

# Administration of Justice Memorandum

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## HOUSEHOLD FINANCE VS. ELLIS: **NEW RULES FOR EXEMPTIONS FROM JUDGMENTS**

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This memorandum discusses a recent appellate court decision, Household Finance Corp. v. Ellis, 107 N.C. App. 262 (1992), *aff'd per curiam*, 333 N.C. 785 (1993), that interprets the North Carolina statutes providing exemptions from judgments. The decision will have an impact on the procedure followed by clerks in issuing writs of execution and by sheriffs in serving them.

The facts in Household Finance were as follows: Household Finance Corporation obtained a judgment against Ellis. Ellis was served with a notice of rights to designate exemptions and failed to respond within the 20-day period required by the statute. Two executions were issued within the next year but were returned because the plaintiff and defendant entered into an agreement allowing the defendant to make payments. Soon after the second execution was recalled, Ellis filed a motion to claim exempt property, and shortly thereafter stopped making payments under the agreement. Two more executions were issued without the issuance of new notices of rights; one was returned for failure to locate property and the other returned with a notation that defendant was avoiding service. At this point Ellis filed a motion to relieve him of his waiver of exemptions. The district court held that Ellis had waived his right to exemptions by failing to claim them within 20 days of notice and that he had failed to show the grounds of mistake, surprise or excusable neglect required to relieve him of the waiver.

The opinion deals with two major waiver questions. First, does a waiver by not responding to a notice of rights last for the life of the judgment? Second, may a debtor waive his constitutional exemptions by not responding within 20 days to a notice of rights?

### History of Exemptions

The North Carolina Constitution provides that every homestead, to a value fixed by the General Assembly, but not less than \$1,000 and personal property of resident to a value fixed by the General Assembly but not less than \$500 is exempt from sale under execution or other final

process of any court, issued for the collection of any debt.<sup>1</sup> For over 100 years, that constitutional provision had been implemented with a set of statutes<sup>2</sup> that provided for a \$1,000 homestead exemption and \$500 personal property exemption. The statutory procedure for granting the exemptions differed between the homestead and personal property exemptions. Under the statutory scheme the debtor (who qualified) was entitled to the exemption as a matter of right and needed not claim it. The sheriff had to set off the homestead before levying on real property.<sup>3</sup> Three appraisers were called to lay off \$1,000 of the real property. The sheriff would then levy on and sell the remainder of the real property. For personal property, the sheriff levied on the property and then the debtor has the right to request that his exemptions be designated. Upon request, the sheriff summoned three appraisers who set aside \$500 of the property. The sheriff would then proceed to sell the remaining items. In 1981, the General Assembly totally rewrote the law on exemptions, enacting Art. 16 of G.S. Ch. 1C. The new statutory scheme provided for larger and a greater number of exemptions-- \$10,000 in residence; \$3,500 catch all for those who don't claim a residence; \$1,500 in one automobile; \$3,500, plus an additional \$750 per dependent up to four dependents, in household furnishings, wearing apparel, appliances, books, animals, crops or musical instruments; \$750 in tools of the trade; and professionally prescribed health aids for the debtor or his dependent. The new statute provides that a debtor may elect to take his constitutional exemptions of \$1,000 in value in the homestead and \$500 in value in personal property rather than the new statutory exemptions. A new procedure for setting aside exemptions was enacted. Under the new law before an execution is issued to the sheriff, the creditor must have served on the debtor a notice of his right to have exemptions designated and a form to be completed by the debtor to claim exemptions. The debtor who wishes to claim exemptions must file this form with the clerk within 20 days after the notice was served on him. If the creditor objects to the exemptions claimed by the debtor, the creditor may have the matter heard by a district court judge. If the creditor files no objection, the clerk issues an order designating the property claimed by the debtor as exempt. Then the clerk issues an execution ordering the sheriff to levy on and sell any property of the debtor that is not exempt. Once exemptions are designated, they may be modified by motion of anyone interested upon a change of circumstances. The statute provides that the debtor waives his exemptions by failing to assert the exemption after notice to do so. This waiver may be set aside on grounds of mistake, surprise or excusable neglect.

### Statutory Exemptions

G.S. 1C-1603(a)(4) provides that "after judgment, except . . . when exemptions have already been designated, the clerk may not issue an execution unless notice from the court has been served on the judgment debtor advising him of his rights." G.S. 1C-1601(c)(3) provides that failure to assert the exemption after notice to do so pursuant to G.S. 1C-1603 results in a waiver of a debtor's right to exemptions.

These statutes are subject to two interpretations on the length of the life of a waiver by not responding to a notice of rights, and the practice across the state has differed. Some clerks have read the statutes to mean that the waiver is good only for the issuance of the first execution after

<sup>1</sup> N.C. Const. art. X, § 1, 2.

<sup>2</sup> G.S. 1-369 through -392 (repealed by Session Laws 1981).

<sup>3</sup> Stokes v. Smith, 246 N.C. 694 (1957); William v. Johnson, 230 N.C. 338 (1949).

the notice is served. A subsequent execution must be preceded by service of a new notice of rights. Most clerks, however, have taken the position that the clerk and district court judge took in Household Finance. Once a notice of rights has been sent to the debtor and that debtor has failed to respond within the 20-day period, the debtor has waived his right to file exemptions for the life of that judgment.

**If a judgment debtor fails to respond to a notice of rights is that waiver good for the life of the judgment?** The court disagreed with the district court judge. One clear holding of Household Finance is that when a judgment debtor waives his right to exemptions by failing to file a motion to claim exemptions in response to a notice of rights to claim exemptions, the waiver applies only for the execution that follows that notice. Before a clerk may issue a second or subsequent execution, a judgment creditor must serve a new notice of rights to claim exemptions upon the debtor. Thus, those clerks treating a waiver as good for the life of the judgment must change their practice and must require the creditor to issue a new notice of rights before each subsequent execution is issued.

**What happens if the debtor has exemptions designated?** Suppose the judgment debtor responds to a notice of rights by filing a motion to claim exemptions; the clerk issues an order designating exemptions; execution is issued and returned unsatisfied; and six months later the creditor seeks to have another execution issued. Must the creditor serve a new notice of rights on the debtor before the clerk may issue the second execution? On this issue, the decision is not clear. In the opinion, the court uses very broad language. The court states the question in the case as "whether a Notice to Designate Exemptions is required before each execution is issued." And the court's final conclusion is: "We therefore hold that the statute requires that no execution be issued until a Notice to Designate Exemptions has been served and any waiver applies only to the particular execution issued."<sup>4</sup> If read literally, the court held that every execution must be preceded by a notice of rights, no matter whether exemptions have or have not been set aside in that judgment in the past. That is apparently the reading given the case by the Bankruptcy Court of the Eastern District of North Carolina.<sup>5</sup>

However, another reading of the language is to look at it in the context of the facts of the case and the court's analysis. The second phrase of the sentence quoted above places the statement in the context of a waiver. The factual situation with which the court dealt was a waiver. And the court was interpreting the statutes to determine whether a waiver is permanent. If the court had intended to deal with the issue of issuing subsequent executions after an order designating exemptions has been entered, it would have had to deal with the clear language in G.S. 1C-1603(a)(4), which excepts from the general requirement of issuance of a notice of rights before execution is issued cases in which exemptions have already been designated. That language, as well as G.S. 1C-1603(g), which sets out a procedure for modifying exemptions, would be meaningless if the court's decision is read to apply to cases in which the exemptions are designated. The court in Household Finance never discussed the exception in G.S. 1C-1603 nor

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<sup>4</sup> Household Finance Corp. v. Ellis, 107 N.C. App. at 267.

<sup>5</sup> In re Pinner, 146 Bankr. 659 (1992). The facts of the case are not set out clearly in the opinion, but it seems as if the debtor claimed his exemptions in a state judgment enforcement proceeding leaving some of his property not exempt. In the bankruptcy proceeding the judge allowed the debtor to claim the nonexempt property, treating it like a waiver as to that property.

the statute allowing modification of exemptions. If this second possible reading of the case is followed, the holding would be limited to waivers and once an order designating exempt property was issued, it would apply to all subsequent executions of that judgment.

In my opinion, the better reading of Household Finance is that it does not apply to the situation where exemptions have been designated. In that instance, a judgment debtor is not foreclosed from changing his exemptions if he acquires new property or the value of the exempt property substantially changes. The judgment debtor need only file a motion to modify exemptions, and the clerk should modify the exemptions on a showing of change of circumstances. Clerks may disagree with my reading of this case and adhere to the first possible interpretation of the decision.

**What must the clerk do about executions that are currently in the hands of the sheriff, but were issued without requiring the subsequent notice of rights to be issued as required by Household Finance?** Must the clerk recall those executions and require the creditor to issue a notice of rights before issuing another execution? I can find no case law that answers the question regarding the effect of Household Finance on other judgments. The court did not indicate it was making new law, but rather interpreted the meaning of existing law. So, in effect, its decision applies to all outstanding executions because the court was stating what the law has always been. The outstanding executions are not void, but merely voidable, which means that a court would not set aside a sale that has already taken place.<sup>6</sup> It is also clear that a debtor could file a motion in the cause before the clerk to have the clerk recall the execution.<sup>7</sup> And upon the filing of the motion, the clerk would have to recall the execution since no notice of rights was issued. It also seems to me that the clerk may recall the executions on his or her own motion. Issuance of executions is a procedural act, not a judicial function, and the clerk may correct errors in procedure.

**What if a substantial period of time elapses between the time the creditor sends the notice of rights and seeks the issuance of the execution?** In Household Finance the court did not need to deal with the issue of how long a judgment creditor may wait after a waiver to have an execution issued. The notice of rights was issued on February 27, 1989 and the first execution on March 28 of that year. However, creditors are not always so diligent in following up the notice of rights with an execution. What should the clerk do if the creditor waits one year after issuing the notice of rights to ask to have the execution issued? One possibility is to ignore the length of time and issue the execution because it next follows the service of the notice of rights. However, the reasoning of the court in determining that the waiver was good only for the ensuing execution was based on the flexibility in adjusting exemption allotments to enable the debtor to take full advantage of his exemption rights.<sup>8</sup> The court noted that the exemption statute must be read liberally to give exemptions to the debtor. "[T]he allotment should be made from time to time, and as often as the debtor might be pressed with executions; the policy being to enable the debtor not only to have the exemptions allotted to him once, but to keep them about him all the time, for the comfort and support of himself and family."<sup>9</sup> The debtor could not take full

<sup>6</sup> See *McKeithen v. Blue*, 149 N.C. 95 (1908); *Hickory White Trucks, Inc. v. Greene*, 34 N.C. App. 279 (1977).

<sup>7</sup> *Cornelius v. Albertson*, 244 N.C. 265 (1956); *Davis v. Federal Land Bank of Columbia*, 217 N.C. 145 (1940).

<sup>8</sup> *Household Finance* at 266, 267.

<sup>9</sup> *Comm'r of Banks v. Yelverton*, 204 N.C. 441, 447, 168 S.E.2d 505, 508 (1933).

advantage of his exemption rights when he chooses to waive his right to exemptions because he has no property today and then the execution is issued one year later when he has acquired property. And a policy of allowing the creditor to wait a substantial length of time after issuing the notice of rights before issuing an execution might encourage a creditor to circumvent the policy underlying the opinion. The problem with saying that a new notice of rights must be issued if a substantial amount of time has elapsed since the first notice was served is determining what is a substantial amount of time. Is waiting 90 days okay; what about 180 days? When has the creditor waited so long that there is no longer a nexus between the service of the notice of rights and the issuance of the execution. Clerks may wish to adopt some policy regarding this issue or may choose to wait for the General Assembly to address it.

**Should the sheriff return an execution if it is marked "levy on any property" and the sheriff believes the clerk is relying on a waiver from a previous execution?** Generally, a sheriff may rely on the clerk's order if it is valid on its face. In most instances, therefore, a sheriff should not look behind the order. However, if it is clear from the face of the execution that the clerk is relying on an earlier waiver, the sheriff may refuse to serve it and return it to the clerk. For example, the sheriff receives an execution issued on July 5, 1993 ordering the sheriff to levy on any of defendant's property. Attached to the execution is an order signed by the clerk stating that the debtor waived his right to exemptions on June, 1992 by not responding to a notice of rights. In that situation, the order itself indicates that the clerk has not complied with Household Finance. The sheriff should return the execution so that a new notice of rights can be served on the debtor.

**Does Household Finance increase the chance of a sheriff being sued?** Sheriffs who give debtors a substantial time to pay or work out arrangements and do not levy on property that may be available to be seized might subject themselves to a greater chance of having their bonds amerced than they would have before this decision. Assume the following fact situation: The judgment debtor waives his right to exemptions by not responding to the notice of rights, and the clerk issues an execution ordering the sheriff to levy on any property of the debtor. The sheriff has a backlog of papers to serve and waits about 30 days before trying to collect the money. After contacting the debtor, the sheriff waits 40 days for the defendant to pay. After 70 days, the sheriff checks with the Division of Motor Vehicles and discovers the defendant owns a 1989 Ford Taurus with no liens on it. Suddenly on the 90th day, the sheriff realizes that the writ of execution is about to expire, and he has not levied on property that is available. Under the former procedure in counties where the clerk treated the waiver as good for the life of the judgment, the creditor could ask for a new execution to be issued, and the sheriff could then levy on the Ford Taurus. Now, the creditor must serve a new notice of rights and it is possible for the debtor to claim the Ford Taurus as exempt from the second execution. If that were to happen a creditor might be more likely to want to turn against the sheriff if the sheriff failed to exercise due diligence in carrying out the first execution.

#### Claiming Constitutional Exemptions

The second part of the opinion deals with the issue of waiver of the constitutional exemptions. G.S. 1C-1602 provides that the debtor may elect to take the personal property and

homestead exemptions provided in the North Carolina Constitution rather than the statutory exemptions. The constitutional exemptions are \$1000 in real property owned and occupied by the debtor and \$500 in personal property.<sup>10</sup> That statute specifies that if the debtor asks for the constitutional exemptions, the clerk (or district court judge) must designate the property to be exempt.<sup>11</sup> G.S. 1C-1601(c) provides that the debtor waives both the statutory and the constitutional exemptions if the debtor fails to assert exemptions within 20 days after a notice to do so. In Household Finance, the court held that G.S. 1C-1601(c) is unconstitutional in so far as it provides that a debtor waives the constitutional exemptions by failing to respond to a notice to claim exemptions within 20 days after being served with a notice of rights. The debtor may claim the constitutional exemptions anytime "until the moment the money from the sale is applied to the debt to be paid."<sup>12</sup> Thus, the debtor may come to the clerk and seek to have the constitutional exemptions set aside in the proceeds from the sale. The debtor's right to claim the constitutional exemptions die only at the point at which the proceeds have been given to the creditor.

**Is a debtor entitled to constitutional exemptions if he has been given his statutory exemptions?** If the debtor has had statutory exemptions designated, he is not entitled to constitutional exemptions also. If a clerk has issued an execution ordering the sheriff to levy on non-exempt property, the sheriff may levy on and sell any of defendant's property that is not listed as exempt.

**What should a sheriff do if, while attempting to serve an execution, the debtor asks for his constitutional exemptions?** G.S. 1C-1602 provides that the clerk or district judge designates constitutional exemptions as well as statutory exemptions. Therefore, if a debtor who is entitled to exemptions asks the sheriff for them, the sheriff should tell the debtor to see his attorney, if he is represented, or to go to the clerk to claim the exemptions. In most instances, the sheriff probably should not levy on any property at that point, but should wait for further notice from the clerk. However, if the 90-day period on the execution is near expiration, the sheriff should levy on the personal property, but not sell it until further notice from the clerk. (See the discussion below.)

**What if the sheriff has already levied on property under an execution when the debtor asks for his constitutional exemptions?** If the sheriff has already levied on property when the debtor asks for his constitutional exemptions, I believe the sheriff should hold the

<sup>10</sup> G.S. 1C-1602 specifies that the constitutional exemptions are in value. In other words, if the property is worth more than the exemption, the clerk may order the sheriff to sell the property, giving the exemption amount to the debtor and the excess to be used to satisfy the judgment.

<sup>11</sup> G.S. 1C- 1602

<sup>12</sup> Household Finance at 269. In reaching this conclusion, the court indicated that it was merely applying well-settled law and emphasized that the constitution provides that exemptions may be claimed until execution or "other final process" is issued. The court cited several cases to indicate that other process meant the debtor could claim the exemption after sale by the sheriff. The cases the court cites are attachment cases where the property was seized under an attachment, sold before judgment because the value would deteriorate, and then once judgment was issued exemptions were claimed in the proceeds. Obviously, in those cases there was no right to claim exemptions when the property was seized because at that point there was no judgment against the defendant. The right to the proceeds is not determined until judgment is entered, and at that point exemptions may be claimed. In my opinion, the "other process" language in the constitution deals with the attachment situation where the property is not seized under an execution. In no earlier case where a judgment was entered and execution issued has the judgment debtor been allowed to claim his exemption after sale of the property by the sheriff.

property until the clerk directs him to return it to the debtor or go forward with the sale. The policy of the exemptions is to protect the debtor "from loss of the property due to sale under final process for the collection of any debt."<sup>13</sup> As long as the sheriff does not sell the property, he is not violating the underlying policy of the exemptions. On the other hand, if the sheriff were to release property already seized; if that property were not designated as exempt; and if it were then not available for sale, the creditor has been damaged. Holding the property until exemptions have been designated would be consistent with the practice under the former law where property was levied on and then personal property exemptions were designated.

**Should the sheriff return the execution when the debtor asks for his constitutional exemptions?** The sheriff should not return the execution when the debtor asks for constitutional exemptions. Under the first part of the decision in Household Finance, if the sheriff returns the execution, no new execution may be issued without a new notice of rights being served. Under that procedure, a debtor who waived under the original execution, merely by asking for his constitutional exemptions would be allowed to then get his statutory exemptions when the new notice of rights were served. That would make the statutory waiver provisions meaningless. The sheriff should hold the execution and wait for a supplemental order from the clerk.

**How long should the sheriff wait after the debtor has asked for exemptions before proceeding with the execution?** Another practical problem with which sheriffs must deal is the situation where a debtor tells the sheriff he wants his exemptions but does not follow through by going to the clerk to claim the exemptions. If the sheriff does nothing and the execution runs out without levying on property, no new execution may be issued without a new notice of rights being issued. The creditor would have lost his chance of having property levied on and sold. Sheriffs should continue with the execution if the debtor does not follow through within a reasonable period of time. Sheriffs will have to determine what is a reasonable time, but it seems to me that ten days to two weeks would be sufficient time for a debtor to proceed. If a sheriff has stopped proceeding under an execution because the debtor asked for constitutional exemptions, ten days or two weeks after the debtor's request, the sheriff should check with the clerk to determine if exemptions are in the process of being designated. If they are not, the sheriff should be able to go forward with the execution, levy on property (if it has not already been levied on) and sell it. Since the debtor may claim constitutional exemptions until the proceeds from sale have been distributed to the plaintiff, the debtor's right to exemptions would not be cut off if the sheriff proceeds with the execution.

**If the debtor is granted constitutional exemptions in property on which the sheriff has already levied and incurred expenses, who is responsible for paying the expenses?** G.S. 7A-311(b) provides that when fees for civil process are not paid in advance, "a lien shall exist in favor of the county on all property of the party owing the fee. If the fee remains unpaid, it shall be entered as a judgment against the debtor and shall be docketed in the judgment docket book in the office of the clerk of court." Under this statute, the debtor would be responsible for the expenses incurred by the sheriff. The sheriff properly levied on the property under the execution;

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<sup>13</sup>Montford v. Grohman, 36 N.C. App. 733, 736 (1978) (cited in Household Finance).

only after levy did the debtor claim his exemptions. The debtor is charged with the costs of enforcing the judgment.

**What procedure does the clerk follow in setting aside the constitutional exemptions?**

G.S. 1-1602 specifies that if the debtor elects to take his constitutional exemptions, the clerk or district court judge must designate the property to be exempt under the procedure set out in G.S. 1C-1603. The debtor may claim exemptions (1) by filing with the clerk a motion to designate constitutional exemptions, specifying the property he wishes to claim as exempt and its value, and serving a copy on the judgment creditor or (2) by filing a motion that he wishes to designate exemptions, in which case the clerk schedules a hearing at which the debtor claims his exemptions, giving notice to both the creditor and the debtor. Perhaps, the easiest procedure would be to have a form motion to claim constitutional exemptions, and when a debtor appears and asks for exemptions, give him the form to complete, and have him mail a copy to the judgment creditor. Once, the debtor claims his constitutional exemptions, the creditor has 10 days from the date served with the exemptions to file an objection with the clerk. If he objects, the clerk places the motion for hearing by the district court judge at the next civil session. If the creditor does not object, the clerk enters an order designating the property allowed by law and claimed by the debtor as exempt. At that point, the clerk should send a copy of the order designating the exemptions to the sheriff holding an execution and direct him to proceed to carry out the execution except as to the exempt property.

**What property is the debtor allowed to claim under the constitutional exemptions?**

The debtor is allowed to have \$1,000 in value in real property owned and occupied by him. The statutory procedure under the old law to actually set off a portion of the property to be left to the debtor was abandoned by G.S. 1C-1602. It provides that the exemption is in value, which means that if the debtor's equity interest in the property is more than \$1,000, the property may be sold with the excess given to the creditor. The North Carolina cases interpreting the constitutional language "owned and occupied" have held that the debtor is not required to select the land on which his dwelling sits. If the defendant does not own a dwelling, he may take his homestead in land that he does own.<sup>14</sup> He may take the exemption in unmortgaged nonresidential property rather than heavily mortgaged land containing his residence.<sup>15</sup> What is not absolutely clear is whether the debtor may choose to take the homestead in land other than the residence when the residence is free from mortgages. The safest course is for the clerk to allow the debtor to claim his real property exemption in any real property he chooses.

The debtor is allowed \$500 in value in his personal property. The debtor may select any of his personal property to be exempt. If the property he selects is worth more than \$1,000 (after any liens), the clerk may order it sold for the excess value. The debtor is not entitled to take a partial allotment in several items of personal property each worth more than \$500. For example, he cannot claim \$250 in a motor vehicle with a value of \$5,000 and \$250 in a boat with a value of \$2,000.

**How can the creditor reach property set aside as exempt that has excess value?** If the property in which the debtor claims his constitutional exemptions has excess value (the fair

<sup>14</sup> *Equitable Life Assurance Society v. Russos*, 210 N.C. 121 (1936); *Allen v. Shields*, 72 N.C. 504 (1875).

<sup>15</sup> *Flora v. Robbins*, 93 N.C. 38 (1855).



market value, less liens superior to the judgment lien, is more than the exemption amount), G.S. 1C-1602 provides that the clerk, in an execution, may order the sale of the property with the exemption amount being distributed to the debtor and the excess to be distributed as ordered. When there is excess value in the property claimed under the constitutional exemptions, the clerk may issue an order to the sheriff to sell the exempt property. The order should direct the sheriff to begin the sale at the exemption amount, give the debtor his exemption amount and apply the remainder of the proceeds to the satisfaction of the judgment.

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