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Guest Article

Homestead Provision In Bankruptcy Law Impacts Asset Protection Planning

By Jeffrey A. Baskies

How does the homestead provision in the new bankruptcy law impact asset protection planning?

Three bankruptcy courts have held that the new law's homestead cap of $125,000 will apply to equity developed in homesteads during the 1215 days prior to filing - even in states that have opted out of the federal exemptions.

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As now modified, Sect. 522(p)(1) of the Bankruptcy Code states in part:

"[A] debtor may not exempt any amount of interest that was acquired by the debtor during the 1215-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;

(B) a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence."

Because there has not been enough time for a body of interpretive law to develop, the meaning of many of these terms is still unclear. The first hurdle addressed by courts, however, was whether the section applied at all in those states that opted out of the federal exemptions and whose homestead exemption exceeds $125,000 (Arizona, Florida, Iowa, Kansas, Minnesota, South Dakota and Texas).

The reason for that first hurdle is the use of the phrase "as a result of electing" in the new law. Debtors in states that opted out of the federal exemptions claimed they did not "elect" to exempt homesteads and thus the cap should not apply.

The first decision to address this issue was issued by Arizona U.S. Bankruptcy Judge Randolph J. Haines in *In re McNabb*, 326 B.R. 785 (2005). The court held that Sect. 322 of the law (which creates a new Sect. 522(p) of the Bankruptcy Code, providing the cap on homestead value) did not apply in Arizona because it had opted out of the federal exemptions. Judge Haines found a "glitch" in the law's drafting (the "as a result of electing" clause) that he ruled permitted the debtor to exempt the homestead without regard for the cap.

But a few months later, Florida U.S. Bankruptcy Judge Robert A. Mark disagreed. Judge Mark found that the "homestead cap" of $125,000 as reflected in Sect. 522(p) of the new law applied to the equity the debtor acquired in her home during the 1215 days prior to filing bankruptcy. (*In re Kaplan*, No. 05-14491-BKC-RAM (2005).)

Only days later, U.S. Bankruptcy Judge Steven H. Friedman also held that the "homestead cap" applied in Florida (and by logical extension in any state that "opted-out" of the federal bankruptcy protections). (*In re Wayrynen*, Case No. 05-32144-BKC-SHF (2005).)

Finally, on Oct. 31, 2005, Nevada U.S. Bankruptcy Judge Linda B. Riegle issued another opinion (covering two cases together) concurring with the two Florida rulings. (*In re Virissimo* and *In re Heisel*, Nos. BK-S-13605-LBR and BK-S-05-15667-LBR).

The debtors in the Florida and Nevada cases all argued that the logic in *McNabb* applied to their cases because Florida and Nevada had opted out of the federal exemptions. However, in each instance, the judge concluded that the law was sufficiently unclear to allow an examination of the legislative history, which led to the inescapable conclusion that Congress intended the $125,000 cap to apply even in opt-out states.

For asset protection planners everywhere, these decisions are obviously very important. There are now three interpretations of the homestead cap in Sect. 522(p) of the new bankruptcy law which directly conflict with the first decision, *McNabb*. If the Florida and Nevada courts are right, this interpretation has implications for planning in every state that has opted out of the federal exemptions and whose homestead exemption exceeds $125,000.

How Significant?

The Florida and Nevada rulings are the most recent interpretations of the homestead cap in Sect. 522(p) of the bankruptcy law, and they directly conflict with the first decision. Given the forceful arguments made by these three judges and the strength of their convictions about the application of the cap, the decisions will be a serious hurdle for anyone arguing Sect. 522(p)(1) shouldn't apply.

Further, if these three judges are correct, that has obvious implications for planning in every state that has opted out of the federal exemptions and whose homestead exemption exceeds $125,000.

The second Florida case, *Wayrynen,* also adds a wrinkle by discussing the previous primary residence exclusion to Sect. 522(p)(1) of the Bankruptcy Code, which provides:

"For purposes of paragraph (1), any amount of such interest does not include any interest transferred from 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." (Sect. 522(p)(2)(B))

The trustee in *Wayrynen* contended that for purposes of this exclusion, the only previous residence that matters is the one owned immediately before the one claimed as exempt in the filing. (In that case, the previous residence was purchased only 966 days before filing.)

However, the judge held that $150,500 of equity was built as a result of the purchase and sale of

the debtor's first home. And since that home was purchased 5,824 days before filing, the equity from that transaction, which passed through to the later home, was excluded from the calculation of the "interest" of the debtor subject to the $125,000 cap.

Judge Friedman held the trustee's interpretation of the exclusion was too narrow.

"The 'safe harbor' language of Sect. 522(p)(2)(B) would appear to have been intended to afford protection to individuals like the debtor who, rather than seeking to take advantage of Florida's exemption provisions to shelter illicitly - or improperly - obtained funds, simply have benefited as a result of their ownership of Florida real property and the general appreciation of property values attributable to previous intra-state transactions."

Another Issue

While these cases all deal with homes purchased within 1215 days, a literal reading of Sect. 522 (p) raises the argument that the date of the purchase of the home may not be relevant. Instead, any equity *acquired* during the 1215 days prior to filing (whether by paying down mortgage principal or by rapid appreciation in the real estate market) may be exempted only up to the value of $125,000 of equity.

If that interpretation applies, then whenever a client files bankruptcy with a homestead, there will need to be an appraisal of the property value and the outstanding debt on both the date of filing and the date that is 1215 days before filing. And to the extent that the net equity increased by more than $125,000 in that time period, the excess would be an asset available to satisfy the claims of creditors.

That would mean that if a client owns a home valued at $1 million (with no debt) on the date that is 1215 days before filing, and if the property is valued at $1.5 million on the date of filing, then $375,000 of the equity in the home can be used to satisfy creditors ($500,000 of total equity was "acquired" during that period and only $125,000 was exempted). If that's the case, an order might be issued forcing the sale of the home to satisfy the creditors - or at the very least requiring a mortgage be taken out on the home to satisfy the creditors. (It is important to note that any interest in a previous residence that was acquired prior to the 1215 days, which is later transferred into a different residence, is still exempt over and beyond the $125,000 cap.)

This matter was not directly addressed in the Florida or Nevada cases. But if such a literal interpretation of "any interest acquired" applies, then the new Sect. 522(p) of the Bankruptcy Code will impact many more clients then otherwise might have been anticipated.

The definition of "*any amount of interest that was acquired"* was squarely addressed in a Texas case published in late November. In that case, U.S. Bankruptcy Judge Harlin D. Hale ruled that where debtors' equity in their homestead increased during the 1215 days prior to filing bankruptcy, as a result at least in part of routine mortgage payments, the increased equity did not constitute an "interest" in homestead "acquired" within the 1215 days preceding filing. (*In re Blair*, No. 05-35922-HDH-7.)

Judge Hale found that for purposes of that section, the intent was to apply to people who *acquire* homes, *not* to those who have mere accretions in value to their existing homes. As he ruled, "one does not actually 'acquire' equity in a home. One acquires title to a home."

If other courts follow *Blair*, then homes purchased more than 1215 days before filing are exempted regardless of any appreciation in the equity caused by regular payments of mortgages. And presumptively the same is true for appreciation of equity by market forces.

However, it is possible that irregular payments of mortgages (such as a lump sum payment to reduce the debt within 1215 days prior to filing) will not be dealt with the same way. Instead, they may be subject to the $125,000 cap, or they may be subject to the fraudulent conversion or

fraudulent conveyance provisions and perhaps then subject to different rules.

For debtors, *Blair* is a big success. However, *Blair* is only the first decision on this subject.

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