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Lien On Me

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When explaining the importance of a secured lien under state law, my law school professor drilled into my head, "First in time, first in line, first to get a dime." This saying is a clever way to remember the three stages of lien creation – attachment, perfection, priority. A basic understanding of lien creation is helpful in the bankruptcy context because having a lien outside of bankruptcy allows a creditor to have a claim inside bankruptcy. Also, on occasion, non-bankruptcy law will impact the ability to avoid a lien in bankruptcy.

Creation of a Lien Under State Law

<u>Step 1</u>: Attachment

- The "thing" that gives rise to an interest in a debtor's property.
- An attached lien is valid between the debtor and creditor

<u>Step 2</u>: Perfection

- The process taken by the creditor/lienholder to make the lien prevail against third parties.
  - How one perfects a lien depends on the type of lien; however, the three most common forms of perfection are: Possession, Recordation, Automatic
- Without perfection, the creditor is considered unsecured.

<u>Step 3</u>: Priority

- Priority becomes important when there is more than one lien against the same piece of property.
- Secured creditors will always "win" against an unsecured creditor

Liens in the Context of Bankruptcy

Section 101(37) of the Bankruptcy Code defines lien as a charge against or interest in property to secure payment of a debt or performance of an obligation.

A. The Nature of a Secured Claim § 506 and the "Strip down"

Once a claim is filed and allowed (§§ 501, 502), § 506 determines whether to treat the claim as secured. A secured claim in bankruptcy has the same status as a secured interest under non-bankruptcy law; meaning, a creditor is entitled to payment from the proceeds of its collateral.

Pursuant to § 506(a)(1), " An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . .is less than the amount of such allowed claim."

Oversecured: If the value of the collateral exceeds the debt, the creditor is oversecured, and the claim will be secured to the amount of the debt.

Undersecured: Where the debt is greater than the value of the collateral, the creditor is undersecured. If a claim is undersecured, then the claim is subject to bifurcation pursuant to § 506(a).

Bifurcation of an undersecured claim results in the splitting of the claim into both a secured and unsecured portion. The claim will remain secured up to the value of the collateral, and any amount of debt above the value is avoided as unsecured. This is often referred to as "stripping down" the lien.

I. Stripping Liens in Chapter 13:

So long as confirmation requirements are satisfied pursuant to § 1325, § 1322(b)(2) allows a chapter 13 plan to modify the rights of all claimants except those whose claims are secured only by an interest in real property that is the debtor's principal residence.

In this regard, aside from the case of a mortgage on the debtor's principal residence, the rule of § 506 regarding oversecured and undersecured claims apply in chapter 13. However, notice that § 1322(b)(2) specifically refers to "secured claims."

a. *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993)

In *Nobleman*, the value of the residence at issue was $23,500.00. The creditor's lien was $71, 335. Therefore, under 506(a), the creditor had a secured claim of $23,500.00 and an unsecured claim of $47,835. The Court, however, held that § 1322(b)(2) prohibited the stripdown because it would be an impermissible modification of the lien rights of the holder who was secured by the residence.

Even though the value of the property was less than the total amount of the debt in *Nobleman*, the creditor remained partially secured by the value. *Nobleman* did not answer the question of whether a debtor may strip off a completely unsecured junior mortgage. This court has answered the question.

b. *In re Kidd*, 161 B.R. 769 (Bankr. E.D.N.C. 1993)

In *Kidd*, the debtors owned a home in Angier, North Carolina. The home was encumbered by a 1st deed of trust in the amount of $61,268.17, and 2nd deed of trust in the amount of $9,689.41. The value of the home was $59,000. Because all of the equity in the residence was consumed by the first mortgage, the holder of the second deed of trust, Associates Financial Service Company,

Inc. ("Associates") did not have a secured claim under § 506(a). Because Associates was wholly unsecured, the court held that the prohibition against modifying a lien on a principal residence did not prevent the avoidance of the lien under § 506(d).

B. Avoiding Liens

I. <u>The debtor's power to avoid interests that impair exempt property</u>

Section 522(f) allows the debtor to avoid all judicial liens, other than domestic support obligations, to the extent the lien impairs an exemption the debtor would have been entitled to but for the lien. A judicial lien is a lien arising out of court proceedings. Statutory and Consensual liens are generally immune to exemption claims.

The "extent of impairment" requires a minor mathematical equation:

(1) The value of the debtor's interest in the property in the absence of liens
(2) Add together:
    a. The liens to be avoided
    b. Other liens on the property
    c. The amount of the allowed exemption
(3) Compare (1) and (2). An exemption is impaired to the extent that (2) is more than (1).

Avoidance under these terms does not mean that the lien is stricken altogether; but, rather, the amount of impairment is rendered unsecured. Any remaining equity is then eligible for exemption.

II. <u>The trustee's ability to avoid a lien</u>

The basic idea behind § 544 is to give the trustee the avoidance rights that would be available against unperfected security interests under non-bankruptcy law.

- §544(a) The "Strong Arm" clause. The Strong Arm clause confers on the trustee as a matter of law hypothetical roles:
    - Judicial lienholder
        - § 544(a)(1) confers greater rights upon the trustee as hypothetical judicial lienholder than an actual judicial lien creditor would have under non-bankruptcy law
        - Example
    - Bona fide purchaser
        - § 544(a)(3)
- § 545 Provides for the trustee's avoidance of statutory liens. Generally, a statutory lien that was validly obtained and perfected under non-bankruptcy law is fully effective in bankruptcy and can only be avoided if it fits into one of three narrower categories.
    - § 545(1) a statutory lien is avoided if it was specifically created to take effect upon insolvency or bankruptcy.

- § 545(2) if the statutory lien was not perfected or enforceable against a hypothetical bona fide purchaser.
- § 545(3) statutory liens for rents are avoidable, and this section will invalidate a landlord's lien.

C. Construction/Mechanics Liens

In re Shearin Family Investments, LLC, Case No. 08-07082-8-JRL, 2009 WL 1076818 (Bankr. E.D.N.C. April 17, 2009).

In re Harrelson Utilities, Inc., Case No. 09-02815-8-ATS (Bankr. E.D.N.C. July 30, 2009).