

9th Circ. Ruling Clarifies Homestead Exemption Ambiguities

WRITTEN BY

Deborah Kovsky-Apap

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Suppose you are a lender or credit provider to California consumers.

At the start of the pandemic, one of your customers runs up \$50,000 in debt and fails to pay. You obtain a judgment and secure it by recording an abstract of judgment — one of the most powerful collection tools a judgment creditor has. The abstract of judgment creates a general lien that attaches to all of the judgment debtor's real property in the county where it is recorded.

Your judgment debtor has a residence in the county that is worth \$350,000 and is already subject to an existing mortgage lien of \$150,000. At the time you record your abstract of judgment, the applicable homestead exemption is \$100,000. In other words, there's enough value to satisfy your lien, plus another \$50,000 in equity.

Fast forward a couple of years. Not being in the business of foreclosing on your customers' homes, you have allowed your lien to sit, secure in the knowledge that as soon as the judgment debtor sells or refinances, you will be made whole. As it turns out, you are not the only creditor who has gone unpaid, and, facing increasing financial pressure, the debtor files for bankruptcy.

By now, the house has appreciated to \$350,000, leaving — as you would suppose — a substantial equity cushion that the trustee can use to pay creditors. Surprisingly, you would suppose wrong.

On Jan. 1, 2021, California's new homestead exemptions went into effect. In 2020, the exemption was \$75,000 for a single homeowner, with a maximum of \$175,000 for homeowners who met certain requirements.

Under the new law, the baseline exemption is \$300,000 and may be as high as \$600,000 depending on median sale prices in the county. In addition, the amount of the exemption now adjusts annually based on the California Consumer Price Index for all urban consumers for the prior year.[1]

Applying the minimum 2023 exemption of \$339,189,[2] your lien is suddenly deeply underwater. In bankruptcy terms, the lien impairs an exemption to which the debtor would have been entitled, and is subject to avoidance under Section 522(f) of the U.S. Bankruptcy Code. If your lien is avoided, you will be a general unsecured creditor

of the debtor and may well recover nothing, rather than the payment in full you confidently expected.

But wait. California law seems clear that the amount of the homestead exemption to which the debtor is entitled is based on the statute in effect at the time the judgment lien was created:

The determination whether property is exempt or the amount of an exemption shall be made by application of the exemption statutes in effect (1) at the time the judgment creditor's lien on the property was created or (2) if the judgment creditor's lien on the property is the latest in a series of overlapping liens created when an earlier lien on the property in favor of the judgment creditor was in effect, at the time the earliest lien in the series of overlapping liens was created.[3]

Shouldn't the applicable exemption be the one in effect when the abstract of judgment was recorded?

That was the question before the U.S. Court of Appeals for the Ninth Circuit in *Barclay v. Boskoski* in 2022.[4] The appeal arose out of the debtor's attempt to avoid, in bankruptcy, a 2014 judgment lien in the original amount of \$256,075.95 recorded against his home.

The debtor filed for bankruptcy protection in 2021, after California's homestead exemptions increased. Depending on whether the bankruptcy court applied the exemption in effect on the creation date of the lien or on the date of the bankruptcy filing, the judgment creditor would either receive payment in full or not at all.

The validity and amount of a debtor's homestead exemption is controlled by applicable state law.

The trustee argued that the entire state law applicable on the filing date determines whether an exemption applies — including the state law that prevents a homestead exemption increase from applying retroactively to judicial liens created prior to the effective date of the increase.

The debtor, on the other hand, argued that the language of Section 522 of the Bankruptcy Code requires the value of the exemption to be determined as of the bankruptcy filing date. The bankruptcy court ruled in favor of the debtor and avoided the judgment creditor's lien. Calling the decision a close call on an important question, the bankruptcy court then certified a direct appeal to the Ninth Circuit.

Relying heavily on the U.S. Supreme Court's 1991 decision in *Owen v. Owen*,^[5] which held that a bankruptcy court is to determine not the exemption to which the debtor is entitled, but that to which he would have been entitled in the absence of any judgment liens on the home, the appellate court upheld the bankruptcy court's ruling:

[In] deciding whether a judgment lien impairs a debtor's California homestead exemption, the Bankruptcy Code requires courts to determine the amount of exemption to which the debtor would have been entitled in the absence of the lien at issue.

Under California law, the existence of the lien itself provided the only basis for application of the earlier exemption amount. Accordingly, the court concluded that "that means we apply the state exemption law in effect on the filing date of the bankruptcy petition."

The Ninth Circuit's ruling creates increased collection risks for judgment creditors, and those who buy judgment claims, in California — particularly since, absent a significant decline in median housing prices, the amount of the homestead exemption is likely to continue to increase annually. A judgment lien that was safe in December of one year might well be exposed to potential avoidance just a month later.

This creates something of a perverse incentive. Before the enactment of the new homestead exemptions, judgment creditors had little reason to rush to incur the cost and hassle of foreclosure even on judgment debtors with substantial equity in their homes.

Creditors could simply wait^[6] to be paid in full, with interest, upon debtors' sale or refinancing of their homes, or — relatively easily — sell their claims to any of the many companies that buy judgments.

The new homestead exemption law, while highly protective of homeowners in one sense, may actually push creditors that otherwise would not have considered forcing the sale of debtors' homes to foreclose on their liens before rising homestead exemptions eradicate the value that can be reached by creditors.

In addition, lenders and other credit providers may need to take the Ninth Circuit's ruling into account when deciding whether to extend unsecured credit to a consumer in the first place.

A borrower who had substantial equity in her home in excess of the homestead exemption in 2020 may look like a much worse credit risk in 2023. That increased risk and uncertainty will almost certainly be priced into the cost of credit, or result in otherwise qualified borrowers being denied credit altogether.

One can also imagine the growth of a niche type of credit risk consultancy that analyzes the current and estimated future value of a consumer's home, estimates the future median home prices in the consumer's county, forecasts changes to the consumer price index and advises judgment creditors on the optimal time to pursue foreclosure.^[7]

[1] See Cal. Civ. Proc. Code § 704.730.

[2] At the high end, the homestead exemption increased from \$600,000 in 2021 to \$678,378 in 2023.

[3] See Cal. Civ. Proc. Code § 703.050(a).

[4] 52 F.4th 1172 (9th Cir. 2022).

[5] 500 U.S. 305 (1991).

[6] A money judgment in California is automatically valid for 10 years and may be renewed.

[7] It is entirely possible that an AI somewhere has already created an algorithm for this.

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