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The Tennessee Advisory Commission on Intergovernmental Relations

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MEMORANDUM

TO: Commission Members

FROM: Lynnisse Roehrich-Patrick
Executive Director

DATE: 2 September 2015

SUBJECT: Homestead Exemption in Tennessee Bankruptcy (Public Chapter 326, Acts of 2015)—Briefing on Initial Research

Public Chapter 326, Acts of 2015, requires the Commission to study the homestead exemption amounts in the state's bankruptcy law and determine whether they should be increased to accurately reflect the cost of living. The act also requires the Commission to compare the various categories of homestead exemptions in detail to those of other states and submit a written report to the General Assembly no later than January 1, 2016. See appendix A. Homestead exemptions are designed to protect some of the equity that people have in their primary residence and mainly come into play in bankruptcy. The exemptions provided by Tennessee law, some of which date back to 1978, have never been updated. Consequently, the value of each exemption relative to home values has eroded. A panel of experts in bankruptcy law will explain related issues and concerns at the Commission's meeting on September 3.

The need for consumer protection in bankruptcy

With traditional consumer loans, lenders could often meet their customers face to face, and the extension of credit was a personal act based on a good faith guarantee of repayment. As Professor Maurie J. Cohen, writing in the International Journal of Consumer Studies, put it, "this geographic proximity enabled lenders to rely on individual judgement to gauge the likelihood of default and to set their rates and terms accordingly." But the nature of personal credit began to change in the 1950s and 1960s with the advent of credit cards and debtor-creditor relationships that were no longer limited by location. Tim Westrich and Malcolm Bush, researchers focused on community reinvestment and economic development, characterized this change in a report presented at a Federal Deposit Insurance Corporation conference:

> Before [the late 1960s], consumer credit was extended by banks primarily through installment loans for large durable goods, such as the family automobile, furniture, and large appliances. "Open-ended" credit was rare. Otherwise, consumers could obtain credit only through "open book" accounts or "tabs" with local businesses, usually guaranteed by a personal relationship between the business owner and the consumer. In the late 1950s, banks began to explore alternatives to these small consumer loans, which had high overhead costs and labor-intensive underwriting. Enter the credit card: an instant line of open-ended credit. Bank of America launched the BankAmericard, the first universal credit card, in 1958; imitators were quick to follow. By 1970, the United States was blanketed by two large merchant networks, the predecessors to Visa and MasterCard.

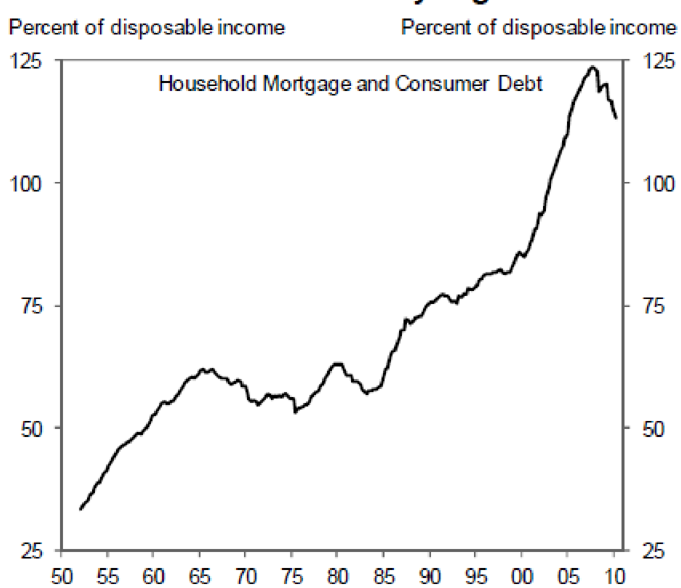
As credit cards became more widespread, banks felt constrained by state usury laws capping interest rates. Lawrence M. Ausubel , an economist writing in *The American Bankruptcy Law Journal*, said, ". . .during the 1970s, the banking industry heavily litigated the issue of the "exportation" of interest rates, i.e., the issue of which state's usury ceiling constrains the interest rate if a bank located in one state issues a credit card to a consumer in a different state." This controversy worked its way up to the US Supreme Court, and in a 1978 ruling, Marquette National Bank of Minneapolis v. First Omaha Service Corporation, the court allowed consumer credit agencies to apply the interest rates from the state in which they incorporated. As explained in the January/February 2007 issue of the Federal Reserve Bank of St. Louis Review

> Prior to this time, many states had usury ceilings on credit card interest rates. The high inflation and interest rates of the late 1970s significantly reduced the earnings of credit card companies. As a result, credit card companies in states with relatively high interest rate ceilings attempted to solicit their credit cards to people living in states with lower interest rate ceilings—and still charge the higher interest rates. Controversy over this practice culminated in [the Marquette case] in which the Supreme Court ruled that lenders in states with high interest rate ceilings could export those high rates to consumers residing in states with more restrictive interest rate ceilings. The result of this ruling was an expansion of credit card availability and a reduction in the average credit quality of card holders.

After the Marquette ruling, many states increased their usury limits in order to compete for the business of national lenders.

By the time of the Marquette decision, Congress had been considering bankrupty reform for roughly a decade. As Bret Fulkerson, Assistant Attorney General, Texas Attorney General's Office put it, "Unlike other major amendments to United States bankruptcy law, the 1978 Act was not passed in response to an economic downturn. Instead, changes were made to the 1898 Act because it was perceived as outmoded and unresponsive to the needs of both debtors and creditors." The last major change was 40 years earlier.[1] The wide disparity in state bankruptcy laws created a hodgepodge that creditors and bankruptcy courts found difficult to administer. This hodgepodge also made navigating the bankruptcy process and making a fresh start difficult for debtors. In response to these concerns, Congress modernized the US bankruptcy code. The Bankruptcy Reform Act of 1978 established federal bankruptcy courts; created a set of exemptions for debtors, including a homestead exemption; and eased the process of filing for Chapter 13, which allows debtors to repay their debt without liquidating their assets. Until then Chapter 7, which allows debtors to discharge most of their debts but may require them to give up most of their property, was the only alternative available to most debtors.

Exhibit 1: Household Debt/Income Ratio Is Still Extremely High



Source: Federal Reserve Board. Department of Commerce.

There are many reasons that consumers end up in bankruptcy court, the most common being medical bills. Job loss or other income reduction or divorce related costs are also frequently cited as reasons. Financing everyday expenses with credit cards, accumulating student loan debt, and taking on high-risk home loans may also lead a consumer into bankruptcy. When a consumer falls behind on their payments debt can increase quickly because of late fees, interest rate hikes, and over-limit fees. As illustrated in exhibit 1, household debt rose sharply as a percentage of disposable income starting around the time of these two major changes.

Balancing the interests of debtors and creditors

Bankruptcy law seeks to promote a balance between the interests of debtors and creditors, being fair to both while allowing a debtor to completely discharge their debt or repay a portion of it based on their ability to pay. State and federal bankruptcy laws allow debtors to exempt certain assets from the claims of creditors, usually up to specified dollar amounts but occasionally without limit, in order to avoid leaving them destitute. As Assistant Texas Attorney General Fulkerson describes it,

[1] The Chandler Act of 1938 first established Chapter 13.

> The Code provides for the debtors' interests by giving them the ability to embark on a fresh start after financial failure by means of liquidation or a restructured payment plan. Conversely, creditors are given an opportunity to collect on some portion of the debtors' contractual obligations through the bankruptcy laws. On a more fundamental level, bankruptcy laws attempt to reconcile countervailing social interests in seeing that obligations to repay debt are fulfilled while allowing individuals to maintain dignity and self-respect after financial ruin. The balance is effected by subjective assessments of debtors, creditors, society, and the administrators of the bankruptcy system.[2]

Both Chapter 7 and Chapter 13 are designed to allow debtors a fresh start and avoid making them destitute while allowing creditors to receive at least a portion of the money owed.

Giving debtors a fresh start

As explained in an article about bankruptcy on the official website of the Judicial Branch of the U.S. Government,

> A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts. The Supreme Court made this point about the purpose of the bankruptcy law in a 1934 decision:
>
> > [I]t gives to the honest but unfortunate debtor...a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).
>
> This goal is accomplished through the bankruptcy discharge, which releases debtors from personal liability from specific debts and prohibits creditors from ever taking any action against the debtor to collect those debts.

The federal bankruptcy code, like most states' bankruptcy laws, permits debtors to protect certain property they own from unsecured creditors. Debtors may be able to exempt all or a portion of the equity in their primary residence through homestead exemptions or some or all "tools of the trade" used by the debtor to make a living (i.e., auto tools for an auto mechanic or dental tools for a dentist). The availability and amount of property the debtor may exempt depends on the state the debtor lives in.[3]

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[2] http://www.jtexconsumerlaw.com/Bankruptcy.pdf.

[3] United States Courts (n.d.).

Homestead exemptions in Tennessee and other states

The first states to offer homestead exemptions were Georgia and Mississippi in 1841; Texas adopted its first homestead exemption in 1829 while still a part of Mexico. Tennessee's homestead exemption dates back to 1852, and was originally set at a maximum of $500.[4] Eighteen years later, Tennessee's 1870 constitution increased that exemption to $1,000, where it remained for over 100 years. The 1977 state constitutional convention increased the exemption to $5,000 and gave the legislature the ability to increase it further.

The US Bankruptcy Reform Act of 1978 established a set of exemptions that included an individual homestead exemption of $7,500, which was $2,500 more than the state exemption at that time, and a higher exemption for joint filers of $15,000, which was double the federal exemption for individuals and $10,000 more than the state exemption. The set of federal exemptions is available in whole or in part to debtors in all states unless the state has passed a law saying otherwise.[5] Thirty-one states including Tennessee currently have laws restricting their residents to state exemptions. Residents of 17 states can choose between state and federal exemptions. Two states, New Jersey and Pennsylvania, have not established their own exemptions; residents there rely on the federal exemptions.

Reacting to the new federal law, the Tennessee General Assembly enacted Public Chapter 919, Acts of 1980, which restricted Tennessee residents to using only state exemptions but added a $7,500 exemption for joint owners, half the federal amount for joint filers. Although the federal amounts increase with inflation and are now $22,975 for individuals and $45,950 for joint filers,[6] Tennessee's exemptions remain at $5,000 for individuals and $7,500 for joint owners to this day.

Past attempts to update Tennessee's homestead exemption

Recognizing that Tennessee's homestead exemption amounts have fallen well behind, the General Assembly has attempted to increase them 13 times in just the last 20 years.

- Six bills sought to increase the homestead exemption for all homeowners but failed.
- Seven bills sought to create new categories of debtors with enhanced exemptions but only two were enacted.
- Public Chapter 659, Acts of 2004, gave individuals who are 62 years of age or older a $12,500 exemption. The exemption increases to $20,000 for married homeowners

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[4] Acts of 1851-52, Chapter 161.

[5] Public Chapter 61, Acts of 1979, restricted the homestead exemption to real property that is the claimant's principal place of residence.

[6] 11 USC 522 d (1).

if only one is 62 years of age or older and $25,000 if both are 62 years of age or older.

- Public Chapter 560, Acts of 2007, gave individuals with one or more minor children an exemption of $25,000.

And while the Tennessee Supreme Court ruled in a 2009 case that current law allows "each of two individuals who are married and have custody of a minor child to claim a $25,000 homestead exemption on real property that each owns and uses as a principal place of residence," bringing the total for them to $50,000,[7] the legislature has not changed the amounts of the homestead exemption since 2007.

Homestead exemption practices vary widely across states.

Most states have higher exemptions than Tennessee (see maps 1 and 2). Some allow residents to choose between the state and the federal exemptions, and some automatically increase the exemption amounts every two or three years for inflation. One adjusts its amount once every six years. See table 1. Twenty-three states have established a single homestead exemption amount, including seven with unlimited exemptions, for all bankruptcy filers; thirteen more have established separate amounts for individuals and for joint filers or allow joint filers to double the individual exemption.[8] The remainder, including Tennessee, have created several categories of debtors with different exemption amounts.

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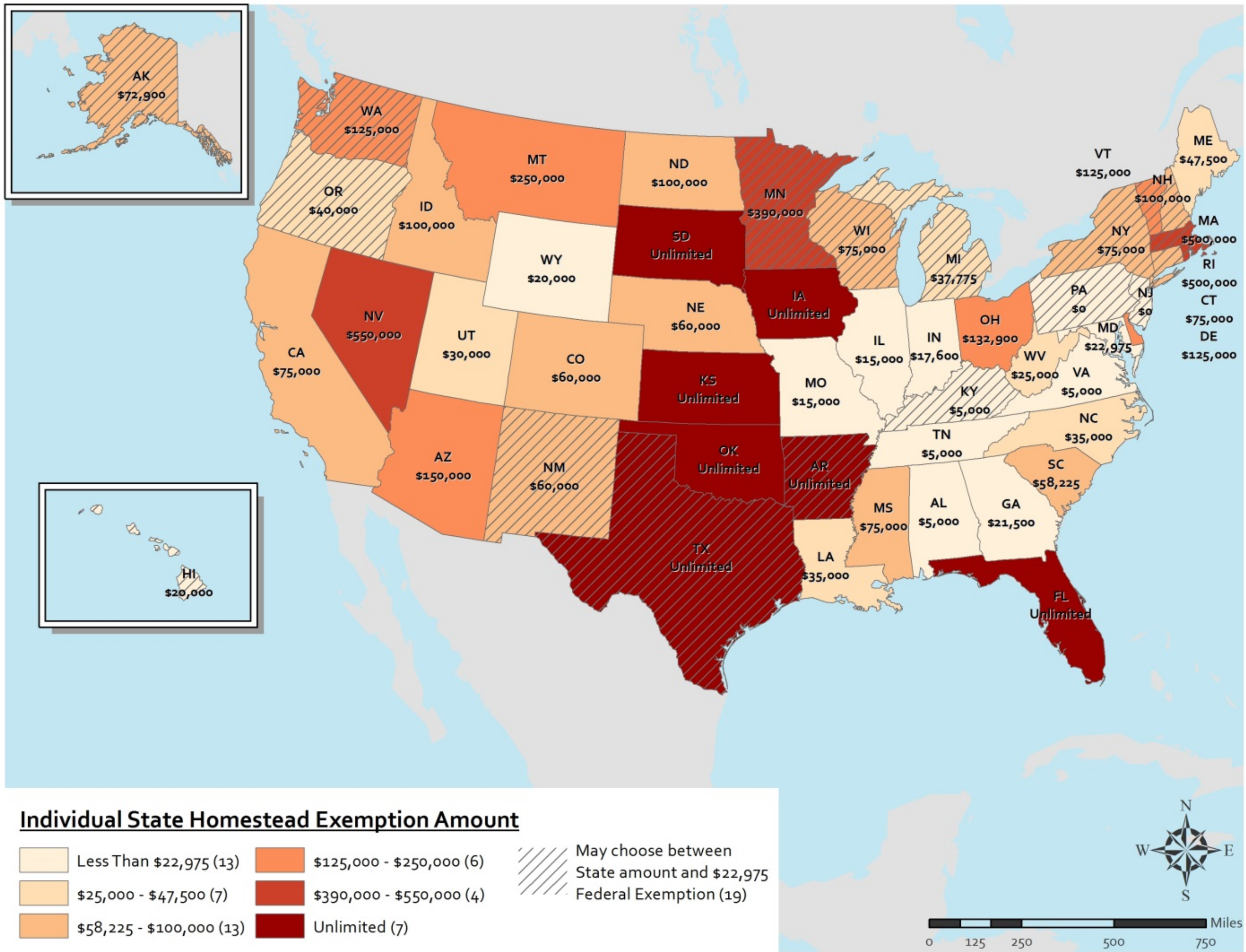
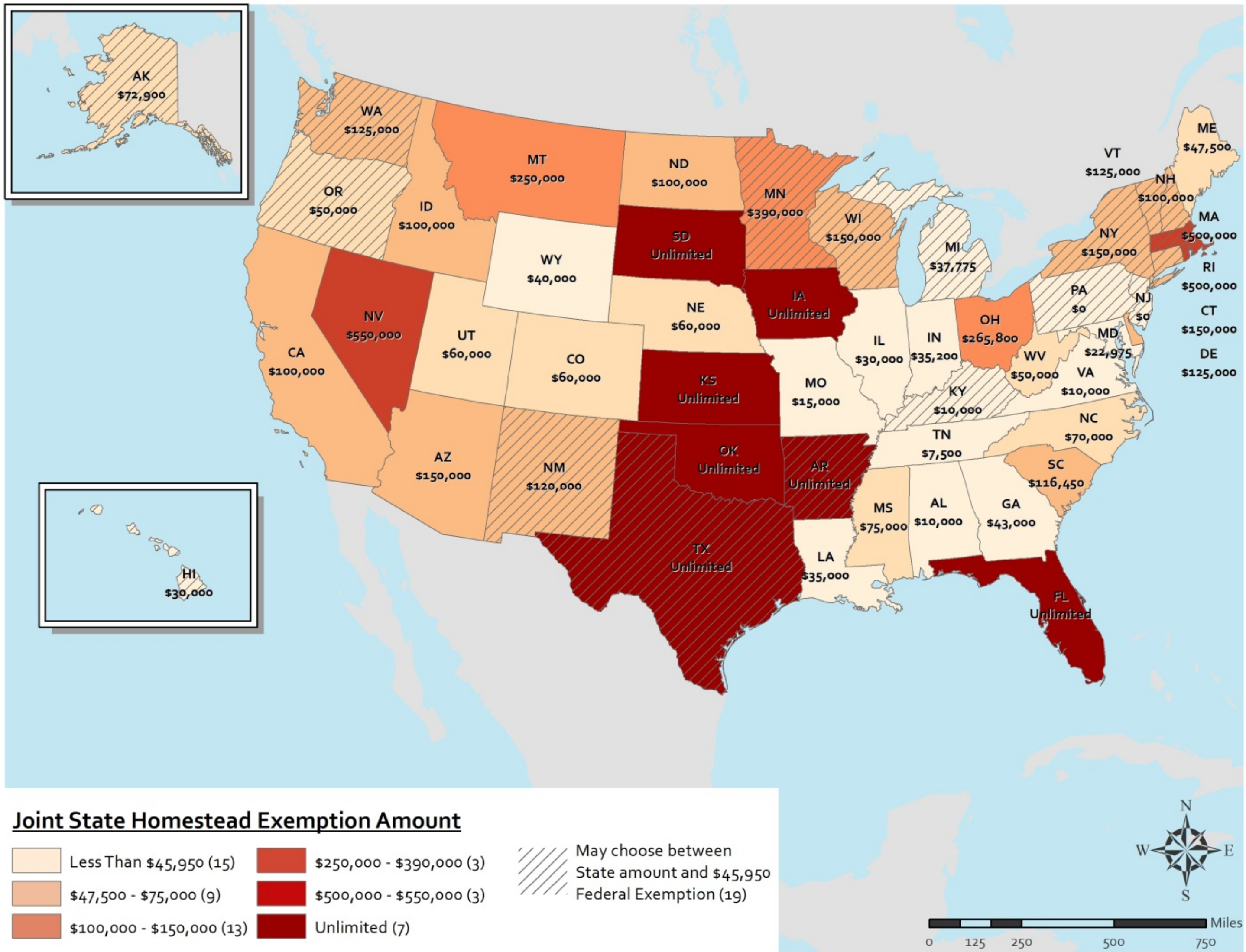
[7] *In re Hogue*, 286 S.W.3d 890 (Tenn. 2009).

[8] For some counties New York has an individual exemption higher than their standard $75,000— Kings, Queens, New York, Bronx, Richmond, Nassau, Suffolk, Rockland, Westchester and Putnam have a $150,000 exemption; Dutchess, Albany, Columbia, Orange, Saratoga and Ulster have an exemption of $125,000.

Map 1. Individual Homestead Exemptions by State



Map 2. Joint Homestead Exemptions by State



Some states periodically adjust exemption amounts for inflation.

If each Tennessee category had increased with inflation, their current values would be

- $16,304 for single,
- $21,645 for joint,
- $15,736 for an individual 62 or older (which is lower than the $16,304 for an individual),
- $25,178 for a married couple with one spouse 62 or older,
- $31,472 for a married couple with both spouses 62 or older,
- $31,472 for an individual with custody of a minor child (doubled to $62,944 for spouses with custody of a minor child).[9]

Seven states, as well as the federal government, adjust their homestead exemptions periodically to reflect increases in inflation (see table 1).

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[9] Bureau of Labor and Statistics CPI Inflation Calculator: http://www.bls.gov/data/inflation_calculator.htm.

Table 1. Frequency and Basis for Adjusting Homestead Exemption Amounts

Government	Frequency	Basis
United States	3 years	Consumer Price Index for all urban consumers
Alaska	2 years	Consumer Price Index for all urban consumers for the Anchorage Metropolitan Area
California	2 years	California Consumer Price Index for all urban consumers
Indiana	6 years	Consumer Price Index for all urban consumers
Michigan	3 years	Consumer Price Index for all urban consumers in the area of Detroit-Ann Arbor-Flint, Michigan
Minnesota	2 years	Implicit Price Deflator (IPD) for the Gross Domestic Product
Ohio	3 years	Consumer Price Index for all urban consumers using U.S. Dept. of Labor
South Carolina	2 years	Consumer Price Index for all urban consumers for the southeastern region

Most states do not allow residents to use the federal exemption.

Initially, 37 states chose to limit residents to state exemptions, but since 1978, six states (Alaska, Arkansas, Kentucky, New York, New Hampshire, and Oregon) have reversed course and now allow their residents to choose between the federal and state exemptions. Twenty-two of the 31 states that do not allow residents to use the federal exemptions have higher exemptions than the federal amounts. Only eight including Tennessee[10] offer an individual homestead exemption less than the federal amount. Tennessee's is the lowest of these. The highest, $21,500 for individuals and $43,000 for joint filers, are in the neighboring state of Georgia.[11]

One state, Maryland, sets their exemption amount to match the federal homestead amount. Seventeen states offer exemptions that range from $25,000 for individuals and $50,000 for joint filers (West Virginia) to $550,000 for individuals with no doubling for joint filers

[10] Alabama, Georgia, Illinois, Indiana, Missouri, Virginia, and Wyoming.

[11] Joint exemption is limited to a debtor who is married but has full individual ownership of the home - In re Taylor, 320 B.R. 214 (Bkrtcy.N.D.Ga., 2005).

(Nevada).[12] Ohio, one of these 17, increased its homestead exemption from $5,000 for an individual to the federal exemption in 2008 and further increased its exemption to $125,000 (subject to doubling for joint) just four years later.[13] Five states that do not allow the federal exemptions—Florida, Iowa, Kansas, Oklahoma, and South Dakota—offer unlimited homestead exemptions.

The homestead exemption amounts in the 17 states that allow a choice between state and federal exemptions range in value from $5,000 for individuals and $10,000 for joint filers (Kentucky) to a flat exemption of $500,000 (Massachusetts and Rhode Island). Two states, Arkansas and Texas, offer unlimited exemptions.

Fourteen states have created enhanced exemption categories for various debtors.

Fourteen states including Tennessee have established higher exemptions for certain groups of debtors (see table 2).

- Seniors—Ten states
    - over the age of 60: Colorado, Maine, and Mississippi
    - 62 or older in Tennessee
    - over 62 in Massachusetts
    - 65 or older in California, Michigan, North Carolina, and Virginia
    - over the age of 65 in Hawaii.
- Filers with dependent minor children—Five states: California, Hawaii, Maine, Tennessee, and Virginia.
- Filers with medical debt—Four states: Connecticut, Louisiana, Ohio, and West Virginia.
- Filers with disabilities—Five states: California, Colorado, Maine, Massachusetts, and Michigan.

[12] Arizona, Delaware, Montana, Nevada, Ohio, and South Carolina.

[13] Email correspondence with Legislative Services Attorney, David Gold, Ohio.

Table 2: States with Enhanced Exemption Categories

State	Individual	Joint	Seniors		Filers with dependent minor children	Filers with medical debt	Filers with disabilities
California	$75,000	$100,000	≥65	$175,000	$100,000	n/a	$175,000
Colorado	$60,000	n/a	>60	$90,000	n/a	n/a	$90,000
Connecticut	$75,000	$150,000	n/a		n/a	$125,000	n/a
Hawaii	$20,000	n/a	>65	$30,000	$30,000	n/a	n/a
Louisiana	$35,000	n/a	n/a		n/a	Unlimited[14]	n/a
Maine	$47,500	n/a	>60	$95,000 individual $190,000 joint	$95,000	n/a	$95,000 $190,000
Massachusetts[15]	$500,000	n/a	>62	$750,000 individual $1,000,000 joint	n/a	n/a	$750,000, $1,000,000
Michigan	$37,775	n/a	≥65	$56,650	n/a	n/a	$56,650
Mississippi	$75,000	n/a	>60	May reside elsewhere	n/a	n/a	n/a
North Carolina	$35,000	$70,000	≥65	$60,000[16]	n/a	n/a	n/a

[14] Unlimited for catastrophic or terminal injury

[15] $750,000 if owned jointly but only one owner qualifies and $1,000,000 if both qualify

State	Individual	Joint	Seniors		Filers with dependent minor children	Filers with medical debt	Filers with disabilities
Ohio	$132,900	$265,800	n/a	n/a	n/a	May not force the sale of the home for medical debts	n/a
Tennessee	$5,000	$7,500	≥62	$12,500 individual, $20,000 joint—one spouse age qualified, $25,000 joint—both spouses age qualified	$25,000[17]	n/a	n/a
Virginia	$5,000	$10,000	≥65	$10,000	$5,000 +$500 per dependent child	n/a	n/a
West Virginia	$25,000	$50,000	n/a	n/a	n/a	$7,500 ($250,000 for physicians)[18]	n/a

[16] "An unmarried debtor who is 65 years of age or older is entitled to a $ 60,000 exemption so long as the property was previously owned by the debtor as a tenant by the entireties or as a joint tenant with rights of survivorship and the former co-owner of the property is deceased."

[17] May be doubled

[18] If physician files bankruptcy because of medical malpractice proceedings but carries insurance of at least $1million: $250,000 exemption

Applying the homestead exemption in Chapter 7 and Chapter 13 bankruptcies

The use of the homestead exemption differs in Chapter 7 and Chapter 13. A debtor earning less than the state median family income may file Chapter 7, which allows them to discharge their remaining debt after the liquidation of their non-exempt assets. The debtor may save the home if the homestead exemption is larger than their equity or if the trustee decides that selling the property will not result in a "meaningful distribution to creditors," which varies from trustee to trustee.[19] Otherwise, the home will be sold by the trustee, whose primary roles are to manage the debtor's estate, liquidate all non-exempt assets, and distribute proceeds to creditors. The debtor will receive any equity up to the dollar value of their claimed exemption. For example, under current law, if an individual debtor under the age of 62 with no dependent children files bankruptcy in Tennessee and has $10,000 equity in their home, the trustee would consider selling the home because the current exemption would only cover $5,000.

If a debtor earns more than the median family income, the trustee and the judge will determine the debtor's ability to repay debts in a Chapter 13 plan, which the trustee then administers. Their primary responsibility is to facilitate the debtor's repayment plan so that creditors receive at least what they would have in a Chapter 7 bankruptcy. Trustees consider the homestead exemption in calculations; this results in lower total repayment. Currently, debtors seeking to save their home in bankruptcy will likely end up in Chapter 13 because the equity in their home is likely greater than the available exemption. See appendix B for description of all bankruptcy chapters.

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[19] Representatives from the offices of a Chapter 7 and a Chapter 13 trustee explained that any calculation must include costs associated with the sale. For example, a sale of the home resulting in $800 being available to creditors would most likely not be pursued.

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