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Bankruptcy

When is a Lien Avoidable in a Chapter 13 Bankruptcy? Judicial Liens versus Statutory Liens

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It must be understood that obtaining a bankruptcy discharge does not automatically extinguish liens that creditors hold against your property. So, even if you successfully file for bankruptcy, you could still lose your property. Fortunately, you may be able to retain such property if the lien against it is a "judicial lien." By filing a motion to avoid a judicial lien, you just might permanently delete the creditor's legal interest in that property. In contrast, if the lien is a "statutory lien"—it stays. And sometimes the line between these types of liens is blurred, leaving the nature of the lien in dispute. With so much at stake hinging on the final determination of the nature of the lien, we want to highlight for our readers a recent decision that focused on this very issue.

In re Shippy: The Facts

In June of 2022, Debtors (husband and wife) filed for Chapter 13 relief. As of the petition date, Debtors' residence was valued at $441,169.00. The residence was encumbered by a deed of trust in the amount of $141,709.00. As permitted under state law, Debtors also claimed a $299,460.00 homestead exemption. Debtors also reported Employer's Lien against their real property in the amount of $71,635.19.

Significantly, the Debtors designated the Employer's Lien as a "judgment lien from a lawsuit." As the court noted, the debt resulting in the Employer's Lien grew out of husband's "receipt of worker's compensation benefits to which he was not entitled." In Debtors' motion, they described it as "a pre-petition 'judgment' lien obtained by [Employer] in the amount of $71,635.19 for overpayment of workers' compensation benefits, and seek to avoid that lien pursuant to §522(f)." As the court stated, the lien was technically generated by an Order and Notice (L&I Order) issued by the appropriate state department (L&I) in conjunction with a warrant, rather than a traditional court-generated judgment.

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Employer filed its claim for the full amount of the lien. Debtors claimed the lien impaired their homestead exemption and should be avoided under 11 U.S.C. §522(f)(1). Employer objected, arguing that the lien is a statutory lien which is unable to be avoided under that section.

The Court's Decision and Analysis

The United States Bankruptcy Court Western District of Washington at Tacoma ruled that the Employer's Lien was a judicial lien, able to be avoided in full under 11 U.S.C. §522(f)(1). Ultimately, the court considered that the state statutory mechanism in place to determine and adjudicate the debt creating the lien was analogous to what other jurisdictions have coined as a "quasi-judicial" process which places the lien squarely within the scope of 11 U.S.C. §522(f)(1).

The court began its analysis by introducing the authority for avoidance of judicial liens found in 11 U.S.C. §522(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 of a kind that is specified in section 523(a)(5) [.]

The court continued by explaining that:

> A lien impairs an exemption to the extent that the sum of all liens on the property, together with the value that the debtor could claim as exempt in the absence of the liens, exceeds the value of the debtor's interest in the property if it were totally unencumbered.

After applying that formula using Debtors' numbers, the court noted that the lien impairs the Debtor's homestead exemption and could be avoided if the lien is a "judicial lien." Confident that was the sole issue before it, the court contrasted the Bankruptcy Code's definition of a judicial lien, under 11 U.S.C. §101(36), with the definition of a statutory lien under 11 U.S.C. §101(53). This left the court to conclude that whether a lien is classified as a judicial or statutory lien is dependent upon "the manner in which the lien arose, not the manner by which it is enforced." And lacking any controlling caselaw within the Ninth Circuit about that issue specifically, the court turned its attention to other jurisdictions' rulings in similar circumstances.

The court's review of In re Schick provided a look at a matter involving a lien held by the New Jersey Motor Vehicles Commission. There, a lien was considered statutory in nature rather than judicial, because the statute creating the lien did not require any judicial action. Rather, the lien arose upon the clerk of court simply docketing the certificate. In contrast, the Seventh Circuit in Matter of Mance, ruled that a lien resulting from unpaid traffic fines

was judicial rather than statutory, because the lien only arose after a "quasi-judicial" process that involved steps along the way including (but not limited to) an opportunity for the owner to contest the liability and enforcement, appeals rights, and first and second determinations of liability. In other words, the lien did not arise without more than a clerk's act of docketing.

After considering other jurisdictions' approaches, the court scrutinized the particular process in Debtors' state for creating a lien based on workers' compensation overpayments. The court discovered a rather complex process beginning with an employee's report of injury to the appropriate party. Subsequently, according to the court the process consists of:

> (1) an initial determination by the self-insurer; (2) a copy of the determination being sent to the worker and L&I; (3) the ability to dispute the self-insurer's denial with L&I; (4) the opportunity to appeal L&I's decision to an industrial appeals judge; (5) the opportunity to present evidence at a hearing conducted by an industrial appeals judge; (6) the opportunity to appeal the industrial appeals judge's decision to an appeal tribunal; (7) the ability of the appeal tribunal to affirm, reverse, or modify the determination; (8) the ability to seek review of the appeal tribunal's decision; and (9) the opportunity to seek judicial review in superior court.

It was clear to the court that the state process in the Debtors' case was (1) "an extensive process that determines or adjudicates the existence of an overpayment and the validity of the amount owed" and (2) required to be completed before an order becomes final. In turn, a final order, stated the court, is a prerequisite for the warrant filing upon which the lien is predicated. As such, the court considered the lien was judicial in nature rather than a statutory; thus, the lien could be avoided and would not act as a lien on the real estate, provided the Debtors complete their Chapter 13 bankruptcy with a discharge.

Conclusion

Significantly, a homestead exemption process similar to the one in Debtors' state exists in Washington, D.C., and it is also subject to the same federal bankruptcy laws as states. So, what happened to Debtors could happen in D.C. It is crucial to your overall bankruptcy case to have an attorney who understands the nuances of the laws of the jurisdiction where you own real estate, including the crucial distinction between "judicial" and "statutory" liens.

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