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RETHINKING EXEMPTIONS IN BANKRUPTCY

RICHARD E. MENDALES*

INTRODUCTION

Exemptions have always played a key role in consumer bankruptcy law. They allow an individual debtor to keep some property after bankruptcy with which to preserve at least a minimal standard of living and to reenter the economy in a productive role rather than being cast out from it. The importance of exemptions in the overall consumer bankruptcy system, therefore, is similar to that of the discharge of most debts.¹ Our present exemption law under § 522 of the U.S. Bankruptcy Code,² however, creates a system that is far too complex, inconsistent, inequitable, burdensome—both to creditors and the consumer debtors whom it is intended to protect—and rife with moral hazard.

No rational legislature, working from a clean slate, would design a bankruptcy exemption system resembling the one created by § 522. The problem is that the system was not drafted on a clean slate, but represents an accretion of layers of sediment from earlier exemption laws that were extremely problematic.³ Reform of bankruptcy exemption law has long been sought. It was a major recommendation of the 1970 Commission on the Bankruptcy Laws of the United States (the "1970 Commission"), whose report⁴ eventually led to the repeal of the Bankruptcy Act of 1898 and the enactment of the present Bankruptcy Code by the Bankruptcy Reform Act of 1978.⁵ The debate concerning bankruptcy exemptions has been thrown open again: first, by the National Bankruptcy Reform Commission ("NBRC") with its report dated

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¹ See Vern Countryman, *For a New Exemption Policy in Bankruptcy*, 14 *RUTGERS L. REV.* 678, 678-79 (1960). The discharge of debt is the primary objective of most consumer debtors who file for bankruptcy. See *id.* at 678.

² See 11 U.S.C. § 522 (1994).

³ See *infra* notes 16-47 and accompanying text.

⁴ See COMMISSION ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pts. I and II (1973).

⁵ See Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1994)).

October 20, 1997,⁶ as part of a broader program of bankruptcy law reform, and more recently by bills initiated by members of Congress under pressure from the consumer credit industry⁷ that would make even more radical changes in the bankruptcy system.⁸ Since consumer bankruptcy law is once more being thoroughly reconsidered, it is time to try again to reorganize bankruptcy exemptions into a statute that is straightforward, effective and fair.

This Article proposes that we discard the central premise of § 522 as it stands—the allowance of exemptions in various amounts for specific categories of property held by a debtor at the time of the bankruptcy petition, with the largest amount going for a homestead allowance—and replace it with a system that will let debtors choose whatever property they wish to exempt, limited only by a fixed maximum value for all property exempted.⁹ This will change bankruptcy exemption law more fundamentally than the recent NBRC proposals would have done, and in a way that, unlike Congressional attempts to restructure bankruptcy law in the interest of the consumer credit industry,¹⁰ will promote fairness to consumer debtors as well as to their creditors.

⁶ See generally NATIONAL BANKR. REVIEW COMM'N, FINAL REPORT, BANKRUPTCY: THE NEXT TWENTY YEARS (1997) [hereinafter "NBRC REPORT"].

⁷ See, e.g., *Bankruptcy Non-Reform Proposed Changes Would Weaken Protections for Truly Needy Debtors and Leave Unchanged Gaping Loopholes that Wealthy Filers Use to Put Up the Shield of Bankruptcy*, L.A. TIMES, June 8, 1998, at B4 (commenting that "[t]he credit card industry has hijacked efforts to reform bankruptcy laws"); Jacob M. Schlesinger, *Card Games: As Bankruptcies Surge, Creditors Lobby Hard to Get Tougher Laws*, WALL ST. J., June 17, 1998, at A1; Katharine Q. Seelye, *House Passes Bill to Curb the Laws on Bankruptcy*, N.Y. TIMES, June 11, 1998, at A24; Katharine Q. Seelye, *House Set to Vote on Bankruptcy Overhaul*, N.Y. TIMES, June 10, 1998, at A24.

⁸ See H.R. 3150, 105th Cong. (1998); S. 1301, 105th Cong. (1998). The proposed Bankruptcy Reform Act of 1998 failed when the House, Senate and White House negotiators could not agree on a compromise between the severely anti-debtor House bill and the much more moderate Senate bill. See *Major Bankruptcy Law Changes—105th Congress*, LEGIS. BULL. (Am. Bankr. Inst., Alexandria, Va.), Oct. 28, 1998, at 1. The draconian House bill was reintroduced in the 106th Congress as House Bill 833, and passed the House on May 5, 1999. Senate Bill 625, introduced on March 16, 1999, roughly corresponds to its counterpart in the 105th Congress and is similarly inconsistent with the bill passed by the House. Senate action on the bill is still pending.

⁹ This simply takes exemption reform one logical step beyond the reforms proposed by the NBRC. Similar proposals have been made prior to the adoption of the Bankruptcy Code, and more recently for changing state exemption law in North Dakota and Minnesota, based primarily on the problem of asset conversion. See Lowell P. Bottrell, *Comfortable Beds, A Church Pew, A Cemetery Lot, One Hog, One Pig, Six Sheep, One Cow, a Yoke of Oxen or a Horse, and Your Notary Seal: Some Thoughts About Exemptions*, 72 N.D. L. REV. 83, 93-97 (1996); Countryman, *supra* note 1, at 746-48. This Article demonstrates that establishing a single umbrella exemption as the basis for federal bankruptcy exemption law would better deal with the serious anomalies created by § 522 as it now stands.

¹⁰ See, e.g., H.R. 3150 (this bill would have severely restricted the rights of consumer debtors to qualify for relief under Chapter 7 of the Bankruptcy Code, while leaving exemption law substantially unchanged); S. 1301 (the Senate version would have left the basic structure of

Moreover, the proposals will reduce moral hazard to debtors and their counsel, while helping to control the litigation costs fostered by the present system.

I. HOW EXEMPTION LAW WORKS AND WHY IT DOESN'T

A. Overview

1. The Purposes of Personal Exemptions in Bankruptcy

The substantive purpose of personal exemptions in bankruptcy is to ensure that individual debtors will not emerge from bankruptcy completely destitute, but rather with certain basic properties needed both to live from day to day and for a quick reentry into normal economic life.¹¹ Without this kind of protection, the "fresh start" that is a debtor's primary goal in consumer bankruptcy¹² would, in most cases, merely be a fresh path to new debt.

Since the Bankruptcy Act of 1898, this has meant that in most states a debtor has been able to retain at least part of an interest in a homestead plus certain personal property such as a vehicle, clothing, tools of a trade, and pension or annuity rights.¹³ Unfortunately, however, both the kind and value of the property that a debtor has been permitted to exempt has varied sharply according to his or her state of residence and often provides a poor fit to a debtor's real needs.

Bankruptcy exemption policy also has what may be called a procedural purpose: to assure that debtors' rights (and the corresponding rights of their creditors) do not sharply differ in bankruptcy from what they would be outside of bankruptcy. On the one hand, this helps to assure that debtors actually join in the collective process of paying creditors in bankruptcy and resuming productive roles in the national economy, rather than simply absconding and joining the underground

exemption law unchanged, although imposing maximum amounts on homestead exemptions in contrast to the unlimited homestead amounts in Florida and Texas under present law).

¹¹ See, e.g., COMMISSION ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. I, at 79-80, 169-70 (1973); Vern Countryman, *Bankruptcy and the Individual Debtor—and a Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U. L. REV. 809, 818 (1983); Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. REV. 235, 240 (1995).

¹² See generally TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 20 (1989). The "fresh start" purpose of consumer bankruptcy has become one of the chief icons of U.S. bankruptcy law since the metaphor was first used in *Wetmore v. Markoe*. See 196 U.S. 68, 77 (1904).

¹³ See, e.g., CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 640-41 (1997).

economy.¹⁴ On the other hand, it reduces creditors' incentives to force debtors into bankruptcy, in order to realize their claims against property protected from seizure by judicial process to satisfy claims under state law but not under federal bankruptcy law.¹⁵

2. The Evolution of Exemption Law

Exemption law is not at all new. It can be traced at least as far back as Roman law, under which a debtor was permitted under limited circumstances to keep certain necessities for day-to-day survival.¹⁶ A brief discussion of the evolution of exemption law is in order, since the current structure of § 522 is based not on a coherent attempt by Congress to accomplish the purposes described above, but on an accretion of past law from highly diverse sources, aggravated by a serious wrong turn taken by Congress in 1898.¹⁷

Current U.S. bankruptcy exemption law stems, at least substantively, from English law that prevailed during the colonial period, beginning in 1705, when debtors were first authorized to keep their clothing and up to 5% of their remaining property as exempt from their creditors.¹⁸ The British colonies in North America started with this background exemption law early in the eighteenth century and this in turn evolved into exemption statutes in each of the various states during the eighteenth and nineteenth centuries. Although the federal Constitution specifically authorized Congress to enact uniform federal bankruptcy laws,¹⁹ Congress was slow to pass, and quick to repeal, federal bankruptcy statutes during most of the nineteenth century.²⁰

¹⁴ One of the purposes of the first long-lived federal bankruptcy statute, the Bankruptcy Act of 1898, was to reduce debtors' incentives to simply run away from their creditors—especially to debtor-friendly jurisdictions such as Texas. See SULLIVAN ET AL., *supra* note 12, at 245. The earliest U.S. bankruptcy statute, the Bankruptcy Act of 1800, expressly rewarded cooperative debtors with a share of the total bankruptcy estate. See ch. 19, § 34, 2 Stat. 19 (repealed 1803).

¹⁵ See, e.g., TABB, *supra* note 13, at 287–88.

¹⁶ See Louis Edward Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 238 (1918).

¹⁷ See COMMISSION ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93–137, pt. I, at 171 (1973).

¹⁸ See 4 Anne, ch. 17 (1705). Under this statute, debtors could exempt from their creditors' claims 5% of their property, to a maximum of £200 (a very large amount at the time), if on the sale of their property creditors received a dividend of at least eight shillings on the pound (40%) for their claims. If creditors received less, the commissioner appointed to deal with the debtor's estate had the power to determine how much, if any, property the debtor would be permitted to keep beyond his clothing.

¹⁹ See U.S. CONST. art. I, § 8, cl. 4.

²⁰ Despite the U.S. Constitution's Bankruptcy Clause, U.S. CONST. art. I, § 8, cl. 4, Congress enacted few bankruptcy statutes during the nineteenth century and all enacted before the 1898

Therefore, until the enactment of the Bankruptcy Act of 1898,²¹ state law was usually the only game in town, except for brief periods when federal statutes prevailed. Because of this, no unitary approach to exemption law was undertaken. Instead, exemption law evolved from the sharply divergent strains of state law that were assimilated into bankruptcy law when the Bankruptcy Act of 1898 was passed.

State exemptions differed sharply from state to state. They were not generally addressed to a collective insolvency process like bankruptcy, but protected debtors from creditors enforcing particular judgments by making certain kinds of property immune from seizure by process of law. In so doing, they tended to reflect local politics, rather than variations in the local cost and mode of living. Thus, in older, commercially-oriented states such as Pennsylvania and Rhode Island, they tended to be minimal,²² while in newer, more agrarian states such as Texas and Florida, they tended to be highly protective of debtors.²³ Moreover, state courts, in interpreting exemption statutes, tended to focus narrowly on local law, avoiding the development of any national consensus on broad principles or particular features of exemption law.²⁴

The system was further complicated by the fact that legislatures in many states were slow to update exemption statutes to match both the changing ways in which people lived and general inflation in the cost of living. As early as 1960, Professor Vern Countryman noted that exemption statutes had become archaic in many states.²⁵ Connecticut, for example, kept substantially the same exemptions on its books, without adjustment in value, from 1821 to 1977.²⁶ Although many states, especially under the prodding of the 1978 federal Bankruptcy

Act were quickly repealed. The Bankruptcy Act of 1800, ch. 19, 2 Stat. 19, was repealed in 1803; the Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, was repealed in 1843; and the Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, was repealed in 1878.

²¹ See ch. 541, 30 Stat. 544 (repealed 1978).

²² Neither Pennsylvania nor Rhode Island provides for a homestead exemption and both provide only limited exemptions for personal property. See 42 PA. CONS. STAT. ANN. §§ 8123-8124 (West 1992); R.I. GEN. LAWS §§ 9-26-3 to -5 (1997).

²³ See, e.g., 14 COLLIER ON BANKRUPTCY (Lawrence P. King ed., 15th ed. 1996) (containing exemption statutes for all U.S. states and territories and the District of Columbia); SULLIVAN ET AL., *supra* note 12, at 28-30.

²⁴ See DAVID G. EPSTEIN ET AL., BANKRUPTCY 602-03 (1993).

²⁵ See Countryman, *supra* note 1, at 681-84.

²⁶ See *id.* at 683. Connecticut's parsimonious list of exemptions during this period let a debtor exempt, *inter alia*, "two cords of wood, two tons of hay, five bushels each of potatoes and turnips, ten bushels each of Indian corn and rye or the meal or flour manufactured therefrom." *Id.* (citing GEN. STAT. CONN. § 52-352 (1958) (original version at GEN. STAT. CONN. tit. 2 act 74 (1821) (repealed 1977))).

Code, have enacted reforms since that time,²⁷ archaic elements survive in state exemption statutes, both in the types of exempt property enumerated and in allowed valuations that, especially with the inflation of recent years, have become pitifully inadequate in many jurisdictions.²⁸

Contrary to what many in and out of Congress appear to believe, federal bankruptcy law did *not*, in deference to states' rights, simply absorb this state-by-state hodgepodge of exemption laws from its inception.²⁹ The first federal bankruptcy act,³⁰ enacted in 1800 and then repealed in 1803,³¹ included parsimonious but purely federal exemption provisions: a debtor was entitled to keep his or her "necessary" clothing and bedding and that of his or her spouse and children.³² In addition, the Act borrowed from British law³³ in providing that a bankrupt whose creditors received at least 50% of the value of their claims could receive a dividend of 5% of the value of the estate (or 10% of the value of an estate whose creditors recovered at least 75% of their claims), as a reward for cooperating with the bankruptcy commissioners.³⁴ Thus, the first implementation of the Constitution's Bankruptcy Clause by Congress indicated that those who drafted and approved it did not believe that state law had any significant role to play in the bankruptcy process.

From 1803 to 1841, the country went without a federal bankruptcy statute. When Congress passed the 1841 Bankruptcy Act,³⁵ in reaction to the hard times following the Panic of 1837, the statute, like its predecessor, established purely federal exemption provisions.³⁶ Also like its predecessor, this statute was short-lived, and suffered repeal in 1843.³⁷

²⁷ See, e.g., Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 95-96 (1997).

²⁸ Iowa, for example, allows a resident to exempt, *inter alia*, "(1) All wearing apparel of the debtor and the debtor's dependents kept for actual use and the trunks or other receptacles necessary for the wearing apparel, not to exceed in value one thousand dollars in the aggregate (2) One shotgun, and either one rifle or one musket" IOWA CODE ANN. § 627.6 (West 1998).

²⁹ See, e.g., 4 COLLIER ON BANKRUPTCY § 522.02[1] (Lawrence P. King ed., 15th ed. 1996).

³⁰ See ch. 19, 2 Stat. 19 (1800) (repealed 1803).

³¹ See TABB, *supra* note 13, at 32 n.13.

³² See Bankruptcy Act of 1800, ch. 19, §§ 5, 18, 2 Stat. 19 (repealed 1803).

³³ See 4 Anne ch. 17 (1705).

³⁴ See ch. 19, § 34, 2 Stat. 19.

³⁵ See ch. 9, 5 Stat. 440 (repealed 1843).

³⁶ See *id.* § 3.

³⁷ See TABB, *supra* note 13, at 32 n.14.

Only with the third federal bankruptcy statute, that of 1867,³⁸ did state exemptions begin to creep into federal bankruptcy law. Even in this case, however, their importance was secondary and was intended to protect debtors rather than states' rights. The 1867 Act followed its predecessors in creating meager but uniform federal exemptions. It also authorized Civil War veterans to keep their uniforms and, recognizing some of the hardships created by the parsimonious federal exemptions, permitted debtors to claim state exemptions to the extent they exceeded the federal amounts.³⁹ Ironically, this provision gave rise to significant objections to the law, on grounds that allowing debtors to claim sharply varying state exemptions was contrary to the constitutional mandate to create "uniform" bankruptcy laws.⁴⁰

The 1867 Act remained in effect longer than any of its predecessors, surviving for eleven years.⁴¹ This permitted a significant amount of federal bankruptcy case law to evolve for the first time. Moreover, it familiarized insolvency lawyers with federal bankruptcy concepts that emerged again when Congress enacted the Bankruptcy Act of 1898, which established federal bankruptcy as a permanent part of the legal landscape. Restoration of federal bankruptcy was, however, fiercely contested. The struggle to pass a new bankruptcy statute raged for fifteen years and succeeded only with the hard times following the Panic of 1893, when a backlog estimated at 150,000 to 200,000 persons in need of relief had to be addressed.⁴² It is thus not surprising, amid the compromises attending such a struggle, that when Congress enacted the Bankruptcy Act of 1898, it took a wrong turn on the exemption issue. The Act abandoned federal exemptions suddenly and completely by authorizing debtors to take whatever exemptions to which they were entitled under state law and no more.⁴³

It was thus the 1898 Act, rather than considerations of federalism inherent in interpreting the Bankruptcy Clause, that established bankruptcy exemptions as incorporating state exemption law. Many of the failings of the system described in this Article⁴⁴ were recognized early in the Act's life.⁴⁵ The Act's long life, however, led lawyers and politi-

³⁸ See ch. 176, 14 Stat. 517 (repealed 1878).

³⁹ See *id.* § 14.

⁴⁰ See S.E.B., *The Constitutionality of the Concluding Exemption Clause in the Bankrupt Law*, 15 AM. L. REG. 721-27 (1867).

⁴¹ See, e.g., TABB, *supra* note 13, at 32-33 & n.15.

⁴² See 58 ALB. L.J. 18 (1898); see also 47 CENT. L.J. 27 (1898).

⁴³ See ch. 541, § 6, 30 Stat. 544 (repealed 1978).

⁴⁴ See *infra* notes 64-91 and accompanying text.

⁴⁵ See *infra* note 64 and accompanying text.

cians to think of the federal incorporation of state exemptions as a fundamental part of bankruptcy law and made it politically impossible to correct the system when Congress superseded the Act with the Bankruptcy Code in 1978,⁴⁶ despite abundant criticism by commentators and the recommendations of the 1970 Commission.⁴⁷

3. How Exemption Law Works Under Bankruptcy Code § 522

The very act of describing the exemption system established by Bankruptcy Code § 522 in 1978 helps to illustrate one of its major flaws: it is far too complex.⁴⁸ Not only is the statutory section itself a labyrinth whose complications make it unsuitable for use in consumer bankruptcy,⁴⁹ but its ambiguities, lacunae and conflicting judicial glosses all combine to make its fair application extremely difficult.

Under the present Bankruptcy Code, an individual debtor in financial difficulty may file for relief under Chapter 7, 11, 12 or 13. Regardless of the chapter under which a debtor files, the petition creates a bankruptcy estate consisting of substantially all the debtor's property interests.⁵⁰ For debtors who file under Chapter 7—used by a substantial majority of all who file for bankruptcy relief⁵¹—there is a basic quid pro quo that requires them to surrender substantially all of their property interests to the trustee in bankruptcy in exchange for a discharge of most creditors' claims.⁵² The surrendered interests go into the bankruptcy estate. Property in the estate, unless encumbered by liens or protected by exemptions, is liquidated and the proceeds are distributed to creditors according to the order of priority accorded to them by the Bankruptcy Code and in proportion to the sizes of their claims.⁵³

After the bankruptcy estate is created, a Chapter 7 debtor has the right to exempt certain property in the estate from distribution to

⁴⁶ See, e.g., NBRC REPORT, *supra* note 6, at 119–20.

⁴⁷ See COMMISSION ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. I, at 170–73 (1973).

⁴⁸ Complexity is a major fault not only of § 522, but of the entire consumer bankruptcy system. See, e.g., Elizabeth Warren, *A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L.J. 483, 494–95 (1997).

⁴⁹ See *infra* Part I.B.2.

⁵⁰ See 11 U.S.C. § 541 (1994). There are some exceptions to this rule, most notably the debtor's beneficial interest in trusts such as pension funds qualified under ERISA. See generally *Patterson v. Shumate*, 504 U.S. 753 (1992).

⁵¹ See, e.g., SULLIVAN ET AL., *supra* note 12, at 33.

⁵² See 11 U.S.C. §§ 541, 727 (1994).

⁵³ See *id.* §§ 363, 506–507, 726.

creditors under Code § 522(b).⁵⁴ Variations in the basis for exemption, concerning both the types of property that the debtor may exempt under § 522 and the value that may be exempted for each type, raise the problems with which this Article is primarily concerned.

Under § 522(b), a debtor, absent legislative action by his or her state, has the right to choose between: (1) the federal exemptions now enumerated in § 522(d),⁵⁵ and (2) the exemptions available under state law, plus property exempt under non-bankruptcy federal law.⁵⁶ If two debtors are spouses filing jointly for bankruptcy, both must elect exemptions from the same list.⁵⁷

The apparent choice described above is further complicated by an additional provision authorizing states to "opt out" of the federal list of exemptions, with the effect of denying their residents the right to choose the federal exemptions.⁵⁸ Since at least thirty-four states have opted out of the federal exemptions,⁵⁹ their residents are back under the state law exemption regime of the former Act, with all of that system's problems and inequities.

A debtor seeking bankruptcy relief under Chapter 7 thus confronts the following situation: if the debtor's state has not opted out of the federal list of exemptions, the debtor will have to study both the federal list under Code § 522(d) and the list of state exemptions available in his or her jurisdiction, in addition to non-bankruptcy federal exemptions, in order to choose the most advantageous set of exemptions.⁶⁰ Since debtor spouses filing jointly must both choose from the same list,⁶¹ this choice can be quite complex. Even if the debtor or debtors live in a typical opt-out state, however, taking full advantage of their exemption rights requires surveying state law that may be scattered across many different statutes⁶² and deciding how best to utilize such statutes to maximize the value of property they may exempt. This, in turn, invites attempts to reshuffle property by means of "asset conversion," which may lead debtors, as described below,⁶³

⁵⁴ See *id.* § 522(b).

⁵⁵ See *id.* § 522(b)(1).

⁵⁶ See *id.* § 522(b)(2).

⁵⁷ See 11 U.S.C. § 522(b).

⁵⁸ See *id.* § 522(b)(1).

⁵⁹ See 4 COLLIER ON BANKRUPTCY § 522.02[1] & n.3 (Lawrence P. King ed., 15th ed. 1996).

⁶⁰ See *supra* notes 55-56 and accompanying text.

⁶¹ See *supra* note 57 and accompanying text.

⁶² In Florida, for example, exemption rights are specified, *inter alia*, at FLA. CONST. art. X, § 4, and at FLA. STAT. ANN. §§ 121.131, 222.01, 222.02, 222.05, 222.14, 222.18, 222.21, 222.22, 222.25, 222.201, 443.051, 497.413, 632.619, 744.626, 769.05, and 960.14 (West 1994).

⁶³ See *infra* notes 72-88 and accompanying text.

into a thicket of conflicting law in which even skilled counsel—not readily obtainable by most consumer debtors—may have difficulty in providing good advice.

B. *Problems with the Present System*

1. Well-Recognized Problems

Scholars, judges and practicing lawyers have long recognized that the exemption system is beset with difficulties.⁶⁴ The most basic problems fall primarily into two categories: lack of uniformity in treatment of debtors from state to state, and problems associated with “bankruptcy planning”—the deliberate shifting of assets from non-exempt to exempt categories by debtors contemplating bankruptcy.

Lack of geographical equity among debtors was a well-recognized failing of the former Bankruptcy Act,⁶⁵ which, as noted above, did not provide a list of federal exemptions but merely permitted debtors to claim their exemptions under state law.⁶⁶ The original report of the 1970 Bankruptcy Reform Commission, recommending exemption reform as part of what became the Bankruptcy Reform Act of 1978, proposed to remedy this by permitting debtors to exempt property only as enumerated on a federal exemption list.⁶⁷ Congress, however, failed to adopt this highly sensible proposal.⁶⁸ While § 522(d) created the recommended federal list, the opt-out provisions of § 522(b) leave most debtors with exemptions that vary incredibly from state to state,

⁶⁴ Professor Vern Countryman argued strongly for a new bankruptcy exemption system at a 1960 symposium on bankruptcy law, well before the 1970 Commission recommended its reforms. In so doing, he cited still earlier calls for reform. See Countryman, *supra* note 1, at 680, 683, *passim*; COMMISSION ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. I, at 170-73 (1973).

⁶⁵ The Act's adoption of state exemptions was attacked almost immediately as failing to comply with the Constitution's uniformity requirement, although this attack was turned aside, without satisfactory explanation, by the Supreme Court. See *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188-90 (1902). Commentators attacked the inherent unfairness of adopting state exemption law for bankruptcy purposes early on. See, e.g., WILLIAM MILLER COLLIER ET AL., COLLIER ON BANKRUPTCY 141 (7th ed. 1909). The attack was renewed by Professor Countryman in 1960. See Countryman, *supra* note 1, *passim*. His criticisms have been accepted by most of those who have studied the question since, including both of the Bankruptcy Reform Commissions. See COMMISSION ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. I, at 81-82; NBRC REPORT, *supra* note 6, at 212-92.

⁶⁶ See Bankruptcy Act of 1898, ch. 541, §§ 6, 70a, 30 Stat. 544 (repealed 1978).

⁶⁷ See H.R. DOC. NO. 93-137, pt. I, at 170-73.

⁶⁸ See Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1994)).

ranging, for example, from almost non-existent exemptions in Rhode Island⁶⁹ to virtually unlimited homestead exemptions in Texas and Florida.⁷⁰ This inequity between state exemptions may lead to a situation where a debtor will move to a different state with the purpose of taking advantage of more generous exemptions. For example, a wealthy debtor who can exempt only \$40,000 of the value of his or her Wisconsin homestead will be strongly tempted to plan for bankruptcy by moving to Florida and taking advantage of the almost unlimited Florida homestead exemption.⁷¹

An even more common form of bankruptcy planning that raises problems is the exchange of non-exempt property for exempt property during the year prior to bankruptcy. Nothing in the present Bankruptcy Code expressly limits a debtor's ability to exchange non-exempt property for exempt property of equivalent value as a key part of "bankruptcy planning."⁷² This practice, generally known as "asset conversion," has led to frequent litigation and highly inconsistent application of the law. The problem arises because courts often find asset conversion on the eve of bankruptcy to be objectionable, especially when non-exempt assets are converted into assets that are subject to very high or unlimited exemption amounts.⁷³

This issue is well illustrated by two cases simultaneously decided by the Eighth Circuit Court of Appeals.⁷⁴ In *Hanson v. First National*

⁶⁹ Rhode Island does not permit a debtor to exempt a homestead, although it allows exemptions for his or her body and burial plot. See R.I. GEN. LAWS §§ 9-26-3, -4(5) (1997). The live debtor may exempt "necessary wearing apparel," tools of a trade up to a value of \$500, up to \$1,000 of "household furniture and family stores," bibles and other books up to the value of \$300, up to \$50 in wages or salary, and certain other personal property under R.I. GEN. LAWS § 9-26-4 (1997). One concession to modernity introduces a discordant note, totally out of keeping with the general parsimony of Rhode Island law: a debtor may exempt an individual retirement account, pension or retirement annuity without any limit in amount under R.I. GEN. LAWS § 9-26-4(11) to (12) (1997).

⁷⁰ See FLA. CONST. art. X, § 4 (homesteads up to 160 acres outside municipalities and up to one-half acre within municipalities are exempt from forced sale by creditors, except for government sale to recover unpaid taxes, without regard to value).

⁷¹ See generally *In re Barker*, 168 B.R. 773 (Bankr. M.D. Fla. 1994); *In re Coplan*, 156 B.R. 88 (Bankr. M.D. Fla. 1993).

⁷² This has been true both under the former Bankruptcy Act and under the present Code. See *Hanson v. First Nat'l Bank*, 848 F.2d 866, 868 (8th Cir. 1988) (decided under the current Code); *Ford v. Poston*, 773 F.2d 52, 54 (4th Cir. 1985) (decided under the current Code); *In re Reed*, 700 F.2d 986, 990 (5th Cir. 1983) (decided under the current Code); *Forsberg v. Security State Bank*, 15 F.2d 499, 501 (8th Cir. 1926) (decided under the repealed Act).

⁷³ See *Levine v. Weissing* (*In re Levine*), 134 F.3d 1046, 1054 (11th Cir. 1998) (holding that debtors' conversion of non-exempt assets to exempt assets by purchase of annuities was a "transfer" for purposes of Florida fraudulent transfer law).

⁷⁴ See *infra* notes 75-86 and accompanying text.

Bank, the debtors were jointly-filed family farmers in South Dakota.⁷⁵ When they encountered financial problems, they followed their attorney's advice by selling \$34,000 worth of non-exempt property—a car, two vans, a motor home and household furnishings—to their sons.⁷⁶ They used the proceeds to purchase life insurance policies with cash surrender value totaling \$20,000 and prepaid \$11,000 on their home mortgage, thereby taking advantage of exemptions available under South Dakota law.⁷⁷ When a creditor objected to this claim of exemptions, the court supported the debtors, noting that “[i]t is well established that under the Code, a debtor’s conversion of non-exempt property to exempt property on the eve of bankruptcy for the express purpose of placing that property beyond the reach of creditors, without more, will not deprive the debtor of the exemption to which he otherwise be entitled.”⁷⁸

While affirming the lower courts in *Hanson*, the same Eighth Circuit panel affirmed another set of lower courts in *Norwest Bank Nebraska v. Tveten*.⁷⁹ In *Norwest Bank*, the debtor had done substantially the same thing as the debtors in *Hanson*, except that the debtor in *Norwest Bank* had converted \$700,000 in non-exempt property into an annuity that his attorney advised him was entirely exempt under Minnesota law.⁸⁰ Like the debtors in *Hanson*, the debtor in *Norwest Bank* had obtained fair appraisals for the property converted and had acted openly.⁸¹ In his case, however, the courts held that his conversion of non-exempt to exempt property was a fraudulent transfer and denied him his discharge in bankruptcy.⁸² The only clear distinction between the facts of the two cases is the size of the exemption claimed, or, as Judge Arnold quoted in his dissent in *Norwest Bank*, “when a pig becomes a hog it is slaughtered.”⁸³ Judge Arnold’s dissent argued that the Bankruptcy Code provides no guidance on matters porcine.⁸⁴ Accordingly, the problem was not with the debtor’s action in *Norwest Bank*, nor with his intent, but in the allowance of an unlimited exemp-

⁷⁵ See 848 F.2d 866, 867 (8th Cir. 1988).

⁷⁶ See *id.*

⁷⁷ See *id.*

⁷⁸ *Id.* at 868.

⁷⁹ See 848 F.2d 871 (8th Cir. 1988).

⁸⁰ Ironically, after denial of Dr. Tveten’s discharge, the Minnesota Supreme Court invalidated the state’s unlimited exemption of property held in annuities issued by fraternal organizations. See *id.* at 872–73 & n.3.

⁸¹ See *id.* at 872–73 & n.1.

⁸² See *id.* at 876–77.

⁸³ *Id.* at 879 (quoting *In re Zouhar*, 10 B.R. 154 (Bankr. D.N.M. 1981)).

⁸⁴ See 848 F.2d at 879.

tion under state law.⁸⁵ If the debtor in *Norwest Bank* had owned his \$700,000 annuity more than a year prior to bankruptcy, instead of buying it when he did, his exemption would have been undisturbed by the federal courts despite the size of the exemption.⁸⁶

In *Norwest Bank*, the debtor's treatment occurred in the absence of clear law forbidding what he did and the case provides no guidance to similarly situated debtors as to the value at which the conversion of non-exempted property will trigger drastic consequences for the debtor. It is even more disturbing that the court found deliberate fraud in his case despite the fact that he acted in good faith on the advice of his attorney.⁸⁷ That the mere size of a transaction can transform it from a normal part of the bankruptcy process to intentional fraud is an anomaly, the absurdity of which is reflected in the major ethical dilemma that it creates for bankruptcy lawyers. Attorneys are strictly forbidden to advise or assist clients engaging in fraud,⁸⁸ but are also required to act competently and diligently on behalf of their clients.⁸⁹ An attorney who, seeking the best result for a client, counsels that client to maximize exemptions within the amounts allowed by state law, may be violating the rules of professional responsibility by inadvertently counseling fraud; but the attorney who counsels the same client to take less than the amount to which the client may be entitled is also breaking the rules by disserving that client.

The current system also suffers from other major problems that, while already recognized by some authorities, have not received as much attention as the anomalies described above. The existing system not only discriminates between the residents of different states, but also discriminates among debtors who are otherwise similarly situated. As § 522 is now structured, the system discriminates against renters in favor of homeowners, against urbanites in favor of rural residents⁹⁰—particularly farmers—and more generally against the poor in favor of the well-to-do. This is true not only for debtors residing in opt-out states, but even for those who can and do elect the federal list of exemptions.⁹¹ It is not only strange to see this in a consumer bank-

⁸⁵ See *id.* at 878-79.

⁸⁶ See 11 U.S.C. § 548 (1994).

⁸⁷ See *Norwest Bank*, 848 F.2d at 872-73.

⁸⁸ See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1983).

⁸⁹ See *id.* Rules 1.1, 1.3 cmt. 1.

⁹⁰ See, e.g., H.R. REP. NO. 95-595, at 126 (1977).

⁹¹ Under the federal list of exemptions, as created in Code § 522(d), as of April 1, 1998, a debtor who owns a home may exempt \$16,150, as a homestead. See 11 U.S.C. §§ 104, 522(d)(1) (1994); Revision of Certain Dollar Amounts in The Bankruptcy Code Prescribed Under Section

ruptcy system, but it goes against the basic principles of equity that are supposed to drive the bankruptcy process.

2. Additional Objections to the System

Exemption law is consumer law.⁹² Its primary intended beneficiaries are people whose strained financial circumstances do not permit them to incur the major legal expenses needed to vindicate rights in a labyrinthine system. The complexity and ambiguity of current exemption law are problems in and of themselves. Not only do they lead to inconsistencies and inequities in application of the law, but their existence makes this body of law ill-suited to the needs of the consumers for whom the law is designed to benefit. The reason is that proper protection of the rights available under the law requires more legal time and talent than are cost-effective for consumer debtors, who are typically represented by lawyers taking large numbers of cases for flat fees or who may even try to represent themselves.⁹³

The present system also gives debtors incentives to keep property in categories that may not be in their best interests. The homestead exemption, which is the largest exemption both on the federal list⁹⁴ and under the law of most states, exemplifies this problem. Apart from the problems created when debtors sell non-exempt property to take advantage of large homestead exemptions, a debtor who lives in a particular jurisdiction, because of a large homestead exemption, may not be allocating property in the best way to enable him or her to emerge from bankruptcy with a genuine "fresh start." In fact, the debtor might have a better chance of full financial recovery, in bankruptcy or even without going through bankruptcy, by making a move

104(B) of The Code, 63 Fed. Reg. 7179, 7179 (1998) (adjusting the amounts of § 522(d)). The exemption is permanent under § 522(c), unless the case is dismissed. *See* 11 U.S.C. § 522(c) (1994). The debtor may sell the home and have \$16,150 in cash to use toward new housing or as a grubstake to a new business. *See id.* §§ 104, 522(d)(1); Revision of Certain Dollar Amounts in The Bankruptcy Code Prescribed Under Section 104(B) of The Code, 63 Fed. Reg. at 7179. A renter, or a homeowner whose more pressing financial circumstances are reflected in a lack of equity in his or her home, may apply a maximum of \$8,075 of the unused amount of the homestead exemption to protect other property under § 522(d)(5). *See* 11 U.S.C. §§ 104, 522(d)(5); Revision of Certain Dollar Amounts in The Bankruptcy Code Prescribed Under Section 104(B) of The Code, 63 Fed. Reg. at 7179.

⁹² *See* 11 U.S.C. § 522(b) (exemptions available only to individual debtors).

⁹³ *See, e.g.,* SULLIVAN ET AL., *supra* note 12, at 22-23. The extent of this problem is illustrated by the enactment of Bankruptcy Code § 110, 11 U.S.C. § 110, added in 1994 by Pub. L. 103-394, Title III, § 308(a), 108 Stat. 4135. This section seeks to regulate non-attorney "petition preparers," who have, under the guise of preparing bankruptcy petitions for unrepresented debtors, widely offered bankruptcy advice to such debtors despite their own lack of legal qualifications.

⁹⁴ *See* 11 U.S.C. § 522(d)(1).

to another jurisdiction where more or better work is available. A self-employed debtor might be well-advised to make at least a temporary switch to rental housing and use the homestead value in his or her business.

The convolution of the present system also distracts those working within the system from what should be its central focus: how much property should a debtor be able to keep as part of a "fresh start" in bankruptcy? This question is central to two problems of fairness: (1) fairness between a debtor and creditors, and (2) equality of treatment among debtors in the bankruptcy system. The forest tends to be lost, however, in debates over the trees—how much value should a debtor be allowed to exempt for a homestead, for tools of a trade, or an annuity?

Focusing on the trees raises an additional problem in terms of legislation: some provisions may become Christmas trees for special interest groups. This is, of course, a problem for federal legislation in general, but it has been a special problem for the Bankruptcy Code. A recent example of this problem arising with respect to the Code's exemption provisions is § 522(f)(3), which limits a debtor's right to avoid liens on certain kinds of property, such as tools of the trade and farm animals, to a maximum of \$5,000.⁹⁵ The fact that Congress limited this particular exemption while refusing to limit more serious abuses as to other exemptions, particularly those dealing with homesteads, indicates that this was a response to the goring of particular oxen.

C. *The Insufficiency of Previous Proposals*

The 1970 Commission's recommendations for a single federal list of exemptions,⁹⁶ which eventually became the list of federal exemptions enumerated in Code § 522(d), provide the basis for the most recent proposals for exemption law reform. Those recommendations were derived from generalization of state exemption law, but did not afford states the power to opt out or allow debtors to choose state exemptions. Accordingly, most subsequent criticism of § 522 has centered around its reintroduction of state law through its debtor's choice and opt-out provisions, and has tended to recommend eliminating states' rights to opt out, which would restore a pure federal list of exemptions.⁹⁷

⁹⁵ See *id.* § 522(f)(3).

⁹⁶ See COMMISSION ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. I, at 171-73 (1973).

⁹⁷ See, e.g., KAREN GROSS, FAILURE AND FORGIVENESS 246 (1997); NATIONAL BANKR. CONFER-

The NBRC moved beyond this position with the recommendations for reforming exemption law as part of the report that it made public on October 20, 1997.⁹⁸ Although the report was dead on arrival due to purely political reasons, its recommendations were sensible and would have significantly ameliorated many of the exemption system's problems. Even if fully implemented, however, the recommendations would not have completely addressed all the problems with the current system as noted in this Article.

The NBRC repeated the 1970 Commission's recommendation that a uniform set of federal exemptions should supplant the complex hybrid of state and federal exemptions available under present § 522.⁹⁹ It went further than its predecessor by stepping away not only from direct application of state exemption law, but from most of the laundry list of exempt amounts derived from state law that now constitutes the set of federal exemptions found in § 522(d). Instead, it would have allowed a debtor to take a homestead exemption in an amount that would still be based on state law, but ranging from a floor amount of \$30,000 to a ceiling of \$100,000, plus an unlimited amount for medical equipment and a lump sum amount of \$20,000 to be allocated to other personal property according to the debtor's wishes.¹⁰⁰

It is unfortunate that the NBRC did not simply discard the concept of classified exemptions entirely. By maintaining some links to state exemption law, both in basing exemptions on particular types of property and particularly in maintaining a strong connection to state law concerning homestead exemptions, it continued the law's discrimination in favor of homeowners and against both renters and urban residents.¹⁰¹ It also sustained the problem noted above of giving debtors incentives to maintain an allocation of property that might be less than optimal for attaining a "fresh start."¹⁰² Moreover, from a practical point of view, continuing the linkage to state exemption law invited Congressional amendments that would, as with the Bankruptcy Reform Act of 1978, restore most or all of the old system through the back door.

ENCE, REFORMING THE BANKRUPTCY CODE 109-10 (1994); William J. Woodward, Jr., *Exemptions, Opting Out, and Bankruptcy Reform*, 43 OHIO ST. L.J. 335, 375-76 (1982).

⁹⁸ See NBRC REPORT, *supra* note 6, at 121-44.

⁹⁹ See *id.*

¹⁰⁰ See *id.* at 125-33.

¹⁰¹ See *supra* notes 90-91 and accompanying text.

¹⁰² See *supra* Part I.B.2.

II. CHASING THE HOGS OUT OF COURT: A MODEST PROPOSAL

A. *The Proposal: Replace the Entire Exemption System with a Single Value for All Exempt Assets*

It is time to discard the entire convoluted exemption structure and start over. This is hardly an unprecedented move; the drafters of the entire Bankruptcy Code took that approach with the prior Bankruptcy Act, which itself had become too convoluted over eighty years of evolution to simply reform by tinkering.

1. The Basic Proposal

Instead of providing for its present multifarious set of exemption categories, § 522 should permit a debtor to exempt a fixed total value of property (which, for purposes of this Article, will be referred to as the "umbrella" amount) of any kind. The amount may be left up to debate, although a figure around \$50,000 seems fair as a starting point for legislative bargaining.¹⁰³ The debtor would choose the property to be protected, claiming appropriate values for items on the schedule of exempt property. As under present law, two debtors filing jointly as spouses could aggregate their exemptions.¹⁰⁴

Parties in interest, such as creditors, the U.S. Trustee and the trustee in bankruptcy, would be able to object only to a debtor's valuation of property to be included under the \$50,000 umbrella. Valuations would be based on resale value as of the time of filing and not on acquisition price.¹⁰⁵ This is an important part of the proposal that addresses some major concerns that might otherwise make it unacceptable. Basic personal property such as clothing, medical devices and items of sentimental value such as photographs are likely to have little or no resale value, and therefore should not be subject to

¹⁰³ This would allow a debtor couple filing jointly to exempt a total of \$100,000, a round number equal to the NBRC's proposed ceiling on homestead allowance alone. As such, it is a compromise between the present high and low extremes permitted under state and federal law, high enough to protect debtors' tenuous hold on middle-class status and to eliminate most exemption litigation, while low enough to avoid providing incentives for strategic bankruptcy filings.

¹⁰⁴ See 11 U.S.C. § 522(b) (1994).

¹⁰⁵ See *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 965 (1997) (establishing collateral value as replacement value rather than foreclosure sale value for purposes of Chapter 13 cram down). While not directly on point for exemption purposes, *Associates Commercial Corp.* is incorrectly decided both as a matter of Code interpretation and in terms of bankruptcy policy and should be expressly overruled by amendments to the Code.

increased risk of sale as compared to present law. In fact, protection of property of this kind may be significantly greater than under state law in many opt-out jurisdictions.

The proposal will not affect periodic payments under most pension plans, which will continue to be excluded from the bankruptcy estate under Code § 541(c).¹⁰⁶ It may be desirable to amend § 541(c), however, to make absolute the exclusion of other similar periodic payments for old age, disability and dependent support from the bankruptcy estate. Any such amendments should carefully limit the exclusions to periodic payments outside the control of the debtor.

2. Filling in Some Details

Certain parts of the present statute, now codified at § 522(e) through (m), need to be retained, although even they should be simplified. These retentions are necessary both for procedural considerations and to prevent certain abuses.

Procedure should remain substantially the same as under current law: the debtor will be required to file a schedule of property claimed as exempt, noting values for all items claimed. Parties in interest, including creditors, the trustee in bankruptcy and the U.S. Trustee, would have the right to object to the claims of exemption prior to a certain bar date.¹⁰⁷ One relatively minor modification would deal with the risk that a debtor might claim more than he or she is entitled to, in the hope that no party would object.¹⁰⁸ In that case, the trustee in bankruptcy and the U.S. Trustee would have the right to object to a claim of exemption after the bar date on a showing that a claim of exemption was based on actual fraud.

The umbrella amount would, like the amounts currently provided for by the federal list of exemptions,¹⁰⁹ be subject to cost of living adjustment at regular intervals under Code § 104.¹¹⁰ As noted below,¹¹¹ Congress might also consider an option to adjust the amount for geographic differences in cost of living.

¹⁰⁶ See 11 U.S.C. § 541(c) (1994); *Patterson v. Shumate*, 504 U.S. 753 (1992) (ERISA-qualified pension plan excluded from estate under § 541(c)).

¹⁰⁷ See 11 U.S.C. § 522(d) (1994).

¹⁰⁸ See *Taylor v. Freeland & Kronz*, 503 U.S. 638, 638 (1992) (sustaining debtor's claim of exemption for non-exempt property in absence of timely objection by creditor); Lynn M. LoPucki, *Common Sense Consumer Bankruptcy*, 71 AM. BANKR. L.J. 461, 468-70 (1997).

¹⁰⁹ See 11 U.S.C. § 522(d).

¹¹⁰ See *id.* § 104.

¹¹¹ See *infra* paragraph accompanying note 119.

One of the important provisions of the current Bankruptcy Code is § 522(f), which provides for avoiding liens encumbering certain kinds of personal property in order to permit the debtor to claim them as exempt.¹¹² The purpose of this lien avoidance is to prevent unscrupulous creditors holding non-purchase money security interests in debtors' personal property that has little or no cash value, but high personal value, from using the leverage created by the security interests to coerce debtors into reaffirming debts in amounts far more than the actual value of the encumbered property.¹¹³ A revised statute will need to retain this, at least in simplified form, unless Congress also adopts the NBRC's recommendation that would do away with reaffirmations, except for debt secured by the debtor's home.¹¹⁴

The bankruptcy court will need to retain considerable discretion concerning exemptions. This will be exercised chiefly in the matter of valuation of exempt property. The court should also, however, have some discretion to modify a particularly improvident use of exemptions by a debtor, particularly where the debtor has dependents who will be affected by the debtor's choice of exempt property.¹¹⁵

The court's discretion might also be extended to make a single exception to the rigor of the normal exemption limit for professionally prescribed medical equipment. The NBRC Report recognized the need for and potential high cost of such equipment and would have placed it in an automatically exempt special category.¹¹⁶ A blanket exception of that nature, however, raises certain moral hazards. For instance, a debtor could take advantage of an unqualified exemption to engage in pre-bankruptcy planning, buying gold-plated equipment that could be reconverted after bankruptcy into fully functional but much cheaper equipment plus cash. The best way to deal with the problem appears to be to allow the court to consider an application for a special exemption for such equipment and to allow the special exemption on a showing of: (1) genuine need; (2) prescription by a properly qualified physician or other professional; and (3) nonavailability of equally effective lower cost substitutes.

¹¹² See 11 U.S.C. § 522(f)(1)(B) (1994).

¹¹³ See H.R. REP. NO. 95-595, at 126-27 (1977).

¹¹⁴ See NBRC REPORT, *supra* note 6, at 145-69.

¹¹⁵ The Bankruptcy Code already delegates this kind of discretion to the bankruptcy court in other situations. See, e.g., 11 U.S.C. §§ 105, 523(a)(15), 524 (1994).

¹¹⁶ See NBRC REPORT, *supra* note 6, at § 1.2.4.

3. Options

Although the proposal will be most effective in the simple form described above, it may need to be made more politically palatable in order to assure enactment. Although legislative proponents should be careful to avoid letting the old, complex system in through the political back door, they might consider including certain minimal options in the revised statute in order to win Congressional approval.

The basic option that should be considered for this purpose might be called the states' rights option. It is crucially important that this option, if it is available at all, be kept in substantially the simple form proposed and not let out of control, as happened with the present § 522(b).¹¹⁷ Under the terms of this option, a debtor would be able to exempt the aggregate value of property that he or she could exempt under the law of his or her state. In order to assure nationwide uniformity and to prevent abuses noted under the present exemption system, however, this amount would be subject to national upper and lower limits. The upper limit should be no more than 50% above the federal amount otherwise described; the lower limit perhaps 50% of the federal amount, subject to negotiation. These limits would, like the federal umbrella amount, be subject to regular cost of living adjustment under Code § 104.¹¹⁸

This option, in addition to making the proposal more politically acceptable, would also have the advantage of reducing potential differences between state and federal exemptions. This would reduce discrepancies in substantive rights between bankruptcy and non-bankruptcy law, thereby reducing potential incentives for creditors to file involuntary bankruptcy cases against debtors in order to recover against debtor property that would have been protected against their claims under state law. By reducing the potential incentives for creditors to file involuntary bankruptcy cases against debtors, the likely effect is that there will be a decrease in the amount of involuntary actions against consumers.

The superior option, however, would take into account economic reality rather than state borders. Under this option, the umbrella amount would be subject to adjustment for geographical variations in the cost of living, thereby taking into account the fact that a \$25,000 exemption for a debtor in New York City is worth far less than the same nominal exemption in Fargo, North Dakota. Salaries of many federal

¹¹⁷ See *supra* notes 48-62 and accompanying text.

¹¹⁸ See 11 U.S.C. § 104 (1994).

employees are already subject to adjustment in this same way in areas where the cost of living is especially high.¹¹⁹ Although this option would be preferable in terms of accomplishing the purposes of exemption law, its disregard of traditional state lines would probably make it more difficult to push through Congress.

B. *Advantages of the Proposal Over the Current System and Other Reform Proposals*

The best way to test the merits of this proposal, short of actual controlled experiments, is to see how well it deals with the problems described above. As will be shown, the proposal deals with them well enough that comparatively little discussion of each is needed.

1. Theoretical Advantages

This proposal will help debtors optimize their "fresh start" capabilities and help creditors make more realistic pre-bankruptcy decisions, while minimizing wasteful litigation. In addition, simplifying the analysis of how much property they can protect will also aid debtors in making better decisions regarding whether to file under Chapter 7 or Chapter 13. It will also permit legislators revisiting the system to address the key issue of how much property a fair bankruptcy process should permit a debtor to shield from creditors. Moreover, it minimizes the consideration of exemptions for certain types of property and the temptations offered by special interests in considerations of that kind. Furthermore, the proposal will permit debtors to allocate their personal resources in ways that best suit their post-bankruptcy needs, rather than forcing them into the Procrustean bed of the old categories of exempt property. Bankruptcy planning will thus be transformed from its present status of ethically ambiguous loophole-seeking into more straightforward and realistic financial planning.

A related consideration is that the proposal should significantly reduce another kind of moral hazard: debtors' temptation to conceal or fraudulently transfer previously non-exempt assets such as jewelry. The flexibility of the proposal will let debtors lawfully exempt property of this kind, at least up to a reasonable value.

¹¹⁹ See, e.g., 5 U.S.C. §§ 5301, 5304 (1994) and regulations and executive orders thereunder.

2. Practical Advantages

One of the chief problems with rights created by consumer legislation, both at the federal and state levels, has always been the expense of legally enforcing them. Theoretical rights are of little advantage to consumers who cannot afford expensive legal talent. This is a particular problem for bankruptcy exemption laws, since consumer bankruptcy lawyers often work for fixed, relatively limited fees. In addition, procedures such as administrative enforcement and class action suits cannot be used to enforce complex exemption rights in the ways that they can for other consumer legislation such as the Fair Credit Reporting Act.¹²⁰

By drastically simplifying exemption law, the proposal will make it available on a more favorable basis to real life consumers and should substantially reduce legal malpractice in this area. As such, it could serve as a useful prototype for simplifying other areas of consumer bankruptcy law. Consumers will not be the only beneficiaries, however, since even creditors will benefit from reduced opportunities for abuse by well-to-do debtors, and from lower litigation costs. The bankruptcy courts, administrative system and overall process will benefit from savings in time and resources and reduced incentives for fraud.

3. Answers to Possible Objections

a. *The Proposal Will Upset Entitlements*

Both debtors and creditors are likely to object that the proposal will seriously detract from their present rights. Debtors are likely to focus on the homestead exemption, which would most likely be limited by the proposal's overall umbrella amount. This is an emotional issue and one can imagine the anguished protests to the effect that debtors entitled to keep their homes under present law would lose them under this proposal.

There are a number of good answers to such arguments. First, even in the two states with virtually unlimited homestead exemptions, Florida and Texas, debtors who have mortgaged their homesteads will still forfeit them unless they can make appropriate deals with the mortgagees.¹²¹ It is not at all clear why it is worse for a debtor to forfeit a home to a trustee in bankruptcy than to a mortgagee; or, for that

¹²⁰ See 15 U.S.C. §§ 1681(c)-1681(t) (1994).

¹²¹ See FLA. CONST. art. X, § 4(a); TEX. CONST. art. XVI, § 50.

matter, why it should be more difficult to make a home-preserving deal with a trustee. In any event, like the existing set of federal exemptions under § 522(d), most states do not provide unlimited exemptions for homesteads. In those states, to the extent that the homestead is unencumbered, the trustee in bankruptcy will sell the homestead property and pay the amount protected by the homestead exemption to the debtor in cash.¹²² Even in Florida, where the exemption is unlimited in dollar value but limited in area to one-half acre in urban regions,¹²³ the courts will authorize sale of homesteads larger than one-half acre in cases where, for zoning or other reasons, the property cannot be physically divided. In those cases, the court will decide how much of the sale proceeds are protected by the exemption and remit that amount to the debtor in cash.¹²⁴ When this occurs, debtors find themselves in the same situation that would exist under this Article's proposal: holding cash to be invested in post-bankruptcy life and/or business rather than continuing to reside in their pre-bankruptcy homestead. Any difference that these proposals make for debtors in this situation will simply be in terms of the amount protected and an elimination of temptations to convert assets during the approach to bankruptcy. Moreover, debtors will continue to be able to preserve their homes by agreeing to repayment plans under Chapter 13 rather than merely discharging their debts under Chapter 7.

It may be argued that debtors who have more property than the amounts proposed by this Article should not have the right to keep it from their creditors without agreeing to at least partial repayment from future income under the terms of Chapter 13.¹²⁵ In response, creditors are likely to object that the proposal will actually reduce their recovery from the average bankruptcy estate. This is because, despite the overall reductions in exemptions that might theoretically be claimed—at least in states allowing high or unlimited exemptions—more debtors will actually be able to exempt more property under this proposal. The answer, as noted below with regard to the question of bankruptcy planning,¹²⁶ is that basic bankruptcy policy requires that debtors be

¹²² See, e.g., *In re Evans*, 51 B.R. 47, 50 (Bankr. D. Vt. 1985).

¹²³ See FLA. CONST. art. X, § 4(a).

¹²⁴ See *In re Englander*, 95 F.3d 1028, 1031–32 (11th Cir. 1996).

¹²⁵ Some caution, however, is needed on this matter. Despite widespread pressure from creditor groups to push more debtors into repayment plans under Chapter 13, empirical evidence suggests that the chapter does not actually result in better outcomes for debtors or creditors than under Chapter 7, since most debtors fail to complete the payments promised by their Chapter 13 plans. See SULLIVAN ET AL., *supra* note 12, at 222.

¹²⁶ See *infra* paragraph accompanying note 128.

allowed to make their "fresh start" with property whose value should not depend upon the location and type of the property.

b. *The Proposal Will Not Materially Reduce Litigation*

It also may be argued that debtor-creditor litigation will persist under the proposal, primarily over the valuation of property claimed under the umbrella exemption. Although litigation over exemption issues will not disappear entirely, there are good reasons to believe that this litigation will be sharply reduced.

To begin with, the moral hazard now posed under the rubric of bankruptcy planning will disappear.¹²⁷ Not only will debtors no longer be tempted to move from state to state in order to maximize their exempt property, but the asset conversion problem will disappear when debtors can simply decide what property they want to include under a uniform exemption umbrella.

This is a far better solution than that offered by the legislation currently before Congress, which would simply restrict the time a debtor would have to acquire exempt property in order to qualify for exemption in bankruptcy.¹²⁸ That type of rule favors the more sophisticated debtor, who can "time" bankruptcy to greatest advantage, over the poorer, less sophisticated debtor, who is caught suddenly by economic catastrophe. Bankruptcy policy, aside from favoring equality among debtors, dictates that exemption amounts should be based on what the debtor needs for a fresh start, rather than on the fortuitous nature of what categories of property he or she happened to own on a given date.

Of course, there will always be some opportunities to litigate over the value of property that a debtor wants to claim as exempt; this situation exists under present law and would exist under the NBRC's proposals to an even greater extent than under this proposal. A reasonable upper limit on the umbrella amount, such as the \$50,000 suggested by this Article, will materially reduce overall creditor incentives to litigate debtor valuations of exempt property, except in the unusual case where the debtor's claims are obviously outrageous—situations that should be limited by the professional responsibility of debtor's counsel.¹²⁹

¹²⁷ See *supra* Part II.B.1.

¹²⁸ See H.R. 124, 106th Cong. (1999).

¹²⁹ See MODEL RULES OF PROFESSIONAL CONDUCT Rules 1.2(d), 3.1, 3.3. (1983).

c. *The Proposal Is a Federal Encroachment on States' Rights*

The most powerful opposition to the idea of eliminating all reference to state exemption law is likely to be based on the notion that this constitutes a federal encroachment on states' rights. This was the rock upon which the 1970 Commission's recommendations for a uniform schedule of federal exemptions was wrecked, leaving the mess now found at Code § 522.¹³⁰

The Constitution, by providing for a uniform bankruptcy system, intended to make bankruptcy a matter of federal law. James Madison, writing in the *Federalist Papers*, noted that uniform federal bankruptcy provisions were closely bound up with the advancement of interstate commerce and "will prevent so many frauds where the parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question."¹³¹

Until the Bankruptcy Act of 1898, all federal bankruptcy statutes established uniform federal exemption provisions.¹³² The first of these statutes, the 1800 Bankruptcy Act, was passed by a Congress that included signers of the Constitution and was signed into law by President John Adams, who was himself one of the Founders. The assumption of the hodgepodge of state-by-state exemption law into the Bankruptcy Act of 1898 was not traditional bankruptcy exemption law, but a major Congressional error that was strongly criticized at that time and continues to be criticized today. Actual experience with state exemptions shows that its lack of uniformity has had many undesirable effects, both in terms of the inequities and the moral hazard posed by debtors relocating to seize greater exemptions. No compensating advantages have been shown:

Restoring a truly federal exemption system will have benefits reaching beyond the bankruptcy system itself. One benefit is that the learning process goes both ways. In other words, states may learn from federal legislation at least as much as state law "experiments" may help to inform federal lawmakers. The Uniform Fraudulent Transfer Act is a good example of that process: the Conference of Commissioners on Uniform State Laws, when drafting its replacement for the old Uniform Fraudulent Conveyance Act, borrowed heavily from Bankruptcy Code § 548.¹³³ The states also have much to gain from modernizing

¹³⁰ See Lawrence Ponoroff, *Exemption Limitations: A Tale of Two Solutions*, 71 AM. BANKR. L.J. 221, 223-24 (1997).

¹³¹ THE FEDERALIST No. 42, at 271 (James Madison) (New American Library ed., 1961).

¹³² See *supra* notes 29-43 and accompanying text.

¹³³ See 11 U.S.C. § 548 (1994); see also, Michael L. Cook & Richard E. Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87 (1988).

their exemption laws, which, as noted above,¹³⁴ need an overhaul more so than most bodies of law.¹³⁵ Aside from modernization, greater uniformity in state exemption law is as desirable here as it is in other fields where states have adopted uniform laws. It is no more in states' interest to have debtors moving from state to state to take advantage of exemptions outside of bankruptcy—for protection against particular judgments—than it is in the interest of bankruptcy policy.

d. *The Proposal Is Too Radical to Be Adopted*

Sometimes it is easier to discard a complex system that does not work well than to fix it by adding new components here and hammering on old ones there. Good examples of this include the Copernican view of the solar system, the U.S. Constitution and the Bankruptcy Code itself.

Exemption reform has made frustratingly slow progress over the last few decades. The most progress came with adoption of the Bankruptcy Code itself in 1978, although this represented two steps forward and one step back.¹³⁶ The source of resistance to change has been the difficulty of imposing a federal list of exemptions in place of the lists provided by the various states. Accordingly, progress might be achieved once bankruptcy exemption law is totally decoupled from state exemptions. Instead of arguing over how much and what kind of property a debtor should be able to protect (with special interests arguing over nickels and dimes for each type of property), the debate would switch to how much in overall value a debtor may fairly protect from creditors in the bankruptcy process.

CONCLUSION

It is clear that, barely two decades after the Bankruptcy Reform Act of 1978, the U.S. bankruptcy system has once again been thrown open for potentially radical revision. Whether or not this is desirable, it furnishes an opportunity to consider business left unfinished in 1978,

¹³⁴ See *supra* notes 25–26 and accompanying text.

¹³⁵ Several states have modernized their exemption laws in recent years, in part responding to the 1970 Commission's report and the adoption of the Bankruptcy Code in 1978. See, e.g., William J. Woodward, Jr., *Exemptions, Opting Out, and Bankruptcy Reform*, 43 OHIO ST. L.J. 335, 344–45 (1982). It appears reasonable to believe that these reforms would have been more thorough had federal reform been more complete, and that there will be corresponding state responses to new federal reform.

¹³⁶ See *supra* notes 45–47 and accompanying text.

particularly where experience under the 1978 Reform Act has shown the importance of completing the task of revision.

The exemption system established by § 522 of the present Bankruptcy Code is a prominent example of this kind of unfinished business. The 1898 Bankruptcy Act, taking a misguided step from prior bankruptcy law, authorized debtors to use the exemptions of their state of domicile, rather than extending the older scheme of a uniform list of federal exemptions. Despite strong criticism from the inception of the state-exemption scheme to the reconsideration of bankruptcy law by the 1970 Commission, Congress refused to return to a uniform federal exemption system and instead, with Code § 522, created a hybrid system that adds unnecessary complexity to deplorable inequity.

Under the system as it presently exists, debtors may be faced with a difficult choice between complex lists of exemptions or being locked into state exemption schedules that vary strikingly from state to state. The variation is such that a debtor in one state may come away from bankruptcy with only a few thousand dollars in pre-bankruptcy property (or conceivably, less still), while a debtor just across the state line may come away with property worth millions. These variations do not correspond to differences in cost of living. They are unfair not only to debtors but to their creditors as well and have the further undesirable effect of burdening the courts with litigation over transfers of property in anticipation of bankruptcy.

The way to deal with these problems once and for all is to decouple federal bankruptcy exemption law from the exemptions provided by state debtor-creditor law. This decoupling should be total—not just to set up a list of federal exemptions that derive from state analogues, but to establish a different concept for exemptions in bankruptcy, which would establish an overall exempt amount and let the debtor choose property of any kind valued up to that limit. A well-advised debtor could choose property up to the value limit best suited for a fresh start, rather than, as under present law, being limited by property owned before bankruptcy.