#D-312 5/7/80

Memorandum 80-42

Subject: Study D-312 - Creditors' Remedies (Exemptions as Applied to Married Persons--Redraft of Exemption Provisions)

Attached to this memorandum is a redraft of the exemption chapter of the enforcement of judgments statute. Attempting to make the statute work for a married judgment debtor or joint judgment debtors who are married has been one of the most difficult drafting jobs the staff has encountered. We have tried in this redraft to spell out the rights of the spouses in more detail than in previous drafts. Please read the statute with care, noting any problems you see. We hope to approve the statute at the May 1980 meeting for inclusion in the comprehensive statute.

Purchase-Money Judgment

Code of Civil Procedure Section 690.52 provides that property that would ordinarily be entitled to an exemption is not exempt from enforcement of a judgment recovered for its purchase price. The Commission at the April 1980 meeting questioned the usefulness of this provision since it may be difficult or impossible to get the levying officer to levy on property that appears to be exempt even though the judgment is for its purchase price. The Commission also requested the staff to check the treatment of purchase-money judgments under the new Bankruptcy Code.

The exemptions provided in the new Bankruptcy Code apply regardless of the nature of the judgment. There is no exception made for purchase-money judgments. The staff has deleted the purchase-money exception from the draft of the exemption statute.

Homestead Exemption

The scheme of the Commission's current homestead draft is to protect the debtor in the family home until the debtor sells the home or until the equity becomes so great ($100,000) that it should be forcibly sold on execution. The amount of the exemption is substantially increased over existing law so the ordinary debtor cannot be involuntarily evicted from his or her home. When sale occurs, the debtor is given a relatively small amount of the proceeds--$7,500--which the debtor can use for housing or for any other purpose the debtor desires.

Under the Commission's scheme, the $7,500 proceeds exemption is available without regard to any security interests creditors may have in the home. Thus, if a person has a second trust deed on a dwelling and the dwelling is sold on execution or is voluntarily sold by the debtor, the judgment debtor will get his or her $7,500 even though this means that the note secured by the second trust deed will not be satisfied in full. The effect of the provision is that the security for the second trust deed is reduced by $7,500. This provision would be significant if there were a general decline in the market value of houses.

The general rule for other exemptions is that an exemption is not good as against a security interest in the exempt property. The Commission departed from the general rule in the case of the homestead exemption because of the unique nature of the homestead right and because the amount of the homestead exemption on sale of the dwelling would be substantially reduced under the Commission's recommendation.

One drawback to this homestead exemption scheme is that lenders may be less willing to loan money based on the security of the family home, and sellers may be less willing to carry secondary financing for home buyers, than they would if the security interest were not subject to a $7,500 exemption in the property that secures the loan. This presents a basic policy issue--whether the possibly adverse effect on the ability to obtain credit is outweighed by the needs of the dispossessed debtor. The staff is divided on this issue and believes that the Commission should review it.

Time for Application of Exemptions

The Commission has previously decided that exemptions should be determined under the law and circumstances applicable at the time the judgment is sought to be enforced against property. There are cases under the Contract Clause of the United States Constitution indicating that a contract creditor can be bound only by exemptions in effect at the time of the making of the contract. However, it is the Commission's belief that these cases can and should be challenged by statute.

The question remains: At what time is the judgment "sought to be enforced against property"--the time the creditor imposes a lien pursuant to an enforcement process, the time of levy, the time an exemption

claim is made, the time of hearing an exemption claim, or some other time? The time the creditor imposes a lien on property is adopted in the current draft as the time the creditor acquires rights in the property for exemption purposes. The time of the exemption hearing might be a preferable time viewed from the policy of the exemption statutes, which is to protect minimal needs of the debtor. On the other hand, is it good policy to eliminate or reduce the creditor's rights by legislation enacted after the creditor has obtained a lien on the specific property?

One important consideration in this decision is what the Due Process Clause allows--does the creditor acquire vested rights by creation of a lien on property so as to prevent retroactive application of subsequent changes in exemptions? The answer to this question is not clear. See extract from W. Reppy, Retroactivity of the 1975 California Community Property Reforms, 48 So. Cal. L. Rev. 977, 1047-52 (1975), attached as Exhibit 1. Perhaps a more important consideration for our purposes is what the creditors' lobby will stand for and what the debtors' lobby will support. The Commission's effort to improve the wage garnishment exemption to provide greater protection for low income debtors with many dependents failed in the face of opposition from creditors. The Commission should make a judgment on these issues before proceeding.

Respectfully submitted,

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EXHIBIT 1

(Southern California Law Review - pp. 1047-1052)

A. The Lexicon of Retroactivity Cases—The Magic Terms "Vested" and "Proprietary"

Unconstitutionality of retroactive application of legislation is usually asserted on the basis of the due process clause of the fourteenth amendment (or due process and just compensation clauses of the fifth amendment where federal law is at issue) and any state constitutional equivalent of the due process clause. The federal constitutional provision against impairment of contracts has also been invoked in retroactivity cases.[213]

But whichever of these constitutional provisions is asserted, the approach of the courts in cases involving constitutionality of retroactive

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213. U.S. Const. art. I, § 10; *accord*, Cal. Const. art. I, § 16. *See* Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692 (1960) [hereinafter cited as Hochman], and Slawson, *Constitutional and Legislative Considerations in Retroactive Lawmaking*, 48 Calif. L. Rev. 216 (1960) [hereinafter cited as Slawson] for cases applying the federal clause. Retroactivity cases decided under the state impairment-of-contracts clause are not as numerous. A recent example is Frazier v. Tulare County Bd. of Retirement, 42 Cal. App. 3d 1046, 117 Cal. Rptr. 386 (1974). *See also* Coast Bank v. Holmes, 19 Cal. App. 3d 581, 97 Cal. Rptr. 30 (1971).

In cases involving purported retroactive application of statutes affecting English common law property brought into California, the privileges and immunities clause of U.S. Const. art. IV, § 2, has been applied. *See, e.g., In re* Estate of Thornton, 1 Cal. 2d 1, 33 P.2d 1 (1934). However, in these cases the privileges and immunities clause became an issue because of an alleged taking of property at the time of a change of domicile, not, as in retroactivity cases, at the time a new law is enacted and applied to preenactment events or property. The privileges and immunities clause is not directly involved in considering the validity of retroactive application of the statutory changes that became effective January 1 or July 1, 1975.

application of statutes is basically the same:[214] if retroactivity is reasonable under all the circumstances, no constitutional violation will be found.

The analysis of reasonableness of retroactive application of a new statute is essentially a broad, ad hoc weighing or balancing process.[215] On the one side are: (1) whether reliance on prior law by the party affected by retroactivity was reasonable; (2) the extent of actions taken by the party on the basis of such reliance, such as financial investments, an irremeable course of conduct, and so forth; and (3) the extent of impairment or disruption of that investment or course of conduct resulting from retroactive application of the change of law. If reliance on pre-enactment law was reasonable, investments of great value were made on the basis of such reliance, and retroactive application completely destroys the value of such reliance, the strongest case supporting unconstitutionality of retroactive application of the change in the law is made. On the other side of the balance the court weighs: (1) the importance of social policies underlying the new enactment, including the gravity of the social evil sought to be corrected; and (2) the extent to which retroactivity of the new law, as opposed to prospectivity, is necessary to achieve the legislature's social policies. If a serious injustice that can only be eliminated by retroactive application of the new law is found to have existed, the strongest case for constitutionality of retroactivity exists.

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214. For example, the opinion in Frazier v. Tulare County Bd. of Retirement, 42 Cal. App. 3d 1046, 117 Cal. Rptr. 386 (1974), would not have been written any differently had the due process clause been the constitutional provision cited to rather than the impairment of contracts clause. *See* Hochman, *supra* note 213, at 695; Slawson, *supra* note 213, at 221.

215. The balancing test is well explained in the influential article by Hochman, *supra* note 213. Hochman's formulation has been followed in several California cases. *See* Loop v. State, 240 Cal. App. 2d 591, 598, 49 Cal. Rptr. 909, 914 (1966); Flournoy v. State, 230 Cal. App. 2d 520, 532, 41 Cal. Rptr. 190, 198 (1964). *Cf.* Peterson v. City of Minneapolis, 285 Minn. 282, 288, 173 N.W.2d 353, 357 (1969). The same or a similar "reasonableness" formulation of the constitutional standard in the United States Supreme Court cases is found by almost all scholars who have analyzed them. *See, e.g.*, Hochman, *supra* note 213; Slawson, *supra* note 213; Smith, *supra* note 42. This approach can readily be applied in community property retroactivity cases. *See, e.g.*, Armstrong, *"Prospective" Application of Changes in Community Property Control—Rule of Property or Constitutional Necessity?*, 33 CALIF. L. REV. 476, 495-96 (1945) [hereinafter cited as *"Prospective" Application*]; Knutson, *California Community Property Laws: A Plea for Legislative Study and Reform*, 39 S. CAL. L. REV. 240, 268 (1969) [hereinafter cited as Knutson]; Note, *Retroactive Application of California's Community Property Statutes*, 18 STAN. L. REV. 514, 521-23 (1966) [hereinafter cited as *Retroactive Application*].

If the impairment of pre-enactment rights is sufficiently severe, no degree of public harm prevented by retroactive application of a statute can constitutionally justify the impairment without compensation.[216] Thus, if the scales on the first side of the balance are heavily weighted by a strong case of injustice to the individual, the state usually cannot tip the scales in its favor by even the strongest case of harm to the public.

Especially in older cases, this broad inquiry with respect to reasonableness is often obscured by the language of the opinions. It is almost as if the judges considered it unseemly for the law to be flexible, to lack more firm rules governing retroactivity cases. What the older opinions often discussed was whether vested or proprietary rights were taken by a change in the law. If the labels "vested" or "proprietary" were applied by a court, retroactive application of the new law was held unconstitutional. However, studies of the older cases make it clear that in most of them the judges understood that the terms "vested" and "proprietary" were simply legal conclusions that attached only after reasonableness of a retroactive change in the law was analyzed—at least in the secrecy of the conference room. Instances where it appears that the courts became mesmerized by the labels "vested" or "proprietary" and plugged them in as a shortcut to analysis are few. Most contemporary courts are quick to recognize expressly that the terms "vested" and "proprietary" are nothing more than legal conclusions to be applied to pre-enactment rights or expectations of a party only after analysis of the reasonableness of retroactivity of an act under all the circumstances convinces the court that retroactive application was indeed unreasonable.[217]

In California, the meaning of the term "vested" in retroactivity cases became confused in 1966 after the decision in *Addison v. Addison*.[218] The court there stated that some "vested" rights can be taken

216. *See, e.g.*, Slawson, *supra* note 213, at 249; Smith, *supra* note 42, at 241.

217. County of Los Angeles v. Superior Court, 62 Cal. 2d 839, 844, 44 Cal. Rptr. 796, 799, 402 P.2d 868, 871 (1965) ("describing a right as 'vested' is merely conclusory"). *See also* Coast Bank v. Holmes, 19 Cal. App. 3d 581, 594, 97 Cal. Rptr. 30, 37 (1971) (whether statute can be given retroactive effect does not rest on distinction between procedure and substance but on whether statute alters legal effect of past transactions); Estate of Gill v. Hagny, 19 Cal. App. 3d 496, 501, 96 Cal. Rptr. 786, 789 (1971) (whether rule of law is labeled substantive or procedural is not helpful in determining whether a statutory amendment constitutionally may be given retrospective application; rather it is its effect which is decisive of the question).

218. 62 Cal. 2d 558, 566, 399 P.2d 897, 902, 43 Cal. Rptr. 97, 102 (1965): "Vested rights, of course, may be impaired 'with due process of law' under many circumstances."

or impaired constitutionally through retroactive application of a statutory change of law by virtue of the state's police power. No longer does the term signify to California judges a conclusion that the rights and expectations are such that, weighing all the circumstances, their impairment by retroactive application of the new statute would be unreasonable. Rather, after the *Addison* decision in California, the term "vested right" in retroactivity cases seems to signify that the party objecting to retroactivity has come forward with facts that put sufficient weight on that party's side of the scales that the court must engage in the weighing process.

Because it is helpful to the analysis of retroactivity problems to be able to draw on conclusory terms that characterize a particular type of retroactivity case, and since the term "vested right" has never had a clear meaning in the law[219]—and in California now seems to mean one thing in older cases and something quite different in contemporary judicial opinions—a more discriminating retroactivity lexicon should be developed. For purposes of this Article, retroactivity cases are characterized as follows:

1. *Freely Impairable*

This term describes benefits, rights, or privileges (the label here is unimportant) that a party enjoyed under pre-enactment law which, by their nature and in light of the history of legislative authority in this country, must be viewed as subject to change and adjustment at the discretion of the legislature. Any reliance on the continuation of pre-enactment law by the objecting party is per se unreasonable. The party has nothing, therefore, to place on his side of the balancing scales, and retroactive application of the law must be held constitutional unless it is so arbitrary and senseless in light of the social purposes of the legislature that it denies due process. What was described in Part I as "privilege-regulating" retroactivity will usually involve freely impairable rights of a party. For example, no American can reasonably believe, when he purchases real property, that tax rates will remain at the then-existing level. And even if a wealthy man without a will is incurably insane, his uncle, as heir presumptive under a gradual system of descent, cannot assume that the legislature will not, before the intestate dies, convert to a parentelic system of inheritance in which a grandnephew would become the heir.

219. *See* Smith, *supra* note 42, at 231.

2. *Unimpairable*

At the other end of the continuum of retroactivity cases from those involving freely impairable pre-enactment rights are cases where injustice to the objecting party is so apparent by retroactive application of the law that no social policies of the legislature could constitutionally justify the impairment of that party's rights without compensation. A good example of a violation of unimpairable rights would be a conservation measure prohibiting the state from selling coastal lands to private parties. It is obvious that thousands of persons claim coastal lands under chains of title traced back to patents issued by the state (or other conveyances by the state), that such persons will have relied on their titles being good, will have spent considerable funds purchasing and improving coastal properties, and will lose their entire investment if the new law is applied retroactively to upset ancient grants by the state. There is no occasion for balancing of interests, and retroactive application of the law must be held to deny due process. Retroactivity cases involving unimpairable rights will be few and will usually involve what I have termed property-taking and transaction-overturning retroactivity.

3. *Impairable on Balance*

This category probably embraces the bulk of litigated retroactivity cases. For a right to be impairable on balance, there must be at least some reasonable reliance by the objecting party on pre-enactment law, some change of position by that party based on such reliance (*e.g.*, a contract is made, money is spent, an opportunity to act is foregone), and some loss of benefits already obtained or reasonably anticipated resulting from retroactive application of the statutory change. On the other hand, examination of these factors does not present a case of such patent injustice that the harm caused to the objecting party by retroactive application of the statute could not be outweighed by the interest of the state in the exercise of its police power to benefit all the people by eliminating a perceived social evil. Thus the courts must balance the harm to the objecting party against the gravity of the evil sought to be corrected by the legislature and the extent to which retroactivity of the statute is necessary to eradicate that evil.[220] This category of

220. With respect to the importance of the latter consideration, see Thorpe v. Housing Authority, 393 U.S. 268 (1969); Hochman, *supra* note 213, at 701-02. In addition, if the anticipated benefits from the action taken in reliance are themselves speculative, if the action in reliance involved no financial cost, or if the pre-enactment law relied on constituted an "insubstantial equity," the balance is weighted in favor of finding retroactive application of the statutory change to be constitutional. *Id.* at 717, 720, 725.

cases involving rights retroactively impairable on balance will include most instances of transaction-regulating retroactivity and some instances of property-taking and transaction-overturning retroactivity. A statute prohibiting a creditor from seizing security after default without first giving the debtor an opportunity for hearing, even though immediate seizure was permissible under prior law and agreed to in the contract between the parties, would be a good example of a case where balancing of interests is necessary to decide the constitutionality of applying the law to pre-enactment debtor-creditor relationships.[221]

221. Coast Bank v. Holmes, 19 Cal. App. 3d 581, 97 Cal. Rptr. 30 (1971), is a recent California case where the court for the most part applied the reasonableness test to uphold transaction-regulating retroactivity. The statute at issue applied to contracts entered into before its enactment and gave some parties an additional remedy by providing that if there was an attorneys' fees clause for the benefit of one party it applied to the other as well.