹ Beginning in April, 1998, and every three years thereafter, the dollar amounts reflected in the exemption provisions as well as other bankruptcy provisions, will be readjusted to reflect the change in the Consumer Price Index since the last adjustment. This provision would remain applicable to the floor and ceiling on the homestead exemption, as well as the nonhomestead exemption that is discussed below.

(applying Massachusetts law).

²⁵⁶ See, e.g., *In re Lashley*, 206 B.R. 950, 952 (Bankr. E.D. Mo. 1997) (under Missouri law, entireties property "is never immune from the claims of joint creditors").

²⁵⁷ Section 363(h) permits the trustee to sell property held in this form if partition is impracticable, sale of the debtor's undivided interest would yield significantly less, and the benefit to the estate outweighs the detriment to the nondebtor spouse, 11 U.S.C. 363(h) (1994). Even when applying the same state laws, courts disagree on whether there must be an actual judgment rendered, or whether the existence of joint creditors suffices. Cf. *In re Himmelstein*, 203 B.R. 1009 (Bankr. M.D. Fla. 1996) (joint creditor must hold joint *in personam* judgment to defeat exemption and permit sale) with *In re Planas*, 199 B.R. 211, 217 (Bankr. S.D. Fla. 1996) (entitlement to levy is all that is required).

²⁵⁸ See, e.g., *In re Allen*, 203 B.R. 786, 795 (Bankr. M.D. Fla. 1996) (household goods purchased from joint account held in tenancy by entirety are exempt as tenancy by entirety property).

²⁵⁹ 11 U.S.C. § 104(b) was added by the Bankruptcy Reform Act of 1994, 103-394, 108 Stat. 4107, 4112 § 108(e).

1.2.3 Nonhomestead Lump Sum Exemption

With respect to property of the estate not otherwise exempt by other provisions, a debtor should be permitted to retain up to \$20,000 in value in any form. A debtor who claims no homestead exemption should be permitted to exempt an additional \$15,000 of property in any form.

The amount of nonhomestead property that can be retained through a federal bankruptcy process falls squarely within Congressional province and is equally relevant to all debtors who come through the bankruptcy system, regardless of where they live. Debtors' economic profiles are strikingly similar throughout the country.²⁶⁰ This justifies roughly equal entitlement to exemptions. However, people hold their assets in different forms. To this end, the Commission's Proposal provides a lump sum property exemption that can be used for many different kinds of necessary items.

As a practical matter, parity in outcomes cannot be accomplished without considering the actual variety among debtors and creditors with similar economic profiles. Specific property needs may be vastly different, both inter- and intra-region. More significantly, because state exemption laws generally do not take into account the vast *intrastate* variations in the cost of living, they may not, in fact, address local needs at all.²⁶¹ Housing costs in upstate New York and Manhattan, for example, differ greatly, but they are equally subject to a single state exemption. The Commission heard repeated testimony about the differences in local conditions that should not be coaxed into a uniform mold by a rigid federal statute,²⁶² and agrees with that assessment. No legislature—federal or state—can know exactly what types of property optimally facilitate the rehabilitation of any given family. The variety in cultures, trades, and climate yields diversity that makes it inappropriate to predetermine overly-specific categories of property.

Recognition of this tremendous nationwide diversity can be accomplished through a single system with sufficient internal flexibility to accommodate regional, local, and idiosyncratic needs. Debtors are in a superior position to know what items

²⁶⁰ Teresa A. Sullivan, Elizabeth Warren, & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J. L. PUB. POL'Y 801 (1994).

²⁶¹ See, e.g., Raymond C. Marier, Note, *Bankruptcy Exemptions: A Full Circle Back to the Act of 1800?* 53 CORNELL L. REV. 663, 682 (1967-68) (implying that states contain many economically distinct regions, giving rise to greater impetus for national solution).

²⁶² See, e.g., Henry E. Hildebrand, III, *Uniformity Meets Reality*, 15 AM. BANKR. INST. J. 16, 17 (Aug. 1996) (characterizing consumer bankruptcy debates before Commission).

are most essential to their own fresh starts.²⁶³ Narrow and inflexible categories prevent the kind of efficiency that the debtors' own decision-making adds to the process. The bankruptcy system and its users are best served by setting a level of property exemption that is fair and reasonable to both debtors and creditors in light of the goals of the bankruptcy system, without delineating property item by item.

The lump sum approach also is superior in its actual implementation because it will reduce disputes over whether property qualifies for a certain exemption.²⁶⁴ Limiting the regional disparities would minimize forum shopping and pre-exemption planning, by which the carefully-advised debtor preserves large amounts of property while his poorly-advised counterpart loses similar property. Time consuming questions relating to proceeds of otherwise-exempt property will be eliminated.²⁶⁵ By taking these issues off the table, the lump sum exemption would provide equitable results for all debtors and their creditors.

The lump sum property exemption also prevents further tears in the social fabric because it discourages the practice of challenging exemptions of small household items of little economic value, but tremendous idiosyncratic value. This type of activity, which has no place in a collective bankruptcy proceeding, ceases under this Proposal. If an item has nominal liquidation value, and is exempted in the allowable cash value lump sum exemption, the inquiry ends.

²⁶³ "Only an individual can accurately measure the difference between the value he places on an asset and the market price." Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1439 (1985). "Society could formulate a relatively short list of assets considered vital to the typical individual's well being . . . There is another option that might better reflect the individual's subjective belief about his needs for various assets in the future. Society could allow the debtor to exempt a specific amount (say, \$25,000 worth) of existing assets (over and above human capital and, perhaps, wage substitutes) and leave the individual to decide which of his existing assets to exempt." *Id.* at 1435.

²⁶⁴ See, e.g., *In re Johnson*, 14 B.R. 14 (Bankr. W.D. Ky. 1981) ("Is a bus a bus, or is it a car?"); *In re Hall*, 169 B.R. 732 (Bankr. N.D. Okla. 1994) (denying debtor's attempt to claim tractor-lawnmower as "household furniture"). This inquiry also affects the ability of a debtor to exercise his right to avoid a lien to the extent it impairs an exemption. The parties must first determine whether or not the property fits a certain category of exempt property. See *In re Taylor*, 861 F.2d 550 (9th Cir. 1988) (considering how to determine whether car is tool of trade under Oregon exemption statute); *In re McGreevy*, 955 F.2d 957 (4th Cir. 1992) (reviewing what constitutes household goods and concluding that firearms do not). Compare *In re Raines*, 161 B.R. 548 (Bankr. N.D. Ga. 1993) (pistol used for defense is household good and thus is exempt) with *In re French*, 177 B.R. 568 (Bankr. E.D. Tenn. 1995) (firearms not household goods); *Fraley v. Commercial Credit*, 189 B.R. 398 (W.D. Ky. 1995) (aquarium and electronics were household goods). Compare *In re Carson*, 184 B.R. 587 (Bankr. N.D. Okla. 1995) (computer is tool of trade) with *In re Larson*, 203 B.R. 176 (Bankr. W.D. Okla. 1996) (computer is not tool of trade).

²⁶⁵ See, e.g., *In re Williams*, 171 B.R. 451 (D. N.H. 1994) (upholding exemption of workers' compensation benefits that were converted to another use).

The lump sum exemption also permits families some flexibility in protecting their homes. A family may be able to use part of the lump sum exemption to exempt equity that exceeds the state-provided homestead exemption. For example, if a family had \$23,000 of equity in a home when the state exemption protected \$20,000, the family might be able to protect the extra \$3,000 of equity under the lump sum exemption.

The current federal exemptions have both dollar-limited exemptions and some unlimited exemptions for certain kinds of property, such as home health aids. The \$20,000 lump sum exemption in the Commission Proposal is less than the dollar-limited exemption in the current federal law.²⁶⁶ The petition date is the relevant date for property valuation.

Many parties believe that a \$20,000 lump sum exemption is substantially larger than many state exemptions.²⁶⁷ It is true that many states do not have large “wildcard” exemptions under which one can keep property in any form. Yet, some categories of property that one can keep under state law are not limited in value and thus could far surpass \$20,000. For example, a state with exemptions considered to be modest overall permits debtors to keep one horse, even if that horse is a race horse worth over \$600,000.²⁶⁸ Therefore, by capping the lump sum exemption at \$20,000, the Commission’s Proposal eliminates exemptions that might enable a savvy debtor to shelter abundant property while obtaining the benefits of bankruptcy.

Homestead Equalization Exemption. Not all debtors own their own residences and therefore will obtain no protection from the homestead exemption. Likewise, many debtors live in homes that they technically own but have no equity in them. For this reason, current federal exemption law contains a homestead equalization exemption.²⁶⁹ The Commission recommends a \$15,000 homestead equalization exemption to reduce discrimination. It also would provide some balance for the one

²⁶⁶ Adding together the present section 522(d) exemptions yields a total of \$21,700. This includes the exemptions for a motor vehicle (\$2,400), household items (\$8,000, none of which to exceed \$400), jewelry (\$1,000), wildcard (\$800), professional tools (\$1,500), and accrued dividend or interest in unmatured life insurance contract (\$8,000). The homestead equalization exemption would be doubled over its current maximum allowable amount but would be available in fewer cases, e.g., when there was no home equity to be exempted at all.

²⁶⁷ See, e.g., Letter from Gerard R. Miller, Jones & Miller, Muskogee, OK (March 12, 1997).

²⁶⁸ See, e.g., *In re Freedlander*, 93 B.R. 446 (Bankr. E.D. Va. 1988) (Virginia exemption statute that permitted exemption of horse for agricultural purposes included race horse potentially worth \$640,000).

²⁶⁹ 11 U.S.C. § 522(d)(5) (1994).

quarter of homeowner debtors who have no equity in their homes at all.²⁷⁰ Because some nonhomeowners use other means for long-term savings, this equalization provision permits them to reserve necessary value free from creditor attachment. Without a homestead equalization exemption, economic discrepancies among homeowners and nonhomeowners would be exacerbated. The effort to rehabilitate all debtors, not just homeowners, would be undercut.

Establishing the appropriate homestead equalization amount depends on a number of factors. Saving a home is not at issue, which eliminates larger social implications of forcing a family to move and the variations in valuation. Originally, the Commission considered a homestead equalization bonus of half the amount of the unused homestead exemption, but this calculation would invoke needless confusion in conjunction with the floor and ceiling approach to homestead exemptions. In addition, the bonus would have protected a disproportionately high amount of personal property for debtors whose state laws otherwise would have entitled them to a \$100,000 homestead exemption. There is little justification for variation of this exemption among debtors in different jurisdictions, making a uniform equalization amount appropriate.

Application of Indexing. Again, the dollar figures recommended here would remain subject to inflation adjustments under section 104.

Impact of Homestead and Lump Sum Exemptions on Number of No Asset Cases and on Chapter 7 Trustee Practices. Some parties have suggested that the Commission's recommended lump sum exemption and floor on homestead exemption will have a significant effect on distributions to creditors.²⁷¹ The implication is that the exemptions are set higher than current exemptions in many states and therefore more cases will be deemed "no asset" cases because they will have no nonexempt property and creditors will get fewer distributions in Chapter 7. Although reliable data are hard to gather, the Commission attempted to obtain some information on the financial impact of providing a lump sum personal property exemption and floors on homestead exemptions in states that currently have lower exemptions or no exemptions.

The analysis of the impact of creating a federal floor on exemptions begins with the uncontested point that most consumer cases yield nothing from the liquidation of assets. According to a General Accounting Office study of 1.2 million petitions that were closed as of June of 1992, approximately 5% of the total Chapter 7 cases

²⁷⁰ See Letter of Wayne E. Johnson, Brobeck, Phleger & Harrison (Mar. 20, 1997) (endorsing homestead equalization exemption).

²⁷¹ See Letter of Charles E. Beam, Collection Supervisor, K-25 Federal Credit Union, Oak Ridge, TN (August 5, 1997); Letter of Robert H. Waldshmidt, Howell & Fisher, Nashville, TN (March 28, 1997) (speaking as Chapter 7 trustee).

nationwide were denominated as “asset” cases. Therefore, under the current exemptions, 95% of all Chapter 7 cases yield nothing for unsecured creditors. Of this 5% of the Chapter 7 cases that are denominated asset cases, however, it is the *business* cases, not consumer cases, that generated most of the revenue. Nearly 80% of all creditor receipts in Chapter 7 were produced in business cases.²⁷² Businesses in corporate or partnership form have no property exemptions at all, and therefore the Commission’s recommended exemptions would not affect the returns from those cases. Thus, these data suggest that the Proposal would have no effect on nearly 80% of the creditor distributions now received.

Overall, the change to federal exemptions potentially could increase creditor returns. Within the 95% “no asset” cases under the current system are some cases that may be asset cases under the Commission’s Proposal. The present system is based on various state statutory schemes that exempt certain types of property without regard to value. An individual who has an asset of substantial value that fits into a state exemption that has no specific dollar cap would have a no-asset case under the present system, but would have an asset case under the Commission’s proposed lump sum exemption system. For example, a number of states provide full exemptions for many types of insurance plans and other investments without a dollar limit; these would not be exempt under the Commission’s Proposal beyond the lump sum exemption. To the extent that the cases currently listed as “no asset” include those in which debtors have been able to avail themselves of unlimited exemption categories, the number of no asset cases could decline under the Commission’s Recommendation.

Other factors somewhat unrelated to the dollar amount of exemptions may play a large role in determining how much property debtors can keep, but changes in these practices may not always translate into increased returns to creditors. Some judges and practitioners have noted that some Chapter 7 trustees do not find it cost effective to search for assets or to liquidate assets in relatively small cases. Because of the high cost of administration, liquidating the nominal assets in consumer cases does not translate into higher distributions to creditors in the aggregate. When trustees liquidate small consumer estates, more money often goes for their fees and expenses than for distribution to the creditors. For example, the General Accounting Office found that in estates with assets of less than \$50,000, only 22% of the assets were actually distributed to general unsecured creditors, while over 28% went to fees and expenses.²⁷³

²⁷² General Accounting Office, Bankruptcy Administration: Case Receipts Paid to Creditors and Professionals, GAO/GGD-94-173 (July 28, 1994). They generated nearly 80% of the revenue, but the business cases comprised only about a third of all the asset Chapter 7 cases.

²⁷³ General Accounting Office, Bankruptcy Administration: Case Receipts Paid to Creditors and Professionals GAO/GGD-94-173 (July 28, 1994). In another sample of preliminary data from the Central District of California, 243 cases under \$50,000 were liquidated, yielding a total

Propensity to liquidate low asset estates can vary widely even within a state, indicating that the exemption levels themselves do not dictate these practices. According to a U.S. trustee in Georgia, a relatively low exemption state, Chapter 7 trustees in one city in his region pursue hundreds of cases with less than \$5,000 in assets even if cost of administration would consume the majority of those assets, while trustees in other cities in his region do not pursue such cases on the theory that doing so yields nothing for the creditors. The costs of trustee supervision borne by the U.S. trustee offices can be significant even when little or no distribution is made to the creditors.

With a lump sum exemption, fewer of these cases at the margins may be candidates for liquidation, but it is far from clear that this will have any appreciable effect on returns to unsecured creditors. On the flip side, estates with more significant assets are likely to be more accessible for liquidation than under many of the present state law property-specific exemptions. Trustees might liquidate fewer estates but yield higher returns for creditors overall.

1.2.4 All professionally-prescribed medical devices and health aids necessary for the health and maintenance of the debtor or a dependent of the debtor should be exempt.

The Proposal would carve out only one specific personal property exemption: professionally prescribed health aids for a debtor or dependent would be exempt independently and without limitation. Items falling into this category can be exceedingly expensive. A family's need for professionally prescribed health aids is in addition to, and not in place of, other types of property. It would be antithetical to the rehabilitative goals of bankruptcy, and generally contrary to public policy, to require a debtor to choose between retaining household goods, tools of the trade, and a wheelchair for a disabled child. Similarly, a prescribed health aid should not become an object of leverage for general creditors.

distribution for creditors of about \$3 million. 100 cases with \$50,000 or above yielded \$29 million for the unsecured creditors. Again, in both large and small cases, consumer cases make up only a fraction of the distribution.

1.2.5 *Rights to Receive Benefits and Payments*

All funds held directly or indirectly in a trust that is exempt from federal income tax pursuant to sections 408 or 501(a) of the Internal Revenue Code should be exempt.

Few would refute the sound reasons for protecting pension and retirement plans from the reach of creditors. Although families invest significantly less money in retirement funds than they put into homes,²⁷⁴ public policy demands that people not be discouraged from saving for their later non-income producing years when they otherwise might become a drain on the public fisc.²⁷⁵ According to the Federal Reserve, families in all economic sectors report increased retirement savings.²⁷⁶ Retirement funds are the largest single type of financial asset held by American families, constituting over 25% of financial assets held by families in 1995, and the percentage of families in almost every demographic group holding retirement accounts grew between 1992 and 1995.²⁷⁷

Far from signifying excessive wealth, retirement funds have become a middle-class necessity, especially in light of the diminishing adequacy of social security funds and other deferred benefits. Similar to the considerations regarding the homestead, bankruptcy should not discourage what other federal policies and common sense encourage.

Yet, protection of retirement fund contributions should not be boundless. Retirement funds should not become a vehicle for clever debtors to hide money temporarily in contemplation of bankruptcy. Currently, various state federal laws use different means in attempts to control debtors' retirement fund exemptions. Current federal exemptions rely on subjective judicial determinations of what would be "reasonably necessary" for that debtor to support herself and dependents, similar to

²⁷⁴ Ownership of non-home assets, such as stocks, mutual funds, rental property or a business, vehicles, other real estate, IRAs and KEOGH plans, etc. each comprised 7% or less of total assets. Bureau of the Census, Statistical Brief, Household Wealth and Asset Ownership: 1991.

²⁷⁵ This rationale has motivated some state legislatures, such as that of Massachusetts, to grant a larger homestead exemption for citizens past retirement age. Mass. Gen. Laws. Ann. ch. 188 §1A (1997).

²⁷⁶ *Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances*, 83 Federal Reserve Bulletin at 5, 10 (January/February 1997).

²⁷⁷ *Id.*

some state law exemptions.²⁷⁸ This fact-based test can lead to excessive litigation or intrusive and time-consuming inquiries.²⁷⁹ States have employed a variety of other methods to determine the extent to which retirement funds should be exempt. Some state laws effectively exclude certain types of plans from the bankruptcy estate if they qualify as spendthrift trusts, or are federal tax-protected, while other states exempt pension fund contributions in only limited circumstances, such as for public employees.²⁸⁰ Some states employ look-back periods and apply special rules for eve-of-bankruptcy contributions,²⁸¹ while others impose specific monetary caps.²⁸²

The Commission does not contemplate making any significant policy shifts in this area but attempts to provide a uniform and fair rule so that debtors do not receive different levels of protection of their retirement plans depending on who their employers are or where they live. A uniform approach to retirement funds, with as little change to upset nonexcessive past retirement planning, seems appropriate.

Retirement plans that are ERISA-qualified or meet the legal requirements for spendthrift trusts already are protected under current laws in all jurisdictions and are

²⁷⁸ For example, in Ohio, IRA and KEOGH plans are exempt when necessary for support. Nebraska has a similar limitation on profit sharing plans. Missouri imposes the same requirement, assuming the plan met applicable tax restrictions, as do Iowa and Georgia.

²⁷⁹ For example, some courts go through the following analysis to determine whether a retirement fund is reasonably necessary for the Debtor's support: (1) Debtor's present and anticipated living expenses; (2) Debtor's present and anticipated income from all sources; (3) Age of the debtor and dependents; (4) Health of the debtor and dependents; (5) Debtor's ability to work and earn a living; (6) Debtor's job skills, training and education; (7) Debtor's other assets, including exempt assets; (8) Liquidity of other assets; (9) Debtor's ability to save for retirement; (10) Special needs of the debtor and dependents; (11) Debtor's financial obligations, e.g., alimony or support payments. *In re Flystad* 56 B.R. 884, 889-90 (Bankr. N.D. Iowa 1997).

²⁸⁰ Some examples include Indiana, District of Columbia, Nevada, Rhode Island, Delaware, and New Jersey. 14 COLLIER ON BANKRUPTCY (Lawrence P. King et al. eds., 15th rev. ed. 1996).

²⁸¹ For example, Alaska law provides that tax qualified plans are exempt, excluding contributions made 120 days prior to bankruptcy. Likewise, otherwise exempt contributions made within a year of the bankruptcy filing are non-exempt in Louisiana and Mississippi. In Montana, tax qualified stock plans are exempt except for contributions made within 1 year of bankruptcy in excess of 15% of debtor's income for that year. *Id.*

²⁸² *E.g.*, *In re Barshak*, 96-1423, 1997 WL 50616 (3d Cir. Feb. 10, 1997) (Pennsylvania restricted to \$15,000 per year in certain employer sponsored plan contributions). Other states with monetary limitations, either in total or on yearly contributions, include Vermont, North Dakota, South Dakota, and Idaho. 14 COLLIER ON BANKRUPTCY (Lawrence P. King et al. eds., 15th rev. ed. 1996).

not included as property of the bankruptcy estate.²⁸³ The Commission recommends that the exclusive federal bankruptcy exemptions for other pension plans rely on the federal tax restrictions, exempting retirement funds in bankruptcy to the extent they are exempt under federal tax laws. By exempting all funds held indirectly or directly in a trust that are exempt under sections 408 or 501(a) of the Internal Revenue Code, the debtor would be able to protect self-employed KEOGH plans and individual defined benefit plans, as well as other plans that have federal tax protection. This permits the bankruptcy laws to employ the developed supervision of the Internal Revenue Code to evaluate what kinds of plans and what kinds of contributions are encouraged as a matter of public policy.

Three types of pension plans—defined benefit plans, defined contribution plans, and individual retirement accounts—are given special protection in the Internal Revenue Code. Defined benefit plans follow formulas that regulate qualifying contributions. Termination of such plans is very difficult, with penalties exceeding 50% of the amount deposited. Defined contribution plans are limited to 25% of compensation or \$30,000,²⁸⁴ whichever is less. For a family earning the median family income listed in bankruptcy of about \$22,000, the maximum deduction would be \$5,500, *if* the family members made such a contribution. Contributions to IRAs are limited to \$2,000 per year per taxpayer.

Because the tax provisions limit the amount of contributions in a single year, a debtor would not be able to make an extraordinary contribution to shield assets temporarily from creditors. To the extent a contribution exceeded the allowable contribution and thus would be subject to penalty under the tax laws, the contribution would not be exempt for bankruptcy purposes. The integrity of the system would be best served by this limitation that precludes exemption of excessive and improper contributions and prevents the shielding of extraordinary sums through the use of various types of insurance plans, which some state laws currently permit.

1.2.6 *Rights to Payments*

²⁸³ *Patterson v. Shumate*, 112 S. Ct. 2242 (1992). The Supreme Court found that pension plan assets in a qualified pension plan with an anti-alienation provision were not included in the debtor's bankruptcy estate pursuant to the plain language of the Bankruptcy Code and ERISA; the plan's anti-alienation provision was a "restriction on transfer enforceable under applicable nonbankruptcy law" under section 541(c)(2). Approximately 37 states have exemptions applicable to ERISA-regulated pensions. See COLLIER ON BANKRUPTCY at CasHi-37 (Lawrence P. King et al. eds., 15th rev. ed. 1996).

²⁸⁴ The \$30,000 maximum contribution would be available only to a debtor earning more than \$120,000 in the year of the bankruptcy filing. Even if a debtor made \$120,000 a year, the exemption would be \$30,000 only if the debtor's employer made the contribution to the maximum amount. If the plan is established as a spendthrift trust, the contribution is fully exempt under current law.

Rights to receive future payments (e.g., social security benefits, life insurance) should be exempt, and the debtor's right to receive an award under a crime victim's reparations law or payment for a personal bodily injury claim of the debtor or the debtor's dependents should be exempt.

Certain future rights to payment generally have been beyond the reach of liquidation in a Chapter 7 proceeding. The Commission endorses the continuation of those policies. Future wages would not be property of the estate in a Chapter 7 case.²⁸⁵ Debtors would continue to be able to exempt unmatured life insurance contracts,²⁸⁶ although cash value would have to be exempted under the \$20,000 lump sum exemption. The debtor also would retain the right to receive undistributed and unaccumulated social security, unemployment compensation, public assistance, veterans' benefits, and disability, illness or unemployment benefits.²⁸⁷

In addition, the Commission recommends that debtors be able to exempt any rights they might have to receive a crime victim's reparation award or a personal injury award.²⁸⁸ Although the current federal exemptions provision caps personal injury award entitlements at \$15,000, many states do not impose such a limitation. There is little evidence that this type of exemption is a likely or frequent subject of scrutiny or abuse and there is little justification for the cap.

²⁸⁵ 11 U.S.C. § 541(a)(6) (1994). "This reservation of future earnings exclusively and inalienably to the debtor is the 'fresh start' that has been a driving tradition of American bankruptcy law. The system provides a fresh start at least partly because of the difficulty of denying it. Debtors who could neither pay nor discharge their debts might adopt a judgment-proof lifestyle, adopt a new identity, or join the underground economy. Both debtor and creditor might spend considerable efforts on a struggle that yielded less for the creditor than it cost the system in the aggregate." Lynn M. LoPucki, *The Death of Liability*, 106 YALE L. J. 1, 32 (1996). Future wages are, however, part of the estate in Chapters 12 and 13. See 11 U.S.C. §§ 1207(a)(2), 1306(a)(2) (1994).

²⁸⁶ 11 U.S.C. § 522(d)(7) (1994).

²⁸⁷ *Id.* § 522(d)(10) (1994).

²⁸⁸ *Id.* § 522(d)(11) (1994).

Competing Considerations.

This Proposal stops short of providing a uniform homestead exemption and thus it does not resolve all of the difficulties in applying state property laws to a federal bankruptcy proceeding.²⁸⁹

Some remain convinced that each state legislature is better suited to determine the appropriate level of exemptions for their citizens in the context of the federal bankruptcy system and that this Proposal does not take regional differences sufficiently into account. For many of the reasons already discussed, this Proposal does not adopt that view. Exemptions in bankruptcy involve somewhat different considerations than exemptions in state law collection actions, demanding a greater need for uniformity and more considered choices that focus on the discharge and fresh start. These reasons justify more centralized policy choices. State law exemptions cannot be said, as a whole, to be based on the cost of living relative to other states. State law exemptions also do not address the very significant intrastate distinctions that often overshadow interstate distinctions. If there is true concern about disparities in cost of living that Congress ultimately decides must be taken into account, then regional adjustments could be made to the federal exemptions, which would provide more parity than ceding responsibility for exemption policy to the states.

The exemption levels have been criticized by some as being too high and by others as being too low. The previous text attempts to delineate the Commission's reasoning for reaching the recommended numbers and addresses some of the counter arguments.

Involuntary Filings. If uniform bankruptcy exemptions were more restrictive than state law exemptions, creditors might develop a greater interest in bringing more involuntary consumer bankruptcy cases. To prevent a creditor from filing an involuntary petition simply to deny the debtor the protection of state exemption laws, it might be necessary to make a slight adjustment to the standard for involuntary petitions against consumer debtors. For example, an involuntary petition might require a showing that the filing was not made solely for the purpose of entitling the creditor to a less generous federal exemption. Only a handful of involuntary petitions are filed against consumers under the current system, which means that the predicted impact of this change would be minimal.²⁹⁰

²⁸⁹ See, e.g., *In re Kretzinger*, 103 F.3d 943 (10th Cir. 1996) (applying state law to determine whether leased agricultural property can qualify for homestead exemption); *In re Davis*, 105 F.3d 1017 (5th Cir. 1997) (Bankruptcy Code exception to scope of exemption superseded state homestead protection from levy).

²⁹⁰ See, e.g., Susan Block-Lieb, *Why So Few Involuntary Petitions Are Filed and Why the Number is not too Small*, 57 BROOK. L. REV. 803 (1991).

Prebankruptcy Planning. Some remain concerned that a small fraction of borrowers will continue to engage in prebankruptcy planning in attempts to shield assets from their creditors while they discharge their debts. This Proposal vitiates most of the need for the conversion of assets from one form to another because the Proposal does not exempt narrow categories of personal property with no value limits. It would remain possible to use assets that would exceed the exemption limits to buy a home or move to a state with a higher homestead exemption, but the cap on the homestead makes this far less likely or attractive. Because the safeguards against excessive exemptions are accomplished through caps, there is no need to put further restrictions on pre-bankruptcy planning, thus a statutory provision expressly condoning prebankruptcy planning could eliminate unnecessary litigation and clarify the law for debtors who are unsure about how much they can rearrange their financial affairs. Of course, any prebankruptcy planning that runs afoul of other laws, such as fraudulent conveyance provisions, would remain voidable in bankruptcy.

Note on nonbankruptcy debt collection. The bankruptcy exemptions also affect the ability of the United States government to collect debts outside of bankruptcy. The Federal Debt Collection Procedures Act relies on section 522(d) of the Bankruptcy Code to determine what property is exempt from the reach of federal debt collection actions.²⁹¹ For this reason, the Department of Justice has raised the question of whether the recommended exemptions should be applicable to nonbankruptcy federal collection actions.²⁹² The proposed exemptions are lower than the current federal exemptions, but could be used to protect different property than the present provisions.

²⁹¹ 28 U.S.C. §§ 3001, 3014 (1994) (allowing debtor in federal debt collection action to claim as exempt from execution those properties treated as exempt under Bankruptcy Code).

²⁹² Letter from Francis M. Allegra, Deputy Associate Attorney General, U.S. Department of Justice, to Brady C. Williamson at 4 (June 18, 1997).