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Homestead Protection Is Devolving

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Creditors have always feared states with large homestead protections. Florida,[1] one of the five homestead-protective debtor states,[2] was considered by many to be the ultimate "debtor's haven"[3] and was the target of a great deal of criticism. Stocking cash into real estate has never been disdained in Florida. Florida's homestead protectionism was succinctly described by Southern District of Florida Bankruptcy Judge **A. Jay Cristol**, who told the *New York Times*, "You could shelter the Taj Majal in this state and no one could do anything about it." [4] The creditor community perceived this sheltering to be epidemic, especially in the *Havoco* decision, when the Florida Supreme Court allowed a debtor to deliver nonexempt cash to the homestead

after a judgment creditor chased the debtor to Florida, where he avoided attachment by purchasing a large Florida homestead.[5]

Federal Congressional Reaction to Homesteads in Bankruptcy

Before April 20, 2005 – the date President Bush signed into law the, Bankruptcy Abuse Prevention and Consumer Protection Act[6] (BAPCPA) – bankruptcy exemption law for debtor havens was relatively straightforward: If the state prohibited the federal exemptions, called "opt out" legislation, its state exemption would dictate what property was or was not exempt in the federal bankruptcy proceeding. The Bankruptcy Code allows a state to opt out of the federal scheme of exemptions in favor of state-established exemptions.[7] For example, Florida, by virtue of §222.20, opted out of the federal scheme.[8] Three of the four other homestead-protective states similarly opted out of the federal exemptions. [9]

In 2005, the "opt out" states[10] with large homestead exemptions were the concern of Congress, whose attention was alerted by the creditor lobbyists who perceived severe debtor abuse in the five homestead-protective states.[11] This concern spurred Congress to prevent the alleged bankruptcy abusers from being unrightfully protected.[12] Quasi-"opt-in"[13] legislation ensued. Now, in the opt-out states, a debtor may be limited in his or her homestead if he or she has not resided in the homestead-protective state's home for the prescribed time recited by Congress.

The post-April 20, 2005, the Code allegedly stamped out the ability to easily migrate from outside jurisdictions to homestead-protective states.[14] The basic formula is that anyone who resides in a state less than 730 days prior to filing bankruptcy will not be entitled to the homestead-protective state's exemptions.[15] Debtors who reside in a homestead-protective state at least 730 days but less than 1,215 days may have an exemption limitation (cap) for their homestead of $125,000.[16] The majority of debtors who have resided continuously in the homestead for 1,215 days will not be affected by the new legislation.

As of April 20, 2005, Florida's Supreme Court's protections recited in *Havoco* – where the homestead's sanctity will not be disturbed irrespective of its purchase after creditor pursuit or even judgment – certainly should not apply in the bankruptcy forum if the debtor moved into a Florida homestead (as a resident) within 1,215 days.[17]

BAPCPA created a dichotomy between those who are in bankruptcy and those who are not. In the homestead-protective states, a nonfiler who moves to the state between one day and 1,215 days can enjoy the entire homestead to be exempt. Alternatively, a bankruptcy filer whose residency is also less than 1,215 days[18] may be limited to a homestead of a certain amount.[19] Federal law clearly hampers state homestead protections at least until the debtor's residency reaches 1,215 days.

Two Views on §522(p)

McNabb

Just when the homestead-protective states were about to throw in the towel and allow the homestead cap to affect the unlimited homestead, an Arizona bankruptcy judge granted a

reprieve. Judge **Randolph J. Haines** issued an opinion that Congress poorly drafted BAPCPA's limit on the homestead exemption to $125,000 for those who resided in the state between 730 days and 1,215 days.[20]

The argument is simple, but requires review of complex clauses of the Code. Judge Haines demands a reading of the statute as a whole as opposed to a narrow reading of the homestead-cap section.[21] In Arizona, the limitations of homestead described above presently do not apply in "opt-out" states – including homestead-protective states. *In re McNabb*, 2005 WL 1525101 (Bankr. D. Ariz. 2005).

The *McNabb* court required the $125,000 exemption to be seen through the wording of the new bankruptcy provisions. First, the $125,000 cap on homestead refers to §522(b)(3)[22] as incorporated by §522(p).[23] Before the cap of §522(p) applies, one must read §522(b)(2), which states: "Property listed in this paragraph is property that is specified under subsection (d), *unless the state law that is applicable to the debtor under paragraph (3)(A) specifically does not so authorize"* (emphasis added).

The *McNabb* court showed that the Code, as a whole, reads differently than a section by itself. First, "the $125,000 cap applies only 'as a result of electing under subsection (b)(3)(A) to exempt property under state or local law.' Code §522(b)(1) allows debtors to elect to exempt property listed in either paragraph 2 [§522(b)(2)] or alternatively in paragraph 3 [§522(b)(3)]."[24] The *McNabb* court concluded that the limitations of §522(p) cannot apply because "the election ostensibly made available by §522(b)(1) may be taken away by a combination of state law and §522(b)(2)."[25] The *McNabb* court concluded that without the debtor's ability to elect exemptions (Arizona is an "opt out" state where the debtor has no right to elect federal as opposed to state exemptions – the §522(b)(3)(A) election) the debtor cannot be limited to the $125,000 cab, which arises only "as a result of *electing* under subsection (b)(3)(A) to exempt property under state and local law"[26] (emphasis added).

The term "elect" arises in 11 U.S.C. §522(p) as well as §522(b)(3)(A). The prefatory language limiting the homestead to $125,000 in §522(p) specifically requires the debtor's election, as it states that "as a result of electing under subsection (b)(3)(A) to exempt property under state or local law, a debtor may not exempt any amount of interest that was acquired by the debtor during the 1,215-day period preceding the date of the filing of the petition that exceeds in the aggregate $ 125,000 in value in [the debtor's] residence."[27] *McNabb* concludes that because opt-out states prohibit election, debtors in opt-out states cannot elect between federal or state exemption law. As Arizonans cannot elect, then neither §522(b) nor 522(p) can limit their exemptions.

Clear and unambiguous, this apparent glitch of the new Code may upset creditors as it appears §522(p) only applies in the minority of states that did not opt out. The *McNabb* court concluded that the statute cannot be second-guessed: "[H]ere there is no ambiguity nor absurdity in result. The language is unambiguous in stating that the cap is imposed only 'as a result' of an election, so if there is no election there can be no cap. And the result can hardly be deemed absurd when it is consistent with 163 years of bankruptcy law." [28]

Kaplan

Just when homestead-protective states caught their breath after rejoicing over the *McNabb* ruling, Florida reviewed this issue and disagreed. Utilizing the "election theory" of *McNabb* , a Florida debtor sought to prohibit the imposition of a limitation on homestead to $125,000 under §522(p). The debtor received an opposite decision.

Judge **Robert A. Mark**, who strongly disagrees with *McNabb*, rules for the trustee in *Kaplan* and chastised the Arizona court's *McNabb* decision.

> The shaky platform supporting the *McNabb* decision collapses unless the phrase "as a result of electing under *subsection* (b)(3)(A) to exempt property under state law" unambiguously means the statute only applies to debtors who can choose between federal and state exemptions. This court does not agree that the language is unambiguous . . .[29]

Judge Mark further wrote:

> To arrive at this result [*McNabb* decision to allow non-opting states to still use the unlimited homestead] based on a strained and convoluted use of statutory interpretation in the face of this unambiguous legislative intent is simply wrong. [30]

Where Next?

As of November 2005, the courts could either side with Florida's *Kaplan* or Arizona's *McNabb* . In Nevada, where the court had to choose between the two conflicting decisions, the court sided with Judge Mark as it concluded that the legislative intent was to limit the homestead exemption: "Congress clearly intended to apply the provisions of [§522](p) to all debtors and not merely those citizens of states that permit the use of federal exemptions."[31] No other decisions had been entered as of November 2005.

At present, one can only speculate whether the other courts will agree with Judge Mark's directive to cease litigation over this issue.[32] If that happens, then the mansion loophole should finally be closed for the new residents of the homestead-protective states. Until then, this issue and the many other ambiguous clauses of BAPCPA will be the subject of future jurisprudence.

[1]160 acres of unlimited exemption for homestead [Article X, §4, Fla. Const.], all of IRA , all of ERISA plans, and all of life insurance and annuities.
[2]Florida, Kansas, Texas, South Dakota and Iowa. This list also includes the District of Columbia.
[3]*Havoco of America Ltd. V. Hill*, 790 So.2d 1018 (Fla. 2001).
[4]Rohter, Larry. "Rich Debtors Finding Shelter Under a Populist Florida Law," *N.Y. Times* A-1 (July 25, 1993).
[5]*Havoco of America v. Hill*, 790 So.2d 1018 (Fla. 2001).
[6]The President said at the time of the signing:
Thank you all. Please be seated. Welcome. Thank you very much for coming today. Today we take an important action to strengthen -- to continue strengthening our nation's economy. The bipartisan bill I'm about to sign makes common-sense reforms to our bankruptcy laws. By restoring integrity to the bankruptcy process, this law will make our financial system stronger and better. By making the system fairer for creditors and debtors, we will ensure that more Americans can get access to affordable credit.
White House Press Page: www.whitehouse.gov/news/releases/2005/04/20050420-5.html.

[7]*See* 11 U.S.C. §522(b) (1994).
[8]*Owen v. Owe*n, 500 U.S. 305, 309 (1991).
[9]Another exemption is for rural property in Oklahoma.
[10]Only Texas chose not to opt out. As will be discussed below, this subjects Texas to the $125,000 of §522(p).
[11] This does not include the rural exemption allowed in Oklahoma.
[12]Concern existed in Congress about the large homesteads. Representatives stated that BAPCPA "restricts the so-called 'mansion loophole,' " which it identified as permitting "debtors living in certain states [to] shield from their creditors virtually all of the equity in their homes." It did not identify those "certain states." H. Rep. 109- 31, 109th Cong., 1st Sess., text accompanying footnote 71.
[13]Better coined "compelled in."
[14]*See* new 11 U.S.C. §522(b).
[15]11 U.S.C. §522(b)(3)(A).
[16]There are exceptions for bank defrauders and adjudicated DUI offenders.
[17]An exception for certain felons prohibits the exemption scheme even after 1,215 days of residency. 11 U.S.C. §522(q)(1).
[18]The residency must be 730 days in the state before the date of the filing. 11 U.S.C. §522(b)(3)(A). If less than 730 days, then the state exemptions of the state where he came from apply. If a resident for 730 days, but less than 1,215 days, then the exemption is $125,000 of real property acquired by the debtor within 1,215 days of the filing – if the debtor elects to use the state exemption as allowed under §544 and as elected under §522(b)(3)(A). *See* 11 U.S.C. §522(p).
[19]See footnote 20 for restrictions.
[20]*In re McNabb*, 2005 WL 1525101 (Bankr. D. Ariz. 2005); 326 B.R. 785 (Bankr. Ariz. 2005).
[21]11 U.S.C. §522(p).
[22]522(b)(3) Property listed in this paragraph is-

> (A) subject to subsections (o) and (p), any property that is exempt under federal law, other than subsection (d) of this section, or state or local law that is applicable on the date of the filing of the petition at the place in which the debtor's domicile has been located for the 180 days immediately preceding the date of the filing of the petition, or for a longer portion of such 180-day period than in any other place….

[23](p)(1) Except as provided in paragraph (2) of this subsection and §§544 and 548 [11… §§544 and 548], as a result of electing under subsection (b)(3)(A) to exempt property under state or local law, a debtor may not exempt any amount of interest that was acquired by the debtor during the 1,215-day period preceding the date of the filing of the petition that exceeds in the aggregate $ 125,000 in value in-

> (A) real or personal property that the debtor or a dependent of the debtor uses as a residence….

[24]*In re McNabb*, 2005 WL 1525101 (Bankr. D. Ariz. 2005); 326 B.R. 785, 788 (Bankr. D. Ariz. 2005). Also look to footnote 7 for interesting analysis how the new Code authorizes some sections interpreted herein, but the related provisions will not become effective until Oct. 15, 2005, thereby making the reading slightly blinded.
[25]*In re McNabb*, 2005 WL 1525101 (Bankr. D. Ariz. 2005); 326 B.R. 785, 788 (Bankr. D. Ariz. 2005).

[26]*In re McNabb*, 2005 WL 1525101 (Bankr. D. Ariz. 2005); 326 B.R. 785, 788 (Bankr. D. Ariz. 2005). *citing* 11 U.S.C. §522(b)(1).
[27]§522(p).
[28]*In re McNabb*, 2005 WL 1525101 (Bankr. D. Ariz. 2005); 326 B.R. 785, 789 (Bankr. D. Ariz. 2005).
[29]*In re Kaplan*, 331 B.R. 483, 486 (Bankr. S.D. Fla. 2005).
[30]*In re Kaplan*, 331 B.R. 483, 488 (Bankr. S.D. Fla. 2005).
[31]*In re Virissimo*, 2005 Bankr. LEXIS 2085 (Bankr. D. Nev. 2005).
[32]Judge Mark wrote:

> Over the coming months, or years, courts will need to wrestle with some interpretation issues in calculating the available exemptions under the cap in §522 (p) and (q), including, for example, how to handle appreciation in the property. Courts should focus on these issues and the scores of other issues arising under the Reform Act that will engender bona fide debate. This issue, however, should not engender such debate. Determining whether the homestead caps apply in Florida should not be in dispute and should not distract us further.
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> *In re Kaplan*, 331 B.R. 483, 488 (Bankr. S.D. Fla. 2005).