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CAN A JUDICIAL OR STATUTOR LIEN ATTACH TO POST-PETITION APPRECIATION IN REAL PROPERTY ON WHICH THE LIEN HAS ATTACHED?

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A CLE Presentation

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Statutes

Section 506 of Bankruptcy Code

- (a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to set off is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

- (d) To the extent that a lien secures a claim against the debtor that is not an *allowed secured claim*, such lien is void, unless—
 - (1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or
 - (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

Section 522 of Bankruptcy Code

- (c) Unless the case is dismissed, property exempted under this section is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case, except—
 - (1) a debt of a kind specified in section 523(a)(1) or 523(a)(5) of this title;
 - (2) a debt secured by a lien that is—
 - (A) (i) not avoided under subsection (f) or (g) of this section or under section 544, 545, 547, 548, 549, or 724(a) of this title; and
 - (ii) not void under section 506(d) of this title; or
 - (B) a tax lien, notice of which is properly filed;
 - (3) a debt of a kind specified in section 523(a)(4) or 523(a)(6) of this title owed by an institution-affiliated party of an insured depository institution to a Federal depository institutions regulatory agency acting in its capacity as conservator, receiver, or liquidating agent for such institution; or
 - (4) a debt in connection with fraud in the obtaining or providing of any scholarship, grant, loan, tuition, discount, award, or other financial assistance for purposes of financing an education at an institution of higher education (as that term is defined in section 101 of the Higher Education Act of 1965 (20 U.S.C. 1001)).

- (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[.];
- (B) a nonpossessory, nonpurchase-money security interest in any--
- (i) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;
 - (ii) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or
 - (iii) professionally prescribed health aids for the debtor or a dependent of the debtor.
- (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.
- (B) In the case of a property subject to more than 1 lien, a lien that has been avoided shall not be considered in making the calculation under subparagraph (A) with respect to other liens.
- (C) This paragraph shall not apply with respect to a judgment arising out of a mortgage foreclosure.

Section 524 of Bankruptcy Code

- (a) A discharge in a case under this title [11 USCS §§ 101 et seq.]—
- (1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived;
 - (2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived; and
 - (3) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect or recover from, or offset against, property of the debtor of the kind specified in section 541(a)(2) of this title that is acquired after the commencement of the case, on account of any allowable community claim, except a community claim that is excepted from discharge under section 523 or, 1228(a)(1), or 1328(a)(1) of this title, or that would be so excepted, determined in accordance with the provisions of sections 523(c) and 523(d) of this title, in a case concerning the debtor's spouse commenced on the date of the filing of the petition in the case concerning the debtor, whether or not discharge of the debt based on such community claim is waived.

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.

Problems may arise when the lien survives the bankruptcy, and while at the time of the petition the debtor enjoyed no equity in the property, after the entry of the discharge order equity was created either by 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.*

Prior to a Supreme Court decision in 1992, there were two ways to avoid judicial liens in a Chapter 7 case—§ 506(d) and § 522(f) of the Bankruptcy Code—which will be discussed further in the sections below. Before discussing how to avoid a judicial lien, it is necessary to determine what a judicial lien is (or is not), for purposes of the Bankruptcy Code.

What Constitutes a Judicial and Statutory Lien?

It is crucial to distinguish between a judicial and a statutory lien since they receive different treatment under the Bankruptcy Code—for example, statutory liens cannot be avoided under § 522(f)(1)(A), but judicial liens can. In order to determine the nature of a particular lien, “a court must consider the lien’s origin instead of the means enforcing the lien.” *Am. Jur. Bankruptcy* § 1382 (citing *In re Underwood*, 103 B.R. 849 (Bankr. E.D. Mich. 1989)).

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. A “statutory lien,” in contrast, is defined by the Bankruptcy Code as a lien that arises “solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute.” 11 USC § 101(53).

One characteristic of a statutory lien is that it arises automatically—federal tax liens, mechanic’s liens, attorney’s liens, municipality water and sewer liens that attach automatically pursuant to state law, have all been held to be statutory liens. In addition, “[m]ost states provide for some type of statutory landlord’s lien which would be beyond the avoidability parameters of § 522(f),” while “liens in favor of a landlord, created through a judicial eviction process or a sheriff’s levy, have been found to be avoidable judicial liens.” 18 Miss. C. L. Rev., at 502-3. Further, a garnishment lien is an avoidable judicial lien. *Id.*, at 503.

Lien Avoidance and Claim Bifurcation—“Lien Stripping”

One method of avoiding a judicial lien was through using the “lien stripping” provisions of sections 506(a) and 506(d) of the Bankruptcy Code. This was the most effective way for a debtor to deal with an existing judicial lien. 18 Miss. C. L. Rev., at 499. According to section 506(a), “a claim may be bifurcated into a secured and unsecured portion after first determining the value of the property which secures the lien.” 18 Miss. C. L. Rev., at 499. Section 506(d) states, “to the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void.” 11 U.S.C. § 506(d). There are two exceptions to this rule—this section will not avoid a lien if, (1) the underlying claim was disallowed only under sections 502(b)(5) or 502(e), or (2) the underlying claim is disallowed only under section 501 for failure to file a proof of claim. 11 U.S.C. § 506(d).

These two sections were often used in Chapter 7 cases “to strip away existing judgment liens that encumbered the debtor’s property.” 18 Miss. C. L. Rev., at 500. These sections provide “that a lien is void to the extent that there are no assets for the lien to encumber,” however, Chapter 7 debtors often do not have any unencumbered equity to which the lien may attach. *Id.* This means that if the debtors made use of these two sections, their claims would be adjusted as unsecured, and could be declared void pursuant to section 506(d). *Id.* This allowed the debtors to enjoy a “fresh start,” and “enabled them to

avoid the specter of those liens attaching to any post-bankruptcy increase in equity or value” which might develop in their property. *Id.*

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. In this case, the debtors (owners of farmland) were seeking to “strip down” the secured creditor’s lien “by reducing the amount of the debt secured by the lien to the judicially determined value of the property,” and “remove the lien from the unsecured ‘deficiency’ created by the process.” 4 *Collier on Bankruptcy*, 15th Ed. Rev. P. 506.06. The Court, however, 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.

The Court reached its conclusion by focusing “on the word ‘allowed’ in the term ‘allowed secured claim,’ rather than the word ‘secured.’” 18 *Miss. C. L. Rev.*, at 501. In addition, “[t]he Court noted that § 502 of the Bankruptcy Code allows a claim to be disallowed for various reasons and then concluded that the true meaning of § 506(d) is that a lien is void to the extent that the underlying claim is not ‘allowed,’ rather than being merely unsecured.” *Id.* Although the debtors argued that the “words ‘allowed secured claim’ must take the same meaning in § 506(d) as in § 506(a),” the Court was “not convinced that Congress intended to depart from the pre-Code rule that liens pass through bankruptcy unaffected.” *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.

Although the debtor’s ability to “void” a judicial lien using section 506(d) is not allowed a Chapter 7 case, there are bankruptcy courts that continue to allow the stripping of judicial liens pursuant to section 506(d). 18 *Miss. C. L. Rev.*, at 502. Section 1322(b)(2) states that a Chapter 13 plan may “modify the rights of holders of secured claims, other than a claim secured *only* by a security interest in real property that is the debtor’s principal residence...” 11 U.S.C. § 1322(b)(2). The Supreme Court held in *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993), that “§ 506(a) could not be employed to bifurcate a claim, secured exclusively by a mortgage on the debtor’s principal residence, into secured and unsecured portions based on a valuation of the property.” 18 *Miss. C. L. Rev.*, at 501. Conversely, “neither § 1322(b)(2) nor the *Nobleman* decision prohibits a § 506(a)/§ 506(d) stripping of judicial lien in a Chapter 13 case.” *Id.* A judicial lien, “being a non-consensual lien, is outside the anti-modification language of § 1322(b)(2) and the *Nobleman* mandate.” *Id.*

Tax Liens

As indicated above, tax liens are statutory liens, which cannot be avoided pursuant to section 522(f). In addition, it has been held that the “language, legislative history, and judicial interpretations construing § 522(c)(2) reveal that Congress did not intend for debtors to avoid properly filed tax liens through the avoidance powers available under § 506.” *In re Stauffer*, 1995 U.S. Dist. LEXIS 8574, *12 (E.D. Cal. 1995). Further, section 522(c)(2)(B) has been described as, “‘bestow[ing] added protection upon perfected tax liens and providing that exempt property remains liable for a tax lien, notice of which has been properly filed.’” *Id.*, at *5.

The court in *Stauffer* held that even if section 522(c)(2) did allow a tax lien to be avoided pursuant to section 506, the debtors were prevented from “stripping down” the IRS tax lien pursuant to section 506 itself. *Id.* The court noted that under *Dewsnup*, §506(d) allows “a debtor to avoid a lien only if the underlying claim is disallowed, and not if a portion of the claim is deemed unsecured.” *Id.*, at *13. Furthermore, the court stated that “[n]umerous courts in cases actually analogous to this case have held that a chapter 7 debtor may not avoid a valid federal tax lien by operation of § 506(d).” *Id.*, at *15-6.

The court in *In re Vermande*, 1994 Bankr. LEXIS 1430 (Bankr. N.D. Ind. 1994) held that “the debtor’s complaint fails to establish sufficient facts to void the IRS’s tax lien against the debtor’s rights in the Indiana Teachers Retirement Fund under § 506(d) because the section does not apply to liens on property in which the estate has no interest.” *Id.*, at *12. The court continued, and held that even if the retirement fund was property of the estate and § 506 was applicable, “§ 506(d) does not operate to nullify tax liens.” *Id.* The court in *Vermande* cited the Supreme Court’s decision *Dewsnup*, and also looked to a case in which the facts were analogous the case at hand—*In re Fink*, 153 Bankr. 883 (Bankr. D. Neb. 1993). In *Fink*, the court had “determined that the annuity was excluded from property of the debtor’s estate under § 541(c)(2).” *Vermande*, 1994 Bankr. LEXIS, at *15 (citing *Fink*, 153 Bankr., at 886). The court in *Fink* then indicated that “the IRS’s allowed secured claim would be determined exclusive of the value of the annuity. The court concluded, however, that the tax lien survived the bankruptcy filing.” *Id.* The court in *Vermande* thus, holds that § 522(c)(2) “precludes the avoidance of the IRS’s tax lien on the debtor’s exempt property.” *Id.*, at *17. An argument could be made that the lienholder, the United States, benefits from the appreciation of the property, since these cases were relying on *Dewsnup*—which held that it would be a windfall to allow the increase in value to inure to the debtor.

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).

Unlike section 506, which allows a debtor to convert a putative secured claim into an unsecured claim if there is no value to support the lien, after which discharging in bankruptcy and extinguishing the creditor’s right to payment, section 522(f) focuses on protecting the debtor’s exemption rights in certain encumbered property. 18 *Miss. C. L. Rev.*, at 507. Further, section 522(f) has never “enjoyed the same popularity” as section 506(a) and (d), probably since it did not have the “simplicity of a § 506(d) analysis.” *Id.*, at 503. The biggest problem in applying § 522(f) was the courts were unable to reach a consensus on the definition of “impairment.” *Id.* This was one problem solved with Congress’ enactment of § 522(f)(2).

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.

Finally, section 522(f)(1) allows the debtor to avoid a “fixing of a lien on an interest of the debtor in property.” 11 U.S.C. § 522(f)(1). 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.*

Lien avoidance—Pre-1994 Amendments

As mentioned above, there was some confusion as to the correct implementation of section 522(f). The Supreme Court, in *Owen v. Owen*, 500 U.S. 305 (1991), attempted to alleviate this confusion, and held that “the baseline, against which impairment is to be measured, is the amount of an exemption to which the debtor ‘would have been entitled’ but for the judicial lien at issue.” 18 Miss. C. L. Rev., at 504.

While *Owen* was useful in clarifying, to an extent, how section 522(f) was to be implemented, there continued to be differing views as to the correct application of this section, and Congress eventually revised this section in 1994. In general, one of three fact patterns were usually present in dealing with the issue of avoidance of judicial liens that impair exempt property under section 522(f)(1). 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.* An example of this is—when a debtor owns a house whose fair market value is \$100,000, encumbered by a \$100,000 first mortgage. The second fact pattern involved an “unavoidable encumbrance and exemption [that] consume[s] the full value of the property.” *Id.*, at 1222. An example of this is—when a debtor owns a house whose fair market value is \$100,000, subject to a \$90,000 first mortgage, and the debtor is allowed a \$10,000 exemption. *Id.* 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.* An example of this is—when a debtor owns a house whose fair market value at \$100,000, encumbered by a \$60,000 first mortgage, and the debtor is entitled to a \$20,000 homestead exemption. Therefore there is \$20,000 of equity beyond both the unavoidable encumbrance and exemption, but the creditor has a \$30,000 judicial lien. *Id.*

Lien avoidance—Post-1994 Amendments

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). In addition, according to the “legislative history of § 303 of the Bankruptcy Reform Act of 1994, which incorporates the amendments to § 522(f), the formula adopted by Congress in § 522(f)(2)(A) was based on the decision of *In re Brantz*.” 18 Miss. C. L. Rev., at 506. The two formulas “differ in form,” and the goal of each “is to determine the existence of equity in property above consensual liens plus exemptions, and avoid a judicial lien if no such equity exists.” *In re Thomsen*, 181 B.R. 1013, n. 1016 (Bankr. M.D. Ga. 1995). 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.

18 Miss. C. L. Rev., at 505. Thus, if the difference is greater or equal to the judicial lien, then it may be avoided in its entirety. *Id.* However, if the difference is less than the amount of the judicial lien, then most courts would partially avoid the lien. *Id.*

In the formula in § 522(f)(2)(A), part (i) is referring to the lien which is “the amount of the underlying judgment which gives rise to the lien the debtor seeks to avoid.” 18 Miss. C. L. Rev., at 504. In addition, a majority of courts have held that the “value” of the debtor’s interest in the property, is the fair market value at the date of the bankruptcy petition, and “liquidation costs and closing costs are not to be deducted from this market value.” *In re Sheth*, 225 B.R. 913, 918 (Bankr. N.D. Ill. 1998). Further, “[o]nly prior consensual liens and other non-avoidable senior liens are deducted from value prior to the deduction of the judicial lien in applying the avoidance formula. *Id.*, at 919.

The effect of the 1994 Amendments, was to help clear up most of the areas of confusion that courts had faced in deciding the “fact patterns” mentioned above. Congress followed the majority of courts by stating that in situations like the first fact pattern, where there was an absence of equity in the property, the judicial lien can impair an exemption. 39 B.C.L. Rev. 1215,1236. Congress’ rationale was that the debtor does have equitable rights in the property, “such as a possessory interest,” and the debtor

is “entitled to exempt these residual interests.” *Id.* Congress explained further, “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.* As a result, the judicial lien would be entirely avoided if there is no equity beyond the unavoidable encumbrances. *Id.*

The other area that Congress attempted to clarify involve situations like the second fact pattern, where there was no equity existing beyond the unavoidable encumbrances and exemption. *Id.* Congress agreed with the majority of courts, who had found in situations like this, the judicial lien was to be avoided in its entirety. *Id.* Congress expressly rejected the minority view, which held in this situation, 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, the “carve-out approach” 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.*

While Congress expressly addressed the first and second fact patterns, and clarified the extent a lien impairs an exemption, it did not, however, expressly address situations involving the third fact pattern. *39 B.C.L. Rev. 1215, 1237.* The following section will explain how the majority of courts have addressed the problem created with respect to these situations.

Partial avoidance

Although it seems like the formula in § 522(f)(2)(A) is a relatively simple and straightforward calculation, “[u]nfortunately, litigants and the courts have managed to thoroughly complicate the application of this formula.” *Sheth*, 225 B.R., at 917. The issue that was decided by the court in *Sheth* was whether a judicial lien would be avoided in its entirety, or only avoided in part, when it only partially impairs the debtor’s exemption. The court concluded that “the plain meaning of the statutory language, as well as the reference to the *Brantz* formula in the legislative history, allow for partial avoidance of a judicial lien to the extent that the lien only partially impairs the debtor’s exemption.” *Sheth*, 225 B.R., at 918.

The *Brantz* formula had expressly allowed partial avoidance “in the event there is some equity after payment of senior liens and the exemption.” *Id.*, at 917. In addition, many cases have considered the issue of partial avoidance, and most “have concluded that consideration of the legislative history provides little guidance in this regard... The confusion arises because the cases cited in the House Report as examples of the problem the drafters intended to address do not actually contain the fact pattern ascribed to them in the Report.” *Id.*, at 917-8.

In the House Report, Congress specifically overruled two cases, a Massachusetts case, and a Ninth Circuit case, but the Report had mischaracterized the facts and holdings of these cases “when it says they failed to avoid the judicial lien in a no equity situation.” *Sheth*, 225 B.R., at 918 n. 4. These two cases actually involved a situation where there was some equity left after payment of the senior lien and the exemption, therefore the lien was only partially avoided. *Id.* Therefore, based on the Report’s mischaracterizations, “the majority of courts who have looked at the legislative history underlying the 1994 amendments and have concluded that it does not definitively resolve the issue of partial lien avoidance.” *Id.*

The court in *Sheth* thus holds that “when the property’s value, minus the sum of (i) other liens, (ii) the exemption and (iii) the judicial lien, produces a negative number, this is the extent to which the lien should be avoided.” *Id.*, at 918. Therefore, this is the extent to which the exemption is impaired, and “[i]t may be more or less than the face amount of the judicial lien and may result in a full or partial avoidance of that lien.” *Id.* The court also points out that a “majority of the courts considering this issue” have held that the plain language of the statute requires partial avoidance of a judicial lien to the extent that there is only a partial impairment of the exemption. *Sheth*, 225 B.R., at 917. The approach that the majority of courts have taken, 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. In addition, this 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).

Issues with “opt-out” states

Indiana is an “opt-out” state, and the exemptions are thus listed in Indiana Code § 34-55-10, *et seq.* In *Owen*, the Supreme Court had held that “the question is ‘not whether the lien impairs an exemption to which the debtor is in fact entitled,’” but that section 522(f)(1) allows a “debtor to avoid a lien that ‘impairs an exemption to which he would have been entitled but for the lien itself.’” 2 *Norton Bankr. L. & Prac.* 2d § 46:23. This means that “opting out of the federal list of exemptions under § 522(b) does not permit a state to ‘opt out’ of § 522(f)’s avoiding power.” 2 *Norton Bankr. L. & Prac.* 2d § 46:23.

Note that the pro-debtor approach of section 522(f)(2)(A) is consistent with the Supreme Court’s holding in *Owen*. *Vanzant*, 210 B.R., at 1014. Further, this section “underscores the Code’s policy of distinguishing between a debtor’s exemption rights under state law and the availability of lien avoidance in bankruptcy.” *Id.*, at 1015. Thus, even though states may “opt-out” of the federal exemptions listed in § 522(d), “the Code does not adopt or preserve the state exemptions with all their built-in limitations.” *Id.* “Rather, as implied by *Owen* and as demonstrated by the definition of ‘impairment’ in § 522(f)(2), judicial liens on exempt property can be eliminated *regardless of the content of state exemption law.*” *Id.*

The court in *Vanzant* overruled a prior decision, *In re Cerniglia*, 137 B.R. 722 (Bankr. S.D. Ill. 1992), since § 522(f)(2) defines “impairment,” the prior decision was no longer viable. *Vanzant*, 210 B.R., at 1015. Although according to Illinois law, “no judicial lien may attach to a debtor’s exempt homestead interest in property and the debtor may deal with this exempt interest without restraint following bankruptcy,” the debtor’s exemption could, nevertheless, be considered “impaired” under formula in § 522(f)(2)(A). *Vanzant*, 210 B.R., at 1015.

In addition, the court in *Vanzant* dealt with the issue whether a “fixing” of the lien to an interest of the debtor in property had occurred for purposes of § 522(f)(1)(A), since a judicial lien cannot attach to debtor’s exempt interest in property under Illinois law. *Vanzant*, 210 B.R., at 1015. The court looked to the plain language of § 522(f)(1)(A) and noted that it did not require the lien to fix on an “exemptible” interest of the debtor. *Id.* Further, under the Bankruptcy Code, “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. Therefore, under Illinois law, even though a judicial lien does not attach to the debtor’s homestead interest, “this interest is a right to payment of the statutory amount and is distinct from the debtor’s title or possessory interest in the property itself, which is subject to such attachment.” *Id.* As a result, the court held that the judicial lien had “fixed” on an interest of the debtor in property, “even though [the debtor] lacked any equity in the property above the amount of [the debtor’s] homestead exemption.” *Id.*

It is “well settled in Indiana that a judgment lien does not attach to the debtor’s homestead interest in property.” *In re Zupan*, 172 B.R. 250, 252 (Bankr. S.D. Ind. 1993). The court in *Zupan* held that a “judgment lien does not impair a debtor’s homestead interest under Indiana law.” *Id.*, at 252. This case has not been specifically overruled by another case, but it was decided before Congress defined

“impairment” in the 1994 Amendments. In addition, it looked to the Illinois case *Cerniglia*, which has been overruled by *Vanzant* (as discussed above). In citing *Cerniglia*, the court in *Zupan* noted that, “[t]o the extent that a judicial lien attaches to real property upon which a debtor has a homestead exemption, the judicial lien does not attach to the debtor’s homestead interest in that real property, and in no way impedes a debtor’s ability to recover their homestead exemption.” *Zupan*, 172 B.R., at 252. This particular issue has not been addressed in Indiana’s bankruptcy courts since *Zupan* was decided in 1993, however, an argument could be made that, similar to *Vanzant*, while a judicial lien cannot attach to a debtor’s exempt homestead interest in property, the debtor’s exemption could nevertheless be considered “impaired” under § 522(f)(2)(A).

Examples

1. What happens when the debtor wants to avoid a judicial lien of \$10,000, and has an exemption of \$7,500, but the property is not worth more than \$7,500?
2. What happens when the debtor wants to avoid a judicial lien of \$10,000, and has a \$100,000 mortgage, an exemption \$7,500, and the property is only worth the amount of the mortgage and exemption?
3. What happens when the debtor wants to avoid a judicial lien of \$10,000, and has \$80,000 mortgage, an exemption of \$7,500, and the property is worth \$100,000?