TUCKER | HESTER, LLC

AVOIDANCE OF JUDICIAL LIENS

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A CLE Presentation

By: William J. Tucker
Attorney at Law
bill@tucker-hester.com

Tucker | Hester, LLC
www.tucker-hester.com

Pennsylvania Center, Suite 100
429 North Pennsylvania Street
Indianapolis, IN 46204-1816

317.833.3030 | 317.833.3031 [fax]

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Section 522(f) of the Bankruptcy Code

(f) (1) Notwithstanding any waiver of exemptions but subject to paragraph (3),

the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is—

(A) a judicial lien, other than a judicial lien that secures a debt--
(i) to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement; and
(ii) to the extent that such debt--
(I) is not assigned to another entity, voluntarily, by operation of law, or otherwise; and
(II) includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance or support[.];

(2) (A) For the purposes of this subsection, a lien shall be considered to impair an exemption to the extent that the sum of—

(i) the lien;
(ii) all other liens on the property; and
(iii) the amount of the exemption that the debtor could claim if there were no liens on the property;
exceeds the value that the debtor's interest in the property would have in the absence of any liens.

Introduction

A valid judicial lien may or may not survive a bankruptcy—a "pre-petition judgment lien survives bankruptcy and is enforceable *in rem* post-petition if it was not avoided, paid, or otherwise modified so as to preclude enforcement." *18 Miss. C. L. Rev. 497, 498-9*. The Chapter 7 discharge "voids any judgment at any time obtained, to the extent that such judgment is a determination of the *personal liability* of the debtor," (see 11 U.S.C. § 524(a)(1)), but if nothing more is done during the course of the bankruptcy to the judicial lien, "it remains valid and enforceable to the extent allowed by state law against property that has passed through the bankruptcy estate." *18 Miss. C. L. Rev. at 507.*

In Indiana, a judgment creditor "may collect from a judgment debtor by enforcing a judgment lien and/or executing a money judgment via proceeding supplemental." *Arend v. Etsler*, 737 N.E.2d 1173, 1174 (Ind. Ct. App. 2000). In addition, a judgment lien is "purely statutory," and according to Indiana Code § 34-55-9-2,

All final judgments for the recovery of money or costs in the circuit court and other courts of record of general original jurisdiction in Indiana, whether state or federal, constitute a lien upon the real estate and chattels real liable to execution in the county where the judgment has been duly entered and indexed in the judgment docket as provided by law:

(1) after the time the judgment was entered and indexed; and

(2) until the expiration of ten (10) years after the rendition of the judgment;

exclusive of any time during which the party was restrained from proceeding on the lien by an appeal, an injunction, the death of the defendant, or the agreement of the parties entered of record.

Arend, 737 N.E. 2d. at 1175 (quoting *Burns Ind. Code Ann. § 34-55-9-2*). Note that ten years after the entry of judgment or issuing of an execution, "an execution can be issued only on leave of court, upon motion, after ten (10) days personal notice to the adverse party, unless the adverse party is absent or a nonresident, or cannot be found." *Burns Ind. Code Ann. § 34-55-1-2*.

Problems may arise when the lien survives the bankruptcy, although the debtor enjoyed no equity in the property at the time of the petition, after the entry of the discharge order equity was created by either the debtor paying off his or her mortgage, or through post-discharge appreciation of that property. Therefore, "[a]n argument can be made that this post-discharge increase in the value of property is subject to the lien if the judgment passed through the bankruptcy unaffected." *Id.* The judicial lien, thus, could "come back to haunt the debtor" post-discharge unless the lien is dealt with during the bankruptcy proceeding. *Id.*

A "judicial lien" is defined in the Bankruptcy Code as a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding." *11 USC § 101(36).* In most states, "once a judgment is docketed in a county where the debtor owns real or personal property, a judicial lien is created. *2002 ABI JNL LEXIS 186, *3*.

Prior to a Supreme Court decision in 1993, there were two ways to avoid judicial liens in a Chapter 7 case—§ 506(d) and § 522(f) of the Bankruptcy Code. The Supreme Court in *Dewsnup v. Timm*, 502 U.S. 410 (1992), "effectively wrote § 506(d) out of Chapter 7 practice." *18 Miss. C. L. Rev., at 500*. The Court had agreed with the creditor—that if the lien could be "'stripped down' to the judicially determined value, the secured creditor could not then take advantage of any subsequent market increase in the value of the farmland in any subsequent foreclosure action." *Id.* The Court then stated that this "increase would accrue to the benefit of the debtor, a result some of the parties describe as a 'windfall.'" *Dewsnup*, 502 U.S., at 417.

Although *Dewsnup* "involved a consensual lien in a Chapter 7 context, subsequent decisions have expanded the lien stripping prohibition of the decision to nonconsensual or involuntary liens, including judgment liens." *18 Miss. C. L. Rev., at 501*.

Lien Avoidance—§ 522(f)

The main purpose of section 522(f), originally enacted in 1978, was to provide debtors additional protection for their exempt property, and ensure the debtor's fresh start. In essence, this section allows "a debtor to wipe out the interest that a creditor has in particular property if the debtor's interest in that property would be exempt but for the existence of the creditor's lien or interest." *4 Collier on Bankruptcy 15th Ed. Rev. P. 522.11*. This avoiding power may be used only to "avoid the fixing of a lien on an interest of the debtor in property to the extent such lien impairs an exemption." *11 U.S.C. § 522(f)(1)*.

In order for a debtor to make use of section 522(f) to avoid judicial liens there needs to be the following—(1) judicial lien, (2) an exemption that is "impaired," and (3) the fixing of a lien on an interest of the debtor in property. *In re Vanzant*, 210 B.R. 1011, 1015 (Bankr. S.D. Ill. 1997). What constitutes a judicial lien was discussed in the earlier section, but before the formula in § 522(f)(2)(A) can even be applied, it is necessary that the debtors have "actually claimed an exemption in the property." *In re Berryhill* 254 B.R. 242, 243 (Bankr. N.D. Ind. 2000). If the property has not been claimed as exempt, then the lien against it is not avoidable under § 522(f). *Id.* The purpose of this section is to protect the debtor's exemptions and ensure the fresh-start, so if debtors were allowed to avoid a judicial lien without claiming an exemption in that property, this would allow the debtor to "gain all the benefits of § 522(f) without having to bear the consequences which necessarily flow from having allocated part of its limited exemptions to the property." *Berryhill*, 254 B.R., at 244.

The third element that a court must consider before determining whether a creditor's lien may be avoided under section 522(f)(1)(A), is "whether the lien 'fixed on an interest of the debtor in property.'" *Vanzant*, 210 B.R. at 1015. Some courts have looked to the Supreme Court's rationale in *Farrey v. Sanderfoot*, 500 U.S. 291 (1991), that "a debtor must have a property interest that preexisted the lien in order for there to be a 'fixing' of the lien." *Vanzant*, 210 B.R., at 1015. These courts have "declined to avoid a lien that arose simultaneously with the debtor's acquisition of an interest in property, even though the lien would have 'impaired' the debtor's exemption under the formula of § 522(f)(2)." *Id*. This means that the property interest of the debtor must have existed before the lien arose. Section 522(f)(1)(A) does not "require that the lien fix on an 'exemptible' interest of the debtor, only that it fix on 'an interest' of the debtor in property." *Id.* at 1015-16. Therefore, a debtor has "an 'interest in property' even if the property is fully encumbered by liens and the debtor has only an equitable or possessory interest." *Id* at 1016.

Congress enacted the Bankruptcy Reform Act of 1994, and amended section 522(f) by establishing a mathematical formula in section 522(f)(2) that would determine to *what extent a lien should be considered to impair an exemption* for purposes of section 522(f)(1)(A). The determination of "impairment" under section 522(f)(2)(A) is a three-step process—

> First, the movant must calculate the sum of the judgment sought to be avoided, all of the superior liens on the property, and the dollar amount of the available exemption. Second, the debtor must compare this sum to the value of the property. Third, the difference must then be compared to the amount of the judgment sought to be avoided. If the difference is greater than or equal to the subject judgment, the lien may be avoided in its entirety. If the difference is less than the amount of the lien sought to be avoided, only partial avoidance can be granted.

18 Miss. C. L. Rev., at 505.

In general, one of three fact patterns was present in dealing with the issue of avoidance of judicial liens prior to the 1994 Amendments. *39 B.C.L. Rev. 1215, 1221*. The first fact pattern involved an "unavoidable encumbrance, such as a mortgage, that is equal to or greater than the value of the property." *Id*. The second fact pattern involved an "unavoidable encumbrance and exemption [that] consume[s] the full value of the property." *Id, at 1222*. The third fact pattern involved a situation where there was equity in the property beyond the unavoidable encumbrance and exemption, but the equity is less than the amount of the judicial lien. *Id*.

No equity beyond unavoidable encumbrances

Congress resolved the first fact pattern with the 1994 Amendments, by taking the position that "a judicial lien could impair an exemption where there remained no equity in the property above any unavoidable encumbrances, reasoning that a debtor has equitable rights in the property, such as a possessory interest." *39 B.C.L. Rev. at 1236*. In reaching its conclusion that the judicial lien should be fully avoided in situations where there is no equity beyond any unavoidable encumbrances, Congress explained, "that if the judicial lien is not avoided, *any post-bankruptcy appreciation* in the property would accrue for the benefit of the creditor, thereby threatening to deprive a debtor of his exemption." *Id.* Therefore, its stands now that a judicial lien will be entirely avoided if there is no equity beyond any unavoidable encumbrances. *Id.*

No equity in property beyond unavoidable encumbrances and exemptions

Congress succeeded in resolving the second fact pattern as well, and determined that "where there is no equity beyond the unavoidable encumbrances and exemption, the judicial lien is avoided in its entirety." *39 B.C.L. Rev. at 1236*. Congress' main concern was preserving the debtor's exemption and fresh-start. *Id*. In determining that the judicial lien would be avoided in its entirety if there was no equity available beyond the unavoidable encumbrance and exemptions, Congress agreed with the majority view existing at the time of the 1994 Amendments. Congress expressly rejected the minority view, which had held that the exemption was "carved out of the judicial lien," and, as a result, the "maximum amount of a

judicial lien that a debtor can avoid is the amount of a claimed exemption." *Id., at 1239*. Further, in the legislative history of the 1994 Amendments, Congress specifically overruled Ninth Circuit authority that did not allow debtors to claim any exemption in post-filing appreciation. *4 Collier on Bankruptcy 15th Ed. Rev. P. 522.11*.

Congress explained that if it were to follow the minority view, then "any equity created in the property as a result of *mortgage payments* made from the debtor's post-bankruptcy income—income that the fresh-start is supposed to protect for the debtor—would accrue for the benefit of the lienholder." *39 B.C.L. Rev. 1215, 1236*. In addition, the debtor's fresh-start would be "further endangered because the judicial lien may prevent the debtor from selling his home prior to paying the judicial lienholder." *Id.* As a result, the debtor's interest in property is protected into the future as well—"Once the lien is avoided, it does not reattach to the property to reach any future increase in value or other 'equity' in the property that might accrue." *4 Collier on Bankruptcy 15th Ed. Rev. P. 522.11.*

Equity beyond unavoidable encumbrances and exemptions, but less than the amount of judicial lien

Although Congress was able to expressly address the problems and confusion surrounding the first two fact patterns with the enactment of the 1994 Amendment, it did not address the situation where there is equity left after unavoidable encumbrances and exemptions, but less than the amount of a judicial lien. *39 B.C.L. Rev. at 1237.* It seemed like the formula in § 522(f)(2)(A) was a relatively simple and straightforward calculation, but "[u]nfortunately, litigants and the courts have managed to thoroughly complicate the application of this formula." *In re Sheth*, 225 B.R. 913, 917 (Bankr. N.D. Ill. 1998). Therefore, the courts were left to interpret the statute, and determine from the legislative history how to address this problem. As a result, some courts decided to adhere to the "full avoidance approach" while other courts began adopting a new approach, the "entire lien avoidance" approach. *39 B.C.L. Rev. at 1237*.

In the full avoidance approach, the courts completely avoid "any portion of a judicial lien that exceeds the quantity of equity remaining in the property." *39 B.C.L. Rev. at 1239*. The First Circuit in *East Cambridge Savings Bank v. Silveria*, 1998 WL 175119 (1st Cir. 1998), followed this full avoidance approach, and held that the debtor could avoid only partially the judicial lien—the portion that exceeded the amount of equity left in the property. *39 B.C.L. Rev. at 1239*. The court stated that if Congress had intended for § 522(f) to be an all or nothing matter, "it would not have used the word 'if' in lieu of the phrase 'to the extent that.' *Id.* at 1240. Further, the First Circuit noted that following the entire lien avoidance approach would lead to arbitrary and unfair results, and the debtors would receive a windfall. *Id.* at 1240.

Another court that followed the full avoidance approach, in *In re Ryan*, 210 B.R. 7 (Bankr. D. Mass. 1997), held that section 522(f)(2) "only requires avoidance of the portion of the judicial lien which impairs an exemption as determined by that section's arithmetic formula," and the court determined that the lien would be partially avoided, in the amount of the excess of the quantity of equity remaining in the property. *Id*. at 1241.

Only a few courts have followed the entire lien avoidance approach, and "explain that § 522(f) mandates that a lien is either avoided in its entirety or fully survives the bankruptcy." *Id*. at 1242. (See *In re Finn*, 211 B.R. 780 (1st Cir. BAP 1997) (DeJesus, J. dissenting) and *East Cambridge Sav. Bank v. Silveira*, Memorandum & Order, 1 (No. 96-11388-WGY) (D. Mass. 1997), *vacated and remanded*, 1998 WL 175119 (1st Cir. Apr. 21, 1998)). The majority of the courts follow the full avoidance approach, in that this approach, in effect, "furthers the Code's fresh-start policy by preserving the debtor's exempt property and allowing any post-bankruptcy appreciation to accrue for the benefit of the debtor." *39 B.C.L. Rev. 1215, 1246*. Note, that this approach is followed by: *In re Finn,* 211 B.R. 780 (1st Cir. BAP 1997); *In re Silveira,* 141 F.3d 34 (1st Cir. 1998); *In re Ryan*, 210 B.R. 7 (Bankr. D. Mass. 1997); *In re Corson,* 206 B.R. 17 (Bankr. D. Conn. 1997); *In re Todd,* 194 B.R. 893 (Bankr. D. Mont. 1996); *In re Moe*, 179 B.R. 654, 199 B.R. 737 (Bankr. D. Mass. 1995); *In re Johnson*, 184 B.R. 141 (Bankr. D. Wyo. 1995); *In re Thomsen*, 181 B.R. 1013 (Bankr. M.D. Ga. 1995); and *In re Sheth*, 225 B.R. 913 (Bankr. N.D. Ill. 1998). Further, this majority approach also "furthers the Code's other policy objective of helping to protect some

of the rights of creditors by preserving the secured portion of their liens." *Id.* If the debtors would be allowed to avoid the lien in full, "despite the existence of non-exempt equity to which the lien could attach," the debtor would be in effect getting "an unlimited exemption." *In re Finn*, 211 B.R. 780, 783 (BAP 1st Cir. 1997).