Entrepreneur & Innovation Exchange
Published online at EIX.org on November 09 2022
DOI: 10.32617/809-636bfcc8d0997

Be Careful When Using Home Equity to Finance a Business

Dwight Kealy (New Mexico State University)

KEYWORDS: Finance, Entrepreneurial finance.

With home equity at record levels, many are discussing the benefits and dangers of using home equity as a source of small business capital. But nobody is talking about how state foreclosure and bankruptcy laws can complicate the process, or put your personal assets in jeopardy if your venture fails. Some states protect homeowners from having to pay back loans borrowed against a personal residence; others do not. While a handful of states protect all of the equity in a home in the event a homeowner files for bankruptcy, the rest don't.

The upshot: *where* you live may determine *how* you live if your business goes bust: whether you keep or lose your home...or even worse, end up both homeless and in debt.

This article compares state foreclosure and bankruptcy laws to show which states are the most and least friendly toward entrepreneurs seeking to use home equity as a source of capital.

U.S. Census Bureau data shows that 7.3% of all businesses in the U.S. used home equity as a source of capital to start a business. The percentage was even higher in categories such as "Accommodation and food services" (10.3%) and "Other services" (9.8%).[1] Home equity is an appealing source of startup capital because it can be accessed without the detailed business plan, history, or credit scores often required by traditional business loan lenders. Instead, it requires home equity -- and U.S. homeowners are sitting on a record amount of it.[2]

This article places states into the following three groups according to how their laws treat home equity:

Group 1: States Favorable to Home Equity Access

Group 2: States Favorable to Home Equity Protection, and

Group 3: States that Balance Home Equity Access and Protection.

Group 1: States Favorable to Accessing Home Equity

Alaska, Arizona, California, Minnesota, Montana, North Dakota, Oregon, Washington

Entrepreneurs who need capital with home equity in one of the above states should consider taking out as much equity as possible from their personal residence. This is because these states often forbid deficiency judgments (Rafter, 2021). My article on this topic defines it this way:

"A deficiency judgment is an order from a court requiring a borrower to pay any debt still remaining after the collateral property is sold to pay off the debt. For example, imagine someone borrows $1 million to purchase a $1 million home, and the home drops in value from $1 million to $600,000. [Generally speaking], if the borrower stops making payments on the mortgage, the lender could foreclose on the home, selling it for $600,000. The lender could then seek a deficiency judgment ordering the borrower to pay the remaining $400,000 still owed on the home loan" (Kealy, 2022).

However, this is not the case in the states listed in Group 1, where deficiency judgments on primary residences are not allowed. In these states, the most the lender would be able to recover on the loan would be the home's sale price of $600,000. The borrower would not be responsible for the $400,000 still owed on the home loan."

GROUP 2: States Favorable to Home Equity Protection

Arkansas, Florida, Iowa, Kansas, Oklahoma, South Dakota, Texas

Entrepreneurs with home equity in one of these seven states should consider keeping as much equity as possible in their primary residence. This is because these states have an unlimited bankruptcy homestead exemption.

Entrepreneurs, by nature, take risks and sometimes need to be reminded that 45 percent of new businesses fail within their first five years (Table 7). In the event of a business failure, an entrepreneur who qualifies for a chapter 7 bankruptcy can surrender all *non-exempt* assets to creditors in exchange for a fresh start free from "the obligations and responsibilities consequent upon business misfortunes" (*Local Loan Co. v. Hunt*).

What a fresh start looks like can vary greatly by state. Pennsylvania protects only $300 in home equity from creditors. Similarly, Kentucky and Tennessee only protect $5,000. But in the seven states in Group 2, all of the equity in a primary residence may be protected from creditors.

Imagine four entrepreneurs filing for bankruptcy in four different states, each having $1 million in equity in their primary residence, but with overall liabilities in excess of their assets. In the states listed in Group 2 (Arkansas, Florida, Iowa, Kansas, Oklahoma, South Dakota, and Texas) entrepreneurs could exit bankruptcy with a fresh start that includes keeping all of the $1 million in their primary residence's home equity. Unlike the states in Group 2, entrepreneurs in Pennsylvania would only be able to keep the first $300 in equity. Entrepreneurs in Kentucky and Tennessee would be able to keep the first $5,000. Any amount greater than this would be available to pay creditors except for entrepreneurs in the states of Group 2 where all of the equity in the entrepreneur's primary residence is protected from creditors.

Group 3: States that Balance Home Equity Access and Protection

(Includes all 35 other states not mentioned above)

The 35 states in this group allow deficiency judgments and do not have an unlimited bankruptcy homestead exemption. Unlike the states in Group 1, states in Group 3 allow creditors to pursue deficiency judgments against borrowers who still owe money after a foreclosure sale. If an entrepreneur in these states borrows $1 million to purchase a $1 million home that drops in value to $600,000 and then stops making payments, the lender could sell the home for $600,000 and seek a deficiency judgment against the entrepreneur for the remaining $400,000. With this in mind, entrepreneurs in Group 3 may want to maintain more equity in a primary residence than those in Group 1, because a foreclosure with negative equity in the states of Group 3 could result in a default judgment ordering borrowers to pay for loans on homes they no longer own.

However, entrepreneurs in Group 3 should also realize that, unlike the states in Group 2 that have an unlimited bankruptcy exemption, any home equity above a Group 3 state's home exemption limit is at risk of collection from creditors in a chapter 7 bankruptcy (see chart below for details). For example, New York allows deficiency judgments and has a homestead exemption of $179,975. Imagine an entrepreneur in New York purchases or refinances a home to achieve a $1 million mortgage on a $1 million home that then drops in value to $600,000. The entrepreneur then encounters "business misfortunes" making it impossible to make the monthly mortgage payments. In response, the lender could sell the home in a foreclosure sale for $600,000 and seek a deficiency judgment against the entrepreneur for the remaining $400,000.

To avoid the above situation, imagine the New York entrepreneur decides to borrow $600,000 for the purchase of a $1 million home. The entrepreneur then encounters "business misfortunes" that make it impossible for the entrepreneur to make payments for the home loan and other liabilities totaling over $1 million. The home loan lender could be made whole in a foreclosure sale that brings in at least $600,000. But what happens to the $400,000 in equity if the home sells for $1 million? Only $179,975 in home equity is exempt from creditors in a New York chapter 7 bankruptcy. The remaining $220,025 is available for creditors.

Group 3	**Bankruptcy Homestead Exemption Amount**
Pennsylvania	$ 300
Kentucky	$ 5,000
Tennessee	$ 5,000
Illinois	$ 15,000
Missouri	$ 15,000
Alabama	$ 16,450
Indiana	$ 19,300
Wyoming	$ 20,000
Georgia	$ 21,500
West Virginia	$ 25,000

EIX.org (2022)
DOI: 10.32617/809-636bfcc8d0997

Maryland	$	25,150
New Jersey	$	25,150
Hawaii	$	30,000
Virginia	$	30,000
Louisiana	$	35,000
North Carolina	$	35,000
Michigan	$	40,475
Utah	$	42,700
Maine	$	47,500
Nebraska	$	60,000
New Mexico	$	60,000
South Carolina	$	60,975
Colorado	$	75,000
Connecticut	$	75,000
Mississippi	$	75,000
Wisconsin	$	75,000
New Hampshire	$	120,000
Delaware	$	125,000
Vermont	$	125,000
Ohio	$	145,425
Idaho	$	175,000
New York	$	179,975
Massachusetts	$	500,000
Rhode Island	$	500,000
Nevada	$	550,000

ILLUSTRATION

In recent years I moved from the private practice of law in California to accept my dream job as a College Professor of Business Law at New Mexico State University in Las Cruces, New Mexico. I wanted to buy a house. Interest rates were historically low, but housing prices had appreciated for over a decade. It could be a rare opportunity to borrow at such a low interest rate, but as interest rates climb, housing prices could crash, and I could end up owing more than the value of a house. How might variations in state bankruptcy and foreclosure law impact how much money I should pay as a down payment?

I was coming from California, where deficiency judgments are not allowed (Group 1). In California I would be encouraged to borrow as much as possible even after over a decade of appreciation because if housing prices drop, I would not be responsible for any deficiency between the amount I owed and the price at which my house might sell at foreclosure. Just 24 miles South of Las Cruces, NM is Texas, where home equity is protected from creditors (Group 2). In Texas I would be encouraged to pay as much as possible as a down payment because, in a worst-case scenario, 100% of the equity in my home would be protected from creditors. Finally, I found myself in New Mexico (Group 3) where deficiency judgments are allowed and only the first $60,000 in home equity is protected from creditors. I could take advantage of low interest rates to borrow as much as possible, but unlike in California, I may be held responsible for the amount I borrow even if housing prices crash, and I end up owing more than the value of the house. A larger down payment could help me avoid the risk of a default judgment, but unlike in Texas where 100% of the equity of a home is protected, New Mexico would only protect the first $60,000.

In the end, my decision was informed more by my position now as a College Professor writing articles like this instead of needing to seek capital for potentially risky entrepreneurial endeavors. Entrepreneurs seeking capital may balance different risks and rewards. Optimism is crucial to success, but a realistic look at the impact of state law on an entrepreneur's worst-case scenario may determine if they still have a home (Group 2), are homeless (Group 1), or are homeless and owe money (Group 3).

CONCLUSION

Should entrepreneurs access their home equity? Most articles discussing the benefits and dangers of using home equity as a source of small business capital fail to identify the varying protections found in state law. Some states provide little incentive to maintain high levels of home equity because borrowers are not held responsible for borrowing more than the amount that can be satisfied in a foreclosure sale (Group 1). Other states incentivize maintaining high levels of home equity by making all home equity exempt from creditors in a chapter 7 bankruptcy (Group 2). Finally, the remaining states require entrepreneurs to calculate their access to home equity with the knowledge that insufficient equity could result in a default judgment while any equity in excess of their state's bankruptcy exemption limit could be at risk of collection from creditors (Group 3).

Please check state codes for variations. For example, New Mexico doubles the homestead exemption amount from $60,000 to $120,000 for filers who are married, filing jointly, and co-own the real property. And in California, the prohibition against deficiency judgments applies not only to single family homes, but also to any

EIX.org (2022)
DOI:
10.32617/809-636bfcc8d0997

mortgages used to purchase an owner-occupied dwelling for not more than four families.

REFERENCES

Kealy, D. M. (2022) Bankruptcy, Foreclosure, Homestead Exemptions, and Deficiency Judgments: Evaluating National Financial Advice through the Lens of State Law. *Pathways to Research in Business and Economics.*

Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934). https://supreme.justia.com/cases/federal/us/292/234/

Olick, D., 20 July 2022 *June home sales fall 5.4% from May, as prices set yet another record.* https://www.cnbc.com/2022/07/20/june-home-sales-fall-5point4percent-from-may-as-prices-set-yet-another-record.html

Rafter, D. (2021, July 8). Deficiency judgment: What is it and how does it work? *Rocket Mortgage*. https://www.rocketmortgage.com/learn/deficiency-judgment

Table 7. Survival of private sector establishments by opening year. (2022). *US Bureau of Labor Statistics*. https://www.bls.gov/bdm/us_age_naics_00_table7.txt

EIX.org (2022)
DOI: 10.32617/809-636bfcc8d0997