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Whether Section 522(b)(3) of the Bankruptcy Code Contains an Implied Residency Requirement for Determining Which Exemption Scheme Applies

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Introduction

Filing a bankruptcy petition creates a bankruptcy estate consisting of all the debtor's legal or equitable interests in property, plus any proceeds generated from the disposition of property of the estate.[1] Once a debtor's asset becomes property of the estate, all the debtor's rights in that property are extinguished, unless the property is "exempted" under section 522 of the Bankruptcy Code or is otherwise abandoned back to the debtor.[2] Accordingly, while creditors are entitled to seek reimbursement in the rest of the bankruptcy estate, the debtor may retain his or her interest in exempted property.[3]

Thus, section 522 of the Bankruptcy Code lays out the federal exemptions, which list all property that a debtor may reclaim from the bankruptcy estate.[4] However, under the Bankruptcy Code, each individual state may also pass conflicting state exemption laws. As a result, a debtor could be eligible for *both* the federal exemptions and a state's exemption laws, in which case the

[1] *See* 3A Bankr. Service L. Ed. § 29:11.
[2] *See id*. (providing that under 11 U.S.C.A. § 541, the "estate" is initially comprised of all interests of debtor in property, regardless of whether property is exempt or exemptable).
[3] *Id*. at § 29:12 (stating test for determining whether given property interest is included in estate pursuant to 11 U.S.C.A. § 541 is whether property interest is sufficiently rooted in pre-bankruptcy past and not entangled with debtor's ability to make unencumbered "fresh start").
[4] *See id*. at § 29:13 (explaining once property is exempted under the Bankruptcy Code, it is immunized from creditors while outstanding debts are being discharged in bankruptcy).

debtor must choose which exemption scheme to assert.[5] However, a state may also elects to "opt out" of the federal exemption scheme. When a state opts out, it rescinds the federal exemptions as an option, such that debtors domiciled in that state can *only* invoke the state exemption laws.[6]

When a bankruptcy court must address precisely which exemption laws are available to a debtor, the plain text of section 522(b) typically provides a dispositive answer. According to section 522(b)(3), a debtor *must* be domiciled in a given state for a certain number of days *prior* to filing for bankruptcy in order for that state's exemption laws to apply. If the requirements of section 522(b)(3) are not met, then the state exemption laws are unavailable to and nonbinding upon a debtor, regardless of any opt out restrictions. And, where section 522(b)(3) renders the debtor ineligible for *any* state's exemptions, the federal exemptions will always be made available.

This Article, however, will discuss a notable "grey area" of section 522(b), which Bankruptcy Courts throughout the country have struggled to interpret uniformly. Specifically, this Article will analyze whether there is an "implied residency requirement" in section 522(b) that forbids a debtor who files for bankruptcy shortly after changing his or her state of residence, from invoking the state exemption laws of his or her former state. Part I will discuss section 522(b)(3) generally. Part II will examine the current court split as to whether section 522(b)(3) contains an implied residency requirement. Finally, Part III will analyze the issue more broadly, addressing the practical implications of court adopting each side of the court split.

I. Section 522(b)(3) of the Bankruptcy Code

As mentioned above, section 522 of the Bankruptcy Code permits a debtor to reclaim certain property from the bankruptcy estate by affirmatively asserting the federal exemptions.[7]

[5] *See id*. (clarifying that selection of federal exemption precludes assertion of state exemption, and vice versa. Assumption is that debtor will choose whichever exemption scheme is more favorable).
[6] *See id.*

However, that is not to say the federal exemptions provide the only recourse for a debtor seeking to regain certain property rights from the bankruptcy estate. The Bankruptcy Code also vests each state with the power to establish its own unique set of bankruptcy exemptions for the benefit of its residents. Under section 522(b)(1), where both federal and state exemptions are concurrently available, a debtor is then permitted to choose between the uniform federal exemptions and the exemption laws passed by his or her respective state.[8] Having such a choice can prove advantageous to the debtor, as he or she is entitled to exercise discretion in choosing the more favorable option.[9]

In practice, though, such a choice between federal or state exemption schemes is frequently unavailable to a debtor. This is primarily because a debtor's ability to invoke the uniform federal exemptions can be restricted by the state in which he or she resides. If a state elects to eliminate the availability of the federal exemption scheme within its jurisdiction—such that debtors may invoke only the exemption laws of that state—then that state has "opted out" of the federal exemptions.[10] Such behavior by the states in divesting debtors of the right to invoke the federal exemptions is authorized under the Bankruptcy Code.

In a similarly restrictive vein, a state exemption scheme may be unavailable to a debtor, under section 522(b)(3), if the debtor was not domiciled in that state for the requisite time period *prior* to filing for bankruptcy.[11] Specifically, section 522(b)(3) directs the court to determine "the place in which the debtor's domicile has been located for the 730 days immediately preceding date of filing of petition or, if debtor's domicile is not located in a single state for such

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[7] *See* 3A Bankr. Service L. Ed. § 29:13 (declaring once property is exempted under the Bankruptcy Code, it is immunized from creditors while outstanding debts are being discharged in bankruptcy).
[8] *See* 13-CaseHi Collier on Bankruptcy CH.01 (stating debtor cannot claim exemptions under both applicable state and federal exemptions in the same bankruptcy proceeding. Rather, debtor must choose one or the other option).
[9] 11 U.S.C. § 522(b)(1) (2006) (implying debtor has freedom to chose more advantageous option).
[10] *See* 12-Intro Collier on Bankruptcy Intro.02 (noting most states have, under section 522(b)(1), opted out of federal exemptions, such that debtors often have no choice but to invoke state exemptions).
[11] 11 U.S.C. § 522(b)(3) (2006).

730-day period, the place in which debtor's domicile was located for the 180 days immediately preceding that 730-day period . . ."[12]

Simply put, if a debtor files for bankruptcy in the state where he or she was domiciled continuously for the entire 730 days prior to filing, and that state is an opt out state, then the debtor will have to assert that state's exemption laws. If the debtor was domiciled outside the state for any portion of those 730 days, however, then the court will look to the debtor domicile during the 180-day period preceding the 730 days, and the analysis necessarily becomes more complicated. This is because section 522(b)(3) is ambiguous as to whether a debtor who resided in a state for the entire 180-day period, must also still be a current resident of the state at the time of filing in order to invoke that state's exemption laws.

Depending on the facts, then, it would appear that it is possible a debtor could be ineligible for *both* the federal and the state exemptions, such that the debtor is left with no exemption options.[13] Yet, the hanging paragraph attached to section 522(b)(3) provides that "[i]f the effect of the above domicile requirement is to render the debtor ineligible for [all] exemption[s,] . . . then the debtor may elect to exempt property under federal law."[14] This hanging paragraph was designed as a "catch-all" provision to ensure that a debtor rendered ineligible for all exemptions under section 522(b)(3), will still be able to claim the federal exemptions, even if the debtor is domiciled in an "opt out" state.[15] Thus, under section 522(b)(3), that the state (or states) where a debtor was domiciled during certain fixed time

[12] *See* 11 U.S.C. § 522(b)(3)(A) (2006) (referring to two key "windows" for determining if debtor has resided somewhere long enough to claim or be bound by a state's exemption laws, namely initial 730-day period immediately after filing the petition and 180-day period immediately before that).
[13] *See* 11 U.S.C. § 522(b)(3).
[14] *Id.*
[15] *See id*.

periods (i.e., the 730-day and the 180-day periods) will determine which exemption scheme will be available to the debtor.[16]

II. Bankruptcy Courts Have Split Regarding Whether Section 522(b) Contains an Implied Residency Requirement for the Purpose of Invoking State Exemption Laws

Congress enacted section 522(b)(3) primarily to remove the incentive for debtors to change their domicile immediately before filing for bankruptcy, in order to take advantage of their new state's more favorable exemption laws.[17] Yet, the plain language of section 522(b)(3) does not address which exemption scheme applies in circumstances in which (1) the debtor's domicile varied between states during the 730-day period preceding the filing of his petition, and (2) the debtor is domiciled in a different state on the petition filing date than he or she was domiciled in during the 180-day period.[18] In such cases, bankruptcy courts have split regarding which exemption scheme to apply.

A. The Majority of Bankruptcy Courts Determined Section 522(b)(3) Contains an Implied Residency Requirement

The majority of bankruptcy courts have held that a state exemption law is only available to a debtor who resided in that state on the date he or she filed his or her bankruptcy petition.[19] These courts interpret section 522(b)(3) as containing an "implied residency requirement," such that a non-resident is prohibited from claiming that his or her property is exempt under a state's exemption law, regardless of how long the debtor

[16] *See* 13-CaseHi Collier on Bankruptcy CH.01 (noting determinative relationship between state exemptions and debtor's domicile).
[17] *Id*. (preventing debtors from moving en masse to Florida, for example, and then declaring bankruptcy shortly thereafter, for the sole purpose of benefitting from its generous state exemption laws); *See also* 12-Intro Collier on Bankruptcy Intro.02 (explaining after passage of Bankruptcy Code in 1978, some states opting out of federal exemptions offered unusually generous exemption schemes, particularly the homestead exemption. This resulted in perception that debtors who had recently moved to these states were converting nonexempt assets to exempt assets in order to shield the assets from creditors. The clear intent of 2005 amendments, which included section 522(b)(3), was to prevent possible abuse of the bankruptcy process by making it much more difficult for debtors to take advantage of one state's more generous exemptions).
[18] *See In re* Willis, 495 B.R. 856 (noting Seventh Circuit has not yet ruled on this issue, district courts have not thus far been uniform in treatment of issue).
[19] *See In re* George, 440 B.R. 164, 168 (Bankr. E.D. Wis. 2010) (holding that since debtor was Wisconsin resident at time of filing, she was not eligible to take exemptions under Illinois law, nor bound by its opt out provision, regardless of how long she had lived in Illinois prior to switching domicile).

lived in that state prior to filing for bankruptcy.[20] Therefore, under the majority approach, a debtor who lived continuously in one state for the duration of the 180-day period, but moved out of that state during the subsequent 730-day period, is not entitled to invoke such state's exemption laws, unless the debtor returned and reestablished his or her domicile in that state prior to filing for bankruptcy.[21]

For example, in *In re Willis*, the bankruptcy court adopted the majority approach and its "implied residency requirement." There, the court held that under section 522(b)(3) a debtor must be domiciled in a given state at the time of filing a bankruptcy petition in order to access—or be bound by—that state's exemption laws.[22]

In *Willis*, rather than attempting to assert any state exemptions, the debtors claimed that certain property that they owned was exempt under the federal exemptions.[23] The debtors resided in two different states during the 730-day period immediately preceding the filing of their bankruptcy petitions; they lived in Illinois first, and then moved to Wisconsin.[24] Going back further, the debtors were domiciled solely in Illinois (an "opt out" state) during the 180 days prior to the aforementioned 730-day period.[25] The debtors, however, were domiciled in Wisconsin at the time they filed their petitions.

Due to the fact the debtors were residents of Wisconsin at the time of filing, the *Willis* court ruled that Illinois' exemption laws did not apply, notwithstanding all of the time the debtors had spent domiciled in Illinois prior to the petition date.[26] Since the debtors also had not been domiciled in Wisconsin for the requisite number of days prior to filing the petition, the court determined they also could not invoke the state exemption laws of their current residence,

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[20] *See Id*. at 169
[21] *See Id*.
[22] *See In re* Willis, 495 B.R. 856, 856 (Bankr. W.D. Wis. 2013) (finding debtors' residency for purposes of applying state exemption laws must be analyzed as it existed on bankruptcy petition date).
[23] *Id*. at 856-57 (admitting *Willis* is somewhat atypical because normally debtor is trying to gain advantage of state exemption laws, but here debtor was trying to escape the opt-out provisions of state in order to access federal exemptions. Majority of these types of cases will deal with debtor trying to gain eligibility for the more favorable exemption laws of a particular state. This factor does not affect the outcome or analysis though).
[24] *See id*. at 856.
[25] *Id*.
[26] *See id*.

even if they wished to.[27] Faced with no applicable state law exemptions, the *Willis* court held that the debtors were therefore necessarily entitled to claim the "safe harbor" of the federal exemptions.[28]

B. The Minority of Bankruptcy Courts Have Determined Section 522(b)(3) Does Not Contain an Implied Residency Requirement

Conversely, a minority of bankruptcy courts have determined there is no "implied residency requirement" inherent in section 522(b)(3). Rather, these courts hold that the debtor can always invoke the exemption laws promulgated by the state where he or she was domiciled throughout the 180-day period, regardless of whether that state was still the debtor's residence on the petition date.[29] Thus, under the minority approach, if a debtor was domiciled in a state for the entirety of the 180-day period, then he or she is entitled to that state's exemption laws (or in the case of "opt out" states" bound by that state's exemption laws), irrespective of whether the debtor had returned to that state as a domiciliary prior to filing for bankruptcy.[30]

For example, in *In re Garrett*, the bankruptcy court concluded that there is no implied residency requirement under section 522(b)(3).[31] The facts in *Garrett* were similar to those in *Willis*. Specifically, the debtors in *Garrett* were formerly domiciled in North Carolina for several years, before they ultimately moved and established their domicile in Texas. [32] When they filed their bankruptcy petition, the debtors had been domiciled in Texas for less than the requisite 730 days, and had been domiciled in North Carolina for the entire 180 days preceding

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[27] *See id*. at 857.
[28] *See id*. at 858 (explaining "hanging paragraph" or the "safe harbor" provision of Bankruptcy Code prevents debtor from being ineligible for both state or federal exemptions in same proceeding).
[29] *See In re* Shell, 478 B.R. 889, 901 (Bankr. N.D. Ind. 2012) rev'd and remanded sub nom. Shell v. Yoon, 499 B.R. 610 (N.D. Ind. 2013) (arguing contrary to opinions expressed in *Willis*, holding section 522(b)(3) "preempts any residency requirements," meaning a debtor who resided in an "opt out" state for the entire statutory defined 180-day period may be limited to that state's exemption laws, regardless of the debtor's current domicile"). *See also In re* Garrett, 435 B.R. 434, 436 (Bankr. S.D. Tex. 2010).
[30] *See id.*
[31] *Id.* at 437.
[32] *See id*. at 435-36.

the 730-day period. Thus, since the debtors prohibited from invoking the Texas exemption laws under section 522(b)(3), they instead claimed various exemption under the North Carolina exemption law.[33] Ultimately, the *Garrett* court permitted the debtors to invoke the North Carolina exemptions, ruling they satisfied the 180-day period prong of section 522(b)(3) even though they were domiciled in Texas on the date of filing their petition.[34]

III. Analyzing) and Discussing the Implications of the Current Split Among the Bankruptcy Courts

A fundamental aspect of the debate over whether section 522(b)(3) contains an implied residency requirement focuses on the statute's role in preventing forum shopping. As the Bankruptcy Courts uniformly attest, Congress' primary purpose in passing section 522(b)(3) was to prevent individual debtors from forum shopping.[35] In particular, Congress sought to close the "mansion loophole," whereby debtors would relocate to states that allowed them to shield virtually all equity in their homes from creditors.[36] Importantly, there are two types of forum shopping in bankruptcy: (1) "state-to-state" forum shopping, where a debtor changes his or her domicile in an effort to gain the advantage of another state's more favorable exemption laws, and (2) "state-to-federal" forum shopping, in which a debtor attempts to render the opt-out provisions of his or her state moot simply by moving out of that state, thus relying on the hanging paragraph in section 522(b)(3) to claim the federal exemptions.[37]

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[33] *See id*.
[34] *See id*. at 443.
[35] *See Drummond v. Urban (In re Urban),* 375 B.R. 882, 889 (B.A.P. 9th Cir.2007) (citing H.R.Rep. No. 109–31, pt. 1, at 15–16 (2005) (explaining that prior to section 522(b)(3), debtors were only required to spend more than 90 days domiciled in a state prior to filing for bankruptcy in order to invoke their new state's exemption laws). *See also In re* Bingham*,* No. 06–40990, 2008 WL 186277, at 5 (Bankr. D.Kan. Jan. 18, 2008) (noting changes to domicile requirements for exemptions were primarily, if not solely, intended to prevent debtors from forum-shopping to protect assets under certain states' more generous bankruptcy exemptions).
[36] *See In re Urban*, 375 B.R. at 889.
[37] *See In re Shell*, 478 B.R. at 893-94 (noting latter scenario is somewhat rare, due to fact state exemptions are generally more favorable than federal exemptions).

Both sides of the current split agree that the problem of state-to-state forum shopping was one of the abuses Congress intended to preclude through section 522(b)(3). However, state-to-state forum shopping is effectively thwarted regardless of whether a residency requirement is read into section 522(b)(3). This is because, under both the majority and minority views, a debtor cannot invoke the exemption laws of a state where he or she is newly domiciled until at least 730 days have passed since the debtor first established residency there.[38] Thus, the argument that Congress intended to preempt state-to-state forum shopping does not necessarily favor either interpretation of section 522(b)(3).

The courts adopting the minority position have concluded that Congress intended to curb state-to-federal forum shopping as well when it passed section 522(b)(3).[39] Therefore, these courts have reasoned that their interpretation of section 522(b)(3), which does not impose an implied-residency requirement, better prevents state-to-federal forum shopping because if a debtor who is domiciled in an opt out state during the 180-day period changes his or her domicile prior to filing, the debtor will still be unable to invoke the federal exemptions and will instead be restricted to asserting exemptions under the law of the state in which the debtor was domiciled during the 180-day period[40]

The courts in the majority, meanwhile, counter that Congress did not intend for section 522(b)(3) to curtail state-to-federal forum shopping.[41] In reaching this conclusion, the courts have found that Congress intended the federal exemptions to serve as the "baseline" for exemptions. Thus, these courts hold that even though the residency requirement enables more debtors to escape opt-out states and invoke the federal exemptions, the "presumption of

[38] *See In re Urban*, 375 B.R. at 889.
[39] *See In re Shell*, 478 B.R. at 894.
[40] *Id*. (according to the court, such a gambit can be used to manipulate the "hanging paragraph" of section 522(b)(3) so as to gain eligibility for the federal exemptions.).
[41] *See In re Willis*, 495 B.R. at 859.

uniformity" means that state-to-federal forum shopping is encouraged in bankruptcy.[42] An implied residency requirement effectively promotes uniformity, because then the federal exemptions will apply regardless of where the debtor was domiciled during the 180-day period.

It is important to remember that most debtors will not satisfy the implied residency requirement under the majority approach.[43] Indeed, in order to satisfy the implied residency requirement, a debtor must have: (1) resided in state "X" for the majority of the preceding 180-day period, then (2) left state "X" at some point during the subsequent 730-day period to establish residency elsewhere, then (3) returned to reestablish residency in state "X" within that same 730-day period, and (4) finally filed for bankruptcy in state "X." Thus, when an implied residency requirement is read into section 522(b)(3), the 180-day window prong becomes very nearly a moot point of consideration in these residency exemption cases.[44]

However, an issue that appears to bubble beneath the surface of the majority holdings is that some states expressly confine the applicability of their exemptions to property located *within* that state. Indeed, most courts, upon considering this key underlying issue concerning the extraterritorial effect given to state exemptions, have held that while states alone may not apply their exemption laws outside their borders, in the bankruptcy context it is the federal government giving the laws extraterritorial effect.[45] As a result, it is permissible to apply state exemption laws to out-of-state property, but only to the extent that the states, through their laws, *elect* to allow for it.[46]

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[42] *See id. (*explaining any policy arguments in favor of considering debtor's residency as of the 180-day period, are trumped by the presumption of uniformity. The Bankruptcy Clause of the United States Constitution grants Congress the authority to "establish ... uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const. art. I, § 8, cl. 4. This creates a presumption that the federal exemptions should always be available, since they promote uniform treatment of debtors).
[43] *See In re Shell*, 478 B.R. at 897.
[44] *See id*.
[45] *See In re* Fernandez, EP-11-CV-123-KC, 2011 WL 3423373 (W.D. Tex. Aug. 5, 2011).
[46] *Id*.

Thus, the minority interpretation of section 522(b)(3), which allows a debtor to invoke the state exemptions laws of a jurisdiction where he or she is no longer domiciled, could create a serious problem if the debtor tried to apply these state exemptions to property, such as the debtor's home, located outside that state. The courts supporting the majority opinion argue that oversight represents a serious flaw in the minority's treatment of section 522(b)(3), since debtors could invoke the exemption laws of their former state of residence, only to realize they no longer have property located in that state. Such a situation could potentially result in the crippling reality a debtor bound by the opt-out provisions of a former state of domicile, which do not extend to the debtor's out-of-state homestead.[47]

Finally, attorneys advising clients who have changed domiciles within the last two years should be aware of the risk that a bankruptcy court in their jurisdiction could choose to either enforce the "opt out" provisions of a state where the potential debtor is no longer domiciled, or else enforce the federal exemptions. This is critical because the differences between the federal and state exemption schemes can be significant in determining whether a debtor should even file for bankruptcy in the first place. For example, the federal homestead exemption is currently $22,975 when adjusted for inflation.[48] However, other states such as Florida permit the majority of debtors to invoke an unlimited homestead exemption.[49] Therefore, a debtor with a home valued significantly above $22,975 vastly prefer to invoke Florida's state exemptions in bankruptcy, as opposed to the federal exemptions, and his or her ability or inability to do so under section 522(b)(3) would have a large influence on the advisability of filing for bankruptcy at all.

[47] *See Id.*
[48] 11 U.S.C. § 522(d)(1).
[49] Fla. Const. art. X, § 4(a)(1).

Conclusion

Thus, there is still an open question in the Bankruptcy Courts as to whether section 522(b)(3) contains an implied residency requirement. The majority of courts have held there is an implied residency requirement written into section 522(b)(3), such that a debtor must be domiciled in a state on the bankruptcy petition date in order to invoke that state's exemption laws or be bound by that state's opt-out provisions. However, a minority of courts have held there is no residency requirement implicitly included in section 522(b)(3), which means a debtor who satisfies the 180-day prong can invoke or be bound by the exemption laws of the debtor's former domicile, despite the fact the debtor did not reside there on the date he or she filed for bankruptcy.

The courts adopting the majority approach primarily argue that the "presumption of uniformity," combined with the risk of a state's exemption laws having no extraterritorial reach, both cut against the minority approach to interpreting section 422(b)(3). The courts in the minority, meanwhile, counter by noting that the absence of a residency requirement helps to eliminate federal forum shopping and prevents the 180-day prong of section 522(b)(3) from being rendered "superfluous," thus better effectuating Congressional intent. Since either argument can and has carried the day in various Bankruptcy Courts, debtors and their attorneys ought to be aware of the courts' varied treatment of this "grey area" of section 522(b)(3), particularly because the availability of certain state or federal exemptions can dictate whether a debtor should even file for bankruptcy.