Where wife has title, can bankrupt husband who resides in home and shares expenses make a homestead claim?

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A recent case from the Seventh Circuit highlights the unintended consequences that can result from minor changes in the ownership of real estate when one of the owners or residents files for bankruptcy. In In re Belcher, 551 F.3d 688 (7th Cir. 2008), the U.S. Court of Appeals for the Seventh Circuit held that a husband who was not a titled owner of his residence with his wife was ineligible to exempt part of his interest in the residence as a homestead under Illinois law, even though, at the time of the bankruptcy filing, he undisputedly lived in and intended to continue living in the residence. As this result could occur in many other states, anyone contemplating a "technical" transfer of title to a family member, ex-spouse, family business entity, or trust needs to consider the effects of such a transfer on an individual resident's exemptions in a possible bankruptcy case.

Under nearly all states' laws, outside of bankruptcy, an individual can claim a specified portion of his or her "homestead" (in addition to other property, which is often itemized in state statutes) as exempt from creditors. That portion ranges from a low of $5,000 – though some states have no homestead exemption – to an unlimited dollar amount. Exemption laws vary tremendously from state to state, not just in the amount of each exemption, but also in the language used to grant the exemption, the debts from which the property is exempt, and the liberalness or strictness with which the exemption statutes are construed.

Most Americans' only encounter with exemptions is in bankruptcy. Although exemption law is a patchwork of diverse provisions, the majority of states only permit an individual to claim an exemption against judgment debts, and not against tax debts, voluntary mortgages, or child and spousal support obligations. Because only a fraction of Americans have judgment creditors that do not fall into one of those categories, exemption laws are unfamiliar to most consumers, other than knowing that homestead exemptions in some states (most famously, Texas and Florida) are unlimited in amount.

In bankruptcy, all individual debtors ("debtor" meaning the person who files bankruptcy) are permitted to choose between the exemptions provided by their home state's law and a set of federal exemptions found in the Bankruptcy Code.[1] There can be three possible effects of taking a homestead exemption in a liquidation, or chapter 7, bankruptcy: (1) if the amount of the exemption equals or exceeds the value of the debtor's unmortgaged interest in the homestead, it will prevent the bankruptcy trustee from selling the homestead where the trustee otherwise could, with the debtor's unsecured creditors sharing the proceeds of the unencumbered amount; (2) if the amount of the exemption is less than the value of the debtor's unmortgaged interest in the

[1] 11 U.S.C. § 522(b)(1). A state can "opt out" of the federal exemptions, that is, limit its citizens to the state's exemptions, even in bankruptcy. 11 U.S.C. § 522(b)(2).

homestead, it will entitle the debtor to proceeds of the trustee's sale of the homestead, in the amount of the exemption; and (3) if the value of the debtor's unmortgaged interest in the homestead is zero, there will be no effect (at least in the significant majority of states where a homestead exemption does not apply against a mortgage).

The stated purpose of most states' exemption laws is to prevent the harm that would befall the public interest if creditors could render debtors wards of the state. E.g., In re Ballard, 238 B.R. 610 (Bankr. M.D. La. 1999). To that end, all states have enacted some form of protection of assets that the state legislature determines should not be reachable by judgment creditors. In understanding the debate over whether a nontitled spouse can claim a homestead exemption in bankruptcy, it may be helpful to consider that, outside bankruptcy, an exemption prevents a creditor from reaching property that the creditor otherwise could.

The facts in Belcher were that Keith and Katherine Belcher originally were both titled on the property. They divorced. As part of the divorce, Keith deeded his one-half interest to Katherine, so that she became the sole titled owner. The Belchers reconciled and were remarried. However, Keith was never added back onto the title. At the time of the bankruptcy filing, the Belchers were both living on the premises; the bankruptcy trustee did not dispute that the house was Keith Belcher's primary residence.

Illinois law defines a homestead as an individual's "interest in a farm or lot of land and buildings thereon, a condominium, or personal property, *owned or rightly possessed by lease or otherwise and occupied by him or her as a residence*, or in a cooperative that owns property that the individual uses as a residence." 735 Ill. Comp. Stat. § 5/12-901 (emphasis added). When the Belchers' bankruptcy case was filed, each individual could claim up to $7,500 of equity in his or her homestead as exempt, with a maximum per property of $15,000.

The court first reviewed the nature of a nontitled spouse's interest in real property. Keith Belcher arguably had a potential equitable interest in the house that would vest upon Katherine's death or their divorce. But the court, applying case law from Illinois state courts, held that the word "otherwise" in the statute encompassed only "formalized possessory property interests other than outright ownership or leases, such as a life estate." 551 F.3d at 691. Accordingly, the property was not Keith Belcher's homestead.

Whether this result would obtain in other states or under the federal exemption law is a function of how the applicable exemption law is phrased and interpreted. As implied above, there is no such thing as a "one size fits all" discussion of state exemption laws. Nevertheless, a majority of exemption laws fall into one of two categories, and the remainder can likewise be grouped by the language used to create the exemption. While courts in different jurisdictions give different meanings even to laws that are similar to each other, the following framework indicates which exemption laws have the greatest likelihood of being interpreted in a manner similar to the Belcher holding.

A plurality of states grant an exemption to a homestead that is "owned and occupied" by a judgment debtor. For example, in Kansas, "[a] homestead to the extent of

160 acres of farming land, or of one acre within the limits of an incorporated town or city, or a manufactured home or mobile home, occupied as a residence by the owner or by the family of the owner, or by both the owner and family thereof, together with all the improvements on the same, shall be exempted from forced sale under any process of law. . . ." Kan. Stats. § 60-2301.[2] On its face, this exemption appears susceptible to the same result as in Belcher: a court might find that a nontitled spouse is not an "owner" of property.

Many other states, as well as the Bankruptcy Code, exempt interests in property that a judgment debtor uses as a residence. In South Carolina, for example, "[t]he following real and personal property of a debtor domiciled in this State is exempt from attachment, levy, and sale under any mesne or final process issued by a court or bankruptcy proceeding: (1) The debtor's interest, not to exceed twenty-five thousand dollars in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence. . . ."[3] S.C. Code § 15-41-30(A)(1). A variation on this theme is the statute at issue in Belcher, 735 Ill. Comp. Stat. 5/12-901, which provided: "Every individual is entitled to an estate of homestead to the extent in value of $7,500 of his or her interest in a farm or lot of land and buildings thereon, a condominium, or personal property, *owned or rightly possessed by lease or otherwise and occupied by him or her as a residence.*"[4]

Having an interest in property encompasses a greater variety of potential interests in property than owning it does. Practically, though, few individuals will have a valuable interest in property that is less than a fee simple interest.[5] The stated facts in Belcher were that a husband conveyed his half-interest in property to his wife, then later returned. But what the court never explored (possibly because the pleadings did not raise it) was the *capacity* in which Keith Belcher returned to the property. He likely was a tenant at will or at sufferance. It is possible but not probable that the Belcher holding would have been different had the court determined that Keith Belcher's interest was one of those

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[2] See also, e.g., Ark. Const. Art. 9 § 5; Colo. Rev. Stats. § 38-41-201(1)(a); Conn. Gen. Stats. § 52-352a(e); Idaho Code § 55-1001(4); La. Rev. Stats. § 20:1(A)(1); Mich. Comp. Laws § 600.5451(5)(d); Minn. Stats. § 510.01; Miss. Code § 85-3-21 (applies only to "householder"); N.M. Stats. § 42-10-9; N.Y. C.P.L.R. § 5206(a); 31 Okla. Stats. § 2(C) (split--within cities and towns only); Tenn. Code § 26-2-301(a); 27 Vt. Stats. § 101; Rev. Code Wash. § 6.13.010(3); Wis. Stats. § 815.20.

[3] See also, e.g., Alaska Stats. § 09.38.010(a); Ariz. Rev. Stats. § 33-1101(A)(1); 10 Del. Code § 4914(c)(1); D.C. Code § 15-501(a) (applies only to head of a family or householder); Ga. Code § 44-13-100(a)(1); Hawai'i Rev. Stats. § 651-92(a)(1) (applies only to head of household); 735 Ill. Comp. Stat. 5/12-901 (at issue in Belcher); 14 Me. Rev. Stats. § 4422(1)(A); N.C. Gen. Stats. § 1C-1601(a)(1); Nev. Rev. Stats. §§ 21.090(2), 115.01(2); Savage v. Pierson, 157 P.3d 697 (Nev. 2007) (homestead exemption only protects "equity," a term which does not include possessory interests or security deposit under residential lease); Ohio Rev. Code § 2329.66(A)(1)(b); W. Va. Code § 38-10-4(a).

[4] See also, e.g., Ala. Code § 6-10-2; Mass. Gen. Laws 188 § 1; Tex. Prop. Code §§ 41.001(a), 41.002; In re Perry, 345 F.3d 303 (5th Cir. 2003) (Texas homestead consists of debtor's interest in property, but not more--meaning debtor can exempt interest as at-will tenant, to extent of tenancy's value).

[5] Most life estates in residential real property, for instance, have little value to anyone other than the remainderman. A bankruptcy trustee would likewise be hard-pressed to sell the debtor's interest as tenant under a long-term lease for an amount greater than even the smallest homestead exemption. Even if the trustee could find a buyer for such an interest, most debtors would probably prefer a $5,000 or greater cash payment to staying on the property.

types of tenancies. On the one hand, the court did unambiguously declare that only "formalized" interests in real property were intended by the word "otherwise" in the exemption statute. On the other hand, this statement was a holding only as applied to the types of future or potential equitable interests discussed in the case, and arguably would be a dictum as to other interests such as tenancies at will and at sufferance.

In contrast, it is unlikely that a case like Belcher would be decided under exemption laws that focus solely on whether the debtor uses the property as his or her principal residence. Montana's exemption statute provides: "The homestead consists of the dwelling house or mobile home, and all appurtenances, in which the claimant resides and the land, if any, on which the same is situated, selected as provided in this chapter."[6] Mont. Code § 70-32-101. Unlike Illinois' statute, these states' exemption laws do not limit homestead exemptions to "interests" in property, let alone ownership interests in property.

A variation on the Montana statute that defines homesteads as primarily based on residence, but also mentions ownership, poses a closer question. Missouri's statute, for example, defines homestead as "a dwelling house and appurtenances . . . which is or shall be used by such person as a homestead." Mo. Stats. § 513.475(1). However, the very next sentence reads, "The exemption allowed under this section shall not be allowed for more than one *owner* of any homestead if one *owner* claims the entire amount allowed under this subsection. . . ." Id. A court might view the primary definition as ambiguous (if not outright circular) and find the repeated uses of the word "owner" in the subsequent sentence as indicative of legislative intent to limit homesteads to ownership interests. In that event, a result like Belcher could obtain in Missouri and states with similar exemption statutes.[7]

Finally, in some states, the amount of an exemption for a married couple is less than double the amount of a single person's exemption, reducing – and sometimes eliminating – the need to litigate the rights of a nontitled spouse. Compare, e.g., Ala. Code § 6-10-2 ($5,000 per person; $10,000 per married couple) , with Tenn. Code § 26-2-301(a) ($5,000 per person; maximum of $7,500 per pair of joint owners), with Ariz. Rev. Stats. § 33-1101(A)(1) ($150,000 per person or per married couple). The question in Belcher would be moot if adding a spouse to the title would not increase the exempt amount.

Belcher is a stark example of the potential for unforeseen consequences in seemingly innocuous decisions involving real estate (and other property) in a future bankruptcy. In the Belchers' minds, a divorced man was moving back in with his ex-wife. Undoubtedly, it never occurred to the Belchers that the lack of formal documentation of this arrangement would cost them thousands of dollars. Real estate, family law, and probate practitioners are accustomed to anticipating the problems these decisions can cause in subsequent deaths and divorces. Belcher suggests that subsequent bankruptcies should be on that list, too.

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[6] See also N.D. Cent. Code § 47-18-01.

[7] E.g., Neb. Rev. Stats. § 40-101.