

The Michigan Exemption Initiative

By Thomas R. Morris*

The Bankruptcy Appellate Panel (BAP) for the Sixth Circuit, in *In re Schafer*,¹ ruled in February 2011 that Michigan's bankruptcy-specific property exemptions² are unconstitutional. The basis for the ruling is that the bankruptcy-specific exemptions enacted by the Michigan legislature in 2004 violate the "uniformity" requirement of the bankruptcy clause of Article 1 of the United States Constitution.³

This has caused the bankruptcy-specific exemptions to be unreliable for bankruptcy debtors and the attorneys who advise them. The ruling by the BAP is binding only in the specific case, and the bankruptcy judges of the Western District are divided on the question.⁴ None of the bankruptcy judges of the Eastern District has ruled on the issue, although Judge McIvor, one of six bankruptcy judges for the Eastern District, was a member of the panel of the BAP in *Schafer*. *Schafer* is now on appeal to the Sixth Circuit Court of Appeals.⁵ A ruling from the court of appeals would be binding on all Michigan bankruptcy courts. That would settle the matter unless and until the question is ruled on by the Supreme Court. In the meantime, any debtor selecting those exemptions must be prepared for a challenge by the trustee.

A subcommittee of the Debtor-Creditor Rights Committee of the Business Law Section of the State Bar is working on a legislative solution. The subcommittee's project is referred to as the Michigan Exemption Initiative ("Initiative"). The Initiative has drafted proposed legislation to re-unify and modernize Michigan's exemption statutes. The provisions enacted in the bankruptcy-specific statute would be made generally applicable. New provisions covering health and education savings accounts would be added. Other improvements and corrections to the statute would be made.

The Initiative continues the work of the Advisory Committee to the Civil Law and Judiciary Subcommittee of the House Civil and Judiciary Committee,⁶ which was formed in 2001 at the request of the Michigan House of Representatives subcommittee for the purpose of reporting on and recommending changes to Michigan's exemption laws. At that time, the exemption laws had been for the most part unchanged since 1963.⁷ The

exceptions were the addition in 1984 of an exemption of "an IRA" and in 1989 of certain other retirement plans. Many non-IRA retirement plans, however, are protected by federal law.⁸ And the exemption of "an IRA" has been held to exclude an exemption of more than one IRA.⁹ Therefore, the one effective addition since 1963 to Michigan's exemptions was itself in need of revision.

The enactment in 2005 of the bankruptcy-specific exemptions was a diversion from the path intended by the advisory committee. The committee's recommendation had been changes to the "general" exemption statute, MCL 600.6023. The legislature did not alter that statute and instead channeled the recommended changes into the new "bankruptcy-specific" exemption statute. Because Michigan bankruptcy debtors can select either the "state" or the "federal" exemptions,¹⁰ and because most¹¹ debtors (particularly those with no more than \$21,625 in home equity) select the federal exemptions, the adoption of the bankruptcy-specific exemptions had only a marginal impact on bankruptcy practice in Michigan. Because the existing statute, which became the "general" or "non-bankruptcy" exemptions, remained unchanged, debt collection outside of bankruptcy was unaffected, except to the extent that the enhanced state bankruptcy exemptions may have increased filing rates.¹² The most significant change incorporated into the bankruptcy-specific exemptions was to increase the homestead exemption about ten-fold. The allowance for IRAs was also broadened to "all IRAs." The allowance for a motor vehicle was increased. Professionally-prescribed health aids and a computer were added.

Opposition to updating of the general exemption statute by the Michigan Creditors Bar Association and the Michigan Court Officer, Deputy Sheriff & Process Servers Association resulted in the compromise by the legislature. That compromise was to limit the application of the modernized exemptions to bankruptcy cases by creating the bankruptcy-specific statute. The opponents of the reform were willing to accept the compromise because the increases in exemptions would not apply to judgment debtors outside of bankruptcy and therefore would have less

*The opinions in this article are those of the author and do not necessarily reflect the position of the State Bar of Michigan Business Law Section or any other organization of which he may be a member.

effect upon their members and the creditors they serve.

Even with the bankruptcy-specific statute having been held unconstitutional, the same groups oppose legislative reform of the exemptions. Debts, they argue, should be enforced, and an increase in exemptions would be contrary to that policy.

There are several arguments that realistic exemptions are necessary and beneficial. From a utilitarian viewpoint, the small benefit to a creditor of the seizure from a debtor of, for example, clothing or other relatively unmarketable property necessary for the debtor (and his or her dependents) to be functional and productive is outweighed by the detriment to the debtor. Similarly, from a societal standpoint, for a debtor to be rendered destitute by a judgment may place a burden on the state when it is then called upon to support the debtor. Fairness, a vague but fundamental element in the maintenance of a legal system, requires some level of exemptions. These arguments are not new. Michigan has had exemptions since its time as a territory, and exemptions have been mandated by the State Constitution since 1850.¹³

The 1963 State Constitution sets a minimum homestead exemption of \$3,500 and a minimum personal-property exemption of \$750.¹⁴ Thus, it is beyond debate at a legislative level whether some level of exemptions is appropriate. The question, with respect to the homestead in particular, is whether the constitutional minimum is still sufficient. The current non-bankruptcy homestead is set at that minimum. The (invalidated) bankruptcy-specific homestead exemption is approximately \$35,000.¹⁵

Homestead exemptions in other states range from none to unlimited values. The median amount is approximately \$50,000.¹⁶ Other important exemptions, such as household goods, a motor vehicle, and clothing, vary from state to state, but at \$1,000 for a motor vehicle (and only if used in the debtor's trade) and \$1,000 for household goods,¹⁷ Michigan's non-bankruptcy exemptions are lower than many other states. Adjusted for inflation the homestead exemption is lower than at any time since statehood.¹⁸ Other states have adopted exemptions for recent financial innovations such as health savings accounts and education savings accounts.¹⁹ Michigan should consider whether to follow suit.

The opponents of exemption reform argue that because personal bankruptcy has

become an accessible remedy for individual debtors, exemptions outside of bankruptcy are no longer important. When Michigan's first exemption laws were enacted before statehood in 1837, and when exemptions first became a subject of the state constitution, in 1850, personal bankruptcy relief was not available. The number of personal bankruptcies has risen greatly in recent decades.²⁰ The federal exemptions, which most debtors find advantageous, are available to Michigan residents.²¹ Therefore, it can be argued, bankruptcy now provides greater refuge than was historically the case.

Bankruptcy, however, is not available to all debtors. A debtor who has received a discharge in bankruptcy is barred from receiving another discharge for up to eight years.²² Nor is bankruptcy always a fitting remedy for a debtor. For a debtor with relatively few creditors, an out-of-court workout may be an option. The enactment of state exemptions at a level closer to those allowed by the federal bankruptcy exemptions would afford some debtors a better opportunity to restructure their finances without resorting to personal bankruptcy. And a law that favors bankruptcy filers sends a mixed message. According to the state of Michigan's student loan Web site: "Bankruptcy should be the absolute last resort for any borrower....Borrowers are encouraged to try to resolve all credit issues outside of bankruptcy."²³

Reasonable exemption laws are a factor in attracting entrepreneurs and in encouraging business formation. According to a study published by the National Bureau of Economic Research, states with high homestead exemptions have about one-third more entrepreneurs than states with low homestead exemptions.²⁴ The counter-argument is that a system that is more favorable to debtors is less favorable to creditors, who as a result may be less willing to extend credit. But credit appears to have been available in adequate quantities in high-exemption states such as Florida and Nevada, for example, to fuel a construction boom and subsequent bust.

In the event that the court of appeals reverses the BAP and upholds the bankruptcy-exemption statute, the constitutional crisis will be averted. But the question will remain whether Michigan's exemption laws are due for an update. The Michigan Exemption Initiative is continuing work on the project with the goal of assisting the legislature in reevaluating Michigan's exemption laws.

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NOTES

1. *Richardson v Schafer (In re Schafer)* and *Tibble v Jones (In re Jones)*, Nos 10-8030 and 10-8031, 2011 Bankr LEXIS 564 (6th Cir BAP Feb 17, 2011).
2. MCL 600.5451.
3. Art. 1, §8, Cl. 4 provides Congress with the authority to establish “uniform Laws . . . on the subject of Bankruptcies throughout the United States.”
4. Judge Dales rendered the opinions in *Schafer* and *Jones* upholding MCL 600.5451. Judges Gregg (in *In re Pontius*, 421 BR 814 (Bankr WD Mich 2009)) and Hughes (*In re Wallace*, 347 BR 626 (Bankr WD Mich 2006)) have both ruled the statute to be unconstitutional.
5. *In re Jones*, the companion case to *Schafer*, was settled and is not on appeal.
6. Steven L. Rayman, chair; Thomas B. Radom, vice chair; Judy B. Calton, reporter.
7. And the 1963 exemptions are little changed since 1846. See Morris, *The History and Future of Michigan Debtor Exemptions*, 30 Mich Bus L J 57 (summer 2010).
8. ERISA, 29 USC 1056(d)(1); *Patterson v Shumate*, 504 US 753 (1992).
9. *In re Katranji*, 93-CV-75304-DT (ED Mich 1994) (unpublished ruling); *In re Spradlin*, 231 BR 254 (Bankr ED Mich 1999).
10. See 11 USC 522(b).
11. Statistical substantiation was not found, but the prevalence of the federal exemptions has been observed by the author and by practitioners who were consulted.
12. Several published statistical studies address the relationship between the levels of exemptions and filing rates, but the author is not aware of any such study which addresses the effect of the Michigan bankruptcy-specific exemptions.
13. Const. 1850, Art. 16. See also Morris, *The History and Future of Michigan Debtor Exemptions*, *supra*.
14. Const. 1963, Art. X, §3.
15. MCL 600.5451(1)(n) provides an inflation-indexed homestead exemption of \$30,000. The amount is \$45,000 for a debtor who is disabled or over 65 or who has a dependent who is disabled or over 65. The inflation-adjusted figures published on April 15, 2011 are \$35,300 and \$52,925. See http://www.michigan.gov/documents/BankruptcyExemptions2005_141050_7.pdf.
16. See West Bankruptcy Exemption Manual for the amounts allowed in individual states.
17. MCL 600.6023(1)(b).
18. For example, the \$1,500 statutory homestead exemption in 1915 was calculated to be equivalent to \$27,252 in 2003. Report of the Advisory Committee to the Civil Law and Judiciary Subcommittee of the House Civil and Judiciary Committee, August 11, 2003.
19. See, e.g., Rosen, B., *State Creditor Protections for 529 Plans*, Corporation for Enterprise Development (April, 2007), available at cfed.org.
20. In 2010, the number of bankruptcy cases filed, most of which were for individuals, was over 50,000 in the Eastern District and over 16,000 in the Western District. Those figures are below 2005 figures, when filings increased due to debtors desiring to file before the 2005 amendments to the Bankruptcy Code took effect.
21. Michigan is one of 15 states in which the federal exemptions are allowed.
22. 11 USC 727(a)(8) requires eight years between the filing dates of cases filed under chapter 7.
23. http://www.michigan.gov/mistudentaid/0,1607,7-128-38170_38184-129878--,00.html (accessed May 1, 2011).
24. Fan, W. and White, M., *Personal Bankruptcy and the Level of Entrepreneurial Activity* (NBER Working Paper No. 9340).



Thomas R. Morris is a member of the West Bloomfield firm of Silverman & Morris, PLLC. His firm concentrates its practice in the areas of bankruptcy, commercial litigation, and similar matters, and represents both debtors and creditors, as well as landlords, financial institutions, and ordinary businesses. Mr. Morris is a member of the Council of the Business Law Section and the Debtor/Creditor Rights Committee.