Memorandum 80-52

Subject: Study D-300 - Creditors' Remedies (Exemptions Generally)

Attached to this memorandum is a draft of the exemption chapter of the comprehensive statute with a preliminary portion explaining the exemption scheme. At the May 1980 meeting, some of the Commissioners expressed an interest in reviewing the policy decisions on the exemptions. This should be done at the June meeting.

The staff has only one issue to discuss, which was raised but not resolved at the May meeting: whether the $7,500 homestead proceeds exemption should be effective against voluntary encumbrances on the property and against involuntary encumbrances such as mechanics liens. The relevant portion of Memorandum 80-42, which was discussed at the May meeting, is set out below. At the meeting, there was also some discussion of whether the draft scheme should be replaced by a scheme based on existing law--$30,000 for a single person and $45,000 for a head of household.

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.

Respectfully submitted,

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