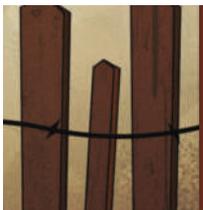


By Scott Talkov and D. Edward Hays

Protecting the Old Homestead



The new homestead exemption offers various benefits to debtors in the post Coronavirus environment, but some provisions may make creditors wary, resulting in higher interest rates

While many California homeowners have heard of the homestead exemption, few understand how this powerful tool can be used to ensure that homeowners stay in their homes, despite creditors, judgments, and even bankruptcies. A homestead exemption is a law that shields a homeowner's principal residence from creditors in the case of bankruptcy or judgment enforcement by a creditor. The homestead exemption is enshrined in California's Constitution, which provides that "[t]he Legislature shall protect, by law, from forced sale a certain portion of the homestead and other property of all heads of families."¹

As one California court explained: "The object of all homestead legislation is to provide a place for the family and its surviving members, where they may reside and enjoy the comforts of a home, freed from any anxiety that it may be taken from them against their will, either by reason of their own necessity or improvidence, or from the importunity of their creditors."² Said another way, "the homestead law is not designed to protect creditors, but protects the home against creditors...thereby preserving the home for the family."³ Nevertheless, while the homestead exemption protects homes from involuntary liens such as a judgment lien, it does not protect homes from consensual liens like mortgages or deeds of trust.

Expanded Homestead Exemption

On September 18, 2020, Governor Gavin Newsom signed Assembly Bill 1885, which expanded California's homestead exemption to further protect homeowners. Effective

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AB 1885

January 1, 2021, Code of Civil Procedure Section 704.730 has been amended to substantially increase homestead exemptions from the previous range of \$75,000 to \$175,000 to instead provide that:

(a) The amount of the homestead exemption is the greater of the following:

(1) The countywide median sale price for a single-family home in the calendar year prior to the calendar year in which the judgment debtor claims the exemption, not to exceed six hundred thousand dollars (\$600,000).

(2) Three hundred thousand dollars (\$300,000).

(b) The amounts specified in this section shall adjust annually for inflation, beginning on January 1, 2022, based on the change in the annual California Consumer Price Index for All Urban Consumers for the prior fiscal year, published by the State Department of Industrial Relations.

While the increased homestead exemption encourages homeowners to acquire and build equity in their homes, the law does not have similar protections for other assets like expensive cars, boats, or bank accounts. Generally, these assets remain available to creditors in state court and bankruptcy proceedings.

The following estimates provide the likely homestead in 2021 for Los Angeles and other Southern California counties based on Zillow:

- Los Angeles County: \$600,000 (estimated \$722,000 median).⁴
- Orange County: \$600,000 (estimated \$821,000 median).⁵
- Ventura County: \$600,000 (estimated \$656,000 median).⁶
- San Diego County: \$600,000 (estimated \$692,000 median).⁷
- Riverside County: \$446,000.⁸
- San Bernardino County: \$416,000.⁹

To calculate how much equity a debtor can have in his or her home without its being sold to pay creditors, it is important to know the actual value of the house. From there, the amount of secured property taxes and consensual liens are subtracted. Any remaining equity can be protected up to the applicable amount of the exemption.

For example, if a debtor owns a \$400,000 unencumbered home in a California county in which the median sales price was \$400,000 in the prior year, since a creditor or bankruptcy trustee would be unable to produce more than the \$400,000 homestead exemption in a forced sale of the house, the courts will refuse to allow the creditor or bankruptcy trustee to proceed. In other words, if the home cannot be sold for an amount in excess of consensual liens and the exemption, the property is protected.

Exemption Planning Methods

Under certain circumstances, debtors may be able to use exemption planning tools to maximize the amount of the homestead. For example, if a debtor sells off his or her assets before bankruptcy and uses this money to pay down the mortgage, this essentially takes otherwise nonexempt assets and turns them into exempt assets. If the equity does not exceed the exemption amount, these assets may be exempt. This strategy, known as exemption planning, will likely become more widespread because creditors will now be prohibited from accessing an even larger amount of home equity. However, before one embarks on such a strategy, it is important to understand that the Bankruptcy Code contains some limits. For example, any equity in a residence acquired during the 10-year period prior to bankruptcy may lose an exemption if such equity was the result of actions taken by the debtor with actual intent to hinder, delay, or defraud creditors.¹⁰

While creditors and bankruptcy trustees will surely raise ques-

tions about exemption planning, the Ninth Circuit Court of Appeals has explained “that the purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not fraudulent per se.”¹¹ Quoting the Ninth Circuit, a 2012 Bankruptcy Court found that, “where the only evidence presented is that non-exempt assets were ‘deliberately converted to exempt assets just prior to filing the bankruptcy petition,’ such evidence is ‘insufficient as a matter of law to establish fraud.’”¹² In other words, debtors are generally able to maximize their exemptions, even when they do so through the sale of nonexempt assets shortly before the filing of a bankruptcy petition.¹³ With the increased exemption amounts, these issues are surely going to generate more litigation.

It is noteworthy that the homestead exemption under California law is restricted to a real property “interest that was acquired by the debtor during the 1215-day period preceding the date of the filing of the [bankruptcy] petition....”¹⁴ If the debtor acquired their interest during the 1215-day period before their bankruptcy petition, they may be stuck with the less-generous federal homestead exemption of \$125,000.¹⁵ A California homeowner may be able to claim more than the \$125,000 federal exemption provided that the equity above this amount resulted from the sale of “a debtor’s previous principal residence (which was acquired prior to the beginning of such 1215-day period) into the debtor’s current principal residence, if the debtor’s previous and current residences are located in the same State.”

Automatic vs. Recorded Homestead

As the Ninth Circuit Bankruptcy Appellate Panel explained in 2016 in *In re Pass*: “Under California law, two species of homestead protection are available to judgment debtors, the ‘automatic’ (or Article 4) homestead exemption and the ‘declared’ (or Article 5) homestead protection, respectively. These protections are available under different circumstances, they serve different purposes and they confer different rights on debtors.”¹⁶

The *Pass* court further stated that “[t]he Article 4 automatic homestead exemption is applicable under California law when a person’s homestead is damaged, destroyed, taken by eminent domain or sold involuntarily in satisfaction of a debt[,]”¹⁷ and that “[f]or purposes of bankruptcy law, the creation of the bankruptcy estate upon the filing of the petition is treated as equivalent to an involuntary sale. Thus, the automatic homestead exemption is applicable in bankruptcy cases.”¹⁸ Further, the court averred: “This is an ‘exemption’ in the familiar bankruptcy law sense: it prevents the judgment creditor (or the bankruptcy trustee) from forcing a sale of the homestead unless there is sufficient equity to pay the debtor the amount of the exemption. The debtor is entitled to be paid ahead of the judgment creditor or trustee.”¹⁹ “The exemption protects a ‘homestead,’ defined as a dwelling in which the debtor or the debtor’s spouse resided on the date the judgment creditor’s lien attached (in bankruptcy, the petition date) and has resided continuously until the court’s determination that the dwelling is a homestead.”²⁰ As the Ninth Circuit Bankruptcy Appellate Panel explained: “Thus, this protection is available in bankruptcy if the debtor was living in the home on the petition date. The exemption is ‘automatic’ in the sense that it requires no affirmative act by the debtor to make it effective; rather, it applies automatically to any dwelling that meets the definition.”²¹

Even further, a declared homestead can protect a homeowner’s equity in his or her home. As the Ninth Circuit Bankruptcy Appellate Panel also explained in *Pass*:

If, however, the debtor chooses to record a declaration of

homestead with the county recorder's office, the debtor is entitled to additional protections, including, without limitation, the following:

i. **Lien Attachment.** If a debtor is entitled to an automatic homestead exemption, the filing of a declaration of homestead prevents judgment liens from attaching to the portion of the debtor's equity in the homestead covered by the exemption.²² Note that this provision does not independently create an impediment to a forced sale.²³ It shields the exempt equity against the future attachment of judgment liens.²⁴

ii. **Voluntary Sale.** If a homesteader voluntarily sells the declared homestead, the proceeds of that sale are themselves exempt for six months.²⁵ This sale protects debtors from the danger that eager creditors will pounce as soon as the homestead is reduced to cash. Under this provision, the debtor has six months to reinvest that cash before creditors can reach it. This protection differs from the lien attachment protection in two important ways. First, it creates an actual exemption (in proceeds of a voluntary sale), rather than merely enhancing the automatic exemption. Second, it can exist even if a debtor is not entitled to an automatic exemption, for instance, if the debtor does not satisfy the continuous residency requirement.²⁶

As noted above, the protections pertaining to a declared homestead are separate and distinct from the automatic homestead exemption, though a debtor may enjoy both sets of protections if he or she satisfies the requirements for both. A declaration of homestead by itself generally does not confer protections or rights in relation to a forced sale.²⁷

Because a declared homestead protects the homeowner in the context of a voluntary sale, these protections are generally unavailable in the context of a forced bankruptcy sale.²⁸

Property Interests and Bankruptcy

Courts have provided guidance on the types of property interests that are available for a homestead exemption. As the Honorable Scott C. Clarkson of the Bankruptcy Court for the Central District of California explained in 2020, some legal interests not reflected as a matter of record title may be entitled to a homestead exemption.²⁹ For most homeowners, being a legal owner on recorded title along with living at the house as their residence on the date that the judgment attaches or that the bankruptcy is filed will generally suffice.

Sometimes, a homeowner may be able to claim a homestead exemption even if he or she is absent from the property. As a California court explained in 2008: "Continuous residence does not mean that the homeowner cannot leave the dwelling, i.e., to go to the grocery store, to work, etc. It does not even mean that the homeowner cannot go on vacation, travel, or live away from his home for a temporary period of time."³⁰ "Pursuant to California law, the factors a court should consider in determining residency for homestead purposes are (1) physical occupancy of the property and (2) the intention with which the property is occupied. A debtor temporarily absent from the property on the date of the petition can claim a homestead exemption. Code of Civil Procedure Section 704.710(c) was amended in 1983 to delete the requirement of actual residency on the date the automatic

homestead exemption claim is made."³¹ While case law suggests that it may be possible to claim a homestead exemption in a property despite a lack of residency on the date of a bankruptcy petition or judgment attaching to the property, the safest course of action is to reside at the home before a bankruptcy to prevent this homestead exemption issue from becoming the source of litigation.

Luckily for homeowners, the homestead exemption cannot be taken away by the Bankruptcy Court for bad faith conduct. This issue was decided by the U.S. Supreme Court in 2014 in a case that arose from fraudulent conduct by a debtor in the Central District of California. The Supreme Court found that "[t]he Bankruptcy Court [had] violated [Bankruptcy Code] § 522's express terms when it ordered that the \$75,000 protected by

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[the debtor]'s homestead exemption be made available to pay [the Chapter 7 Trustee]'s attorney's fees, an administrative expense. In doing so, the court exceeded the limits of its authority under [Bankruptcy Code] § 105(a) and its inherent powers."³²

Maximizing the Homestead Exemption

Many California homeowners know they are eligible to use a homestead exemption but do not know what that means. In a Chapter 7 bankruptcy, a trustee is appointed on behalf of creditors to liquidate a debtor's assets. This liquidation is subject to a major exception: The trustee will only liquidate assets that produce value for the bankruptcy estate and its creditors. As it relates to the homestead, if the trustee cannot produce any value for creditors after paying liens and the homestead exemption, the trustee is effectively prohibited from selling the home because it would produce no benefit.³³

Related to this concept is another that the trustee must also pay the ordinary costs of sale, including a broker's fee, along with escrow and title fees. Even further, the trustee may have an inflated estimate of the home's value. Many times, debtors threatened with a sale of their house are best advised to contact a bankruptcy attorney to negotiate on their behalf to prevent the sale of the property. This settlement in bankruptcy means that the creditors will receive the certainty of some payment while foregoing the chance to receive a greater recovery if the home were to be sold.

Under California's new homestead law, more debtors will be able to walk out of bankruptcy without paying creditors in what is known as a "no asset" case because the equity simply will not cover the homestead exemption.

11 USC Section 522(f)(1)

A discharge in bankruptcy generally protects a debtor's personal liability for a debt. However, it does not discharge the liability of the debtor's property for any liens secured by the property. For example, a debtor who files a bankruptcy with a car that is worth less than the loan will be absolved of liability for any further payments on the loan, but the car can still be repossessed

by the secured lender if the debtor does not pay the debt after the bankruptcy.

Related to this concept, some debtors in bankruptcy have judgment liens recorded in the county where their house is located. Under bankruptcy parlance, this usually means that the judgments “impair” their homestead so long as they remain as liens on their property.

The remedy for this situation is that a debtor in bankruptcy can file a motion under 11 USC Section 522(f)(1) to avoid the lien impairing their homestead. Under Section 522(f)(1)(A) of the Bankruptcy Code, the following conditions must be met:

- The lien must be a judicial lien (i.e., a judgment, not a mortgage).
- The debtor must have an interest in the secured property (e.g., the debtor is usually the owner of record).
- The debtor must claim a valid exemption in the property (e.g., a homestead exemption).
- The lien must impair an exemption in the property (i.e., the debtor must show that the equity in the property after mortgages will be less than the homestead exemption).

Since California has increased the amount of the homestead exemption, this bankruptcy tool is now available to a wider array of debtors.

Chapters 13 and 11 Benefits

The homestead exemption also plays an important role in bankruptcy reorganizations, such as Chapter 13, Chapter 11, and even the rarely used Chapter 12. Specifically, debtors are bound in reorganizations to pay their debts over time, such as a 60-month plan in Chapter 13, from their disposable income as calculated by the court under specific formulas.

However, there is a rule in Chapters 13 and 11 that a debtor’s plan to pay their creditors over time must pass the “best interest of creditors test.”³⁴ This test requires that the debtor pay as much to the creditors as they would receive in a Chapter 7 liquidation.³⁵ In other words, if the debtor has considerable assets but minimal income to pay the creditors over time, he or she cannot choose a bankruptcy reorganization that allows them to pay less than creditors would receive if the debtor’s assets were simply sold off in a Chapter 7 liquidation.

Luckily for debtors, this comparison under the best interest of creditors test allows the debtor to factor in that the home may not be sold in Chapter 7 due to the newly expanded California homestead exemption. Since home equity is often one of the largest assets that debtors would

have in bankruptcy, the increased California homestead exemption will mean that the best interest of creditors test will rarely show that creditors will receive more in Chapter 7.

California law also protects homeowners through the homestead exemption when judgment creditors seek to collect by selling the debtor’s home because “the interest of a natural person in a dwelling may not be sold under [California judgment collection laws] to enforce a money judgment except pursuant to a court order for sale obtained” after inclusion of the homestead exemption.³⁶ The state court will hold a hearing to determine if the homestead exemption applies, the amount of the homestead exemption, and the value of the property such that a sale will produce a payment to the creditor.³⁷

Debtors and Creditors

For debtors, the new homestead exemption is extremely beneficial as sympathy is high for borrowers right now following the Coronavirus pandemic. This means that debtors with what would have formerly been considered extensive assets may now be potential bankruptcy candidates. Additionally, borrowers struggling between making their mortgage payments and credit card payments may no longer have to choose. Chapter 7 bankruptcy will discharge credit card debts while borrowers can continue to make mortgage payments in the home that they will still own after the bankruptcy.

For creditors, they may find themselves in a precarious situation. Homeowners with hundreds of thousands of dollars in equity can now file for bankruptcy while paying nothing to their creditors. These creditors may find that lending in California is now a higher risk such that they may wish to stay out of the state. Alternatively, creditors may charge higher interest rates since there is a higher risk of default under the new homestead laws.

Overall, the increase in homestead exemption is meant to benefit debtors, which will be to the disadvantage of creditors. Since the laws on California’s homestead exemption are complicated, it is important for debtors to consult with an experienced bankruptcy or debtor’s rights attorney. ■

⁵ See Zillow, Median Home Price for Orange County (January 2021), <https://www.zillow.com/orange-county-ca/home-values/>.

⁶ See Zillow, Median Home Price for Ventura County (January 2021), <https://www.zillow.com/ventura-county-ca/home-values/>.

⁷ See Zillow, Median Home Price for Riverside County (January 2021), <https://www.zillow.com/san-diego-county-ca/home-values/>.

⁸ See Zillow, Median Home Price for Riverside County (January 2021), <https://www.zillow.com/riverside-county-ca/home-values/>.

⁹ See Zillow, Median Home Price for San Bernardino County (January 2021), <https://www.zillow.com/san-bernardino-county-ca/home-values/>.

¹⁰ See 11 U.S.C. §522(o).

¹¹ Gill v. Stern (In re Stern), 345 F. 3d 1036, 1043 (9th Cir. 2003)

¹² In re Thomas, 477 B.R. 778, 782 (Bankr. D. Idaho 2012) (quoting In re Stern, 345 F.3d at 1043).

¹³ See House Report of Bankruptcy Reform Act of 1978, H.R. Rep. NO. 95-595, at 361 (1977), reprinted in 1978 U.S.C.A.N. 5963, 6317 (“As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law”); see In re Thomas, 477 B.R. 778, 782-83 (Bankr. D. Idaho 2012) (quoting and discussing exceptions to this rule).

¹⁴ 11 U.S.C. §522(p)(1).

¹⁵ *Id.*; e.g., In re Greene, 583 F. 3d 614, 625 (9th Cir. 2009) (the debtor’s “homestead is not subject to the \$125,000 cap contained in Section 522(p), because he purchased the underlying property interest more than 1215 days before the bankruptcy filing”).

¹⁶ In re Pass, 553 B.R. 749, 757 (B.A.P. 9th Cir. 2016).

¹⁷ *Id.* (citing CODE CIV. PROC. §704.720(b)).

¹⁸ *Id.* (citing In re Diaz, 547 B.R. 329, 333 (9th Cir. B.A.P. 2016))

¹⁹ *Id.* (citing CODE CIV. PROC. §704.850(a)(1)-(4)).

²⁰ *Id.* (citing CODE CIV. PROC. §704.710(c)).

²¹ *Id.*

²² In re Pass, 553 B.R. 749, 757 (B.A.P. 9th Cir. 2016) (citing CODE CIV. PROC. §704.950(c)).

²³ *Id.* (citing CODE CIV. PROC. §704.920).

²⁴ *Id.* (citing Katz v. Pike (In re Pike), 243 B.R. 66, 70 (9th Cir. B.A.P. 1999)).

²⁵ *Id.* (citing CODE CIV. PROC. §704.960(a)).

²⁶ *Id.* (citing In re Anderson, 824 F. 2d 754, 757 (9th Cir. 1987) for the proposition that “after homestead declaration is recorded, moving away from the homestead does not destroy the voluntary sale exemption status”).

²⁷ *Id.* (citing Kelley v. Locke (In re Kelley), 300 B.R. 11, 21 (9th Cir. B.A.P. 2003) and In re Anderson, 824 F. 2d at 758).

²⁸ *Id.* (citing Kelley v. Locke (In re Kelley), 300 B.R. 11, 21 (9th Cir. B.A.P. 2003)).

²⁹ In re Nolan, 618 B.R. 860, 866-67 (Bankr. C.D. Cal. 2020).

³⁰ California Coastal Com. v. Allen, 167 Cal. App. 4th 322, 330-31 (2008).

³¹ In re Pham, 177 B.R. 914, 918-19 (Bankr. C.D. Cal. 1994).

³² Law v. Siegel, 571 U.S. 415, 422-23 (2014).

³³ See, generally, 11 U.S.C. §704(a)(1) (trustee’s duty to “collect and reduce to money the property of the estate”).

³⁴ 11 U.S.C. §§1325(a)(4), 1129(a)(7).

³⁵ See Bank of Am. Nat’l Trust and Sav. Ass’n v. 203 North LaSalle Street P’ship, 526 U.S. 434, 441 (1999).

³⁶ CODE CIV. PROC. §704.740(a).

³⁷ CODE CIV. PROC. §704.780.

¹ CAL. CONST. Art. XX, §1.5.

² Thorsby v. Babcock, 36 Cal. 2d 202, 204 (1950).

³ Amin v. Khazindar, 112 Cal. App. 4th 582, 588 (2003).

⁴ See Zillow, Median Home Price for Riverside County (January 2021), <https://www.zillow.com/los-angeles-county-ca/home-values/>.