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Avoiding judicial liens in bankruptcy:

Moldo v Charnock, 2004

Roger Bernhardt

Plain meaning of 11 USC §522(f)(2) requires avoidance of creditor's judicial lien, even though that lien is senior to consensual lien.

Moldo v Charnock (In re Charnock) (BAP 9th Cir Dec. 15, 2004) 318 BR 720

Moldo was appointed state court receiver in the dissolution proceedings of debtor Paula Charnock. In 1996, Moldo recorded an abstract of judgment, covering \$56,072 in fees and costs incurred in the administration of the receivership estate. Charnock owned a residence that she refinanced in 2002, paying Moldo \$28,000 from the proceeds of the loan; a deed of trust was recorded at that time evidencing the lender's lien. A year later, Charnock filed for Chapter 7 bankruptcy protection and moved to avoid Moldo's judicial lien under 11 USC §522(f)(2). The sum of the balance of the refinancing loan plus the amount of Charnock's homestead exemption exceeded the stipulated value of the property. The bankruptcy court granted Charnock's motion to avoid the lien.

The appellate panel affirmed. As the court noted, Congress chose among conflicting policies and ultimately favored consensual lienholders over judicial lienholders. The clear legislative intent of the changes to the bankruptcy statute was to override case law holding that a judicial lien could not be avoided if it was senior to a nonavoidable mortgage lien, and the total of all mortgages against the property exceeded the value of the property. Congress deliberately determined that judgment lien creditors would be treated differently from consensual lien creditors. The Bankruptcy Code provision is intended to preempt state law lien priorities that would apply outside bankruptcy; the policy favoring preservation of the homestead exemption does not create a windfall for, or confer a benefit not intended by Congress on, the debtor in a consumer bankruptcy proceeding.

THE EDITOR'S TAKE: This case involved a judgment lien of about \$70,000, a deed of trust of \$370,000, and a debtor's homestead protection of \$75,000, against a property valued at only \$435,000. The lien, the deed of trust, and the homestead totaled \$515,000, or \$90,000 more than the worth of the property; at least one of those interests had to suffer.

There is no easy resolution of this issue. The judgment lien is superior to the deed of trust but inferior to the homestead, while the deed of trust is inferior to the judgment lien but superior to the homestead, and the homestead is superior to the judgment lien but inferior to the deed of trust. Everybody is superior to one party and subordinate to another party. It is classic lien circuitry!

While this is a hard issue for state courts to resolve (see *Bratcher v Buckner* (2001) 90 CA4th 1177, 109 CR2d 534, reported in 24 CEB RPLR 256 (Oct. 2001) and cited in *Charnock*), it is apparently a slam dunk for bankruptcy courts, since the plain meaning of §522 of the Bankruptcy Code is that the judicial lien may be avoided as impairing the homestead exemption even though the impairment happens only because of the deed of trust, which came after the judicial lien. Put another way: If the debtor had filed bankruptcy

before putting a deed of trust on her property, the judicial lien would have been allowed, since at that stage it did not impair her statutory homestead exemption. But if the debtor later encumbers her liened property with a deed of trust, leaving her with less than \$75,000 of equity in the property, then to the extent her homestead has been impaired, the prior judicial lien can be avoided.

So, the judicial lien creditor in this situation is the real loser. But who is the winner? The BAP was a little less willing to call that result (it was not before the panel on this appeal), but the judges made their sentiments clear: The winner should be the bankrupt debtor rather than the beneficiary of the deed of trust. The deed of trust is to stay as far below the judgment lien as it always was; the amount avoided enhances the homestead protection instead.

Thus, assuming the property was encumbered by a judgment lien of \$70,000 and worth \$435,000 when the deed of trust was put on, there was only \$365,000 of remaining value to secure the \$370,000 deed of trust; it was undersecured by \$5000. Avoiding the \$70,000 judgment lien could add the missing \$5000 to the beneficiary's security, or it could, as suggested here, add \$70,000 to the debtor's homestead exemption and nothing to the deed of trust. That latter result is not surprising, because that's what bankruptcy is supposed to be about: protecting debtors even at the expense of their creditors.

It is too bad that the deed of trust beneficiary did not also appeal. Its loan was apparently a refinance, meaning that there was a good chance it could have claimed subrogation rights for the old loan it paid off, which loan probably was superior to the judgment lien. That would have generated a whole different set of calculations.— *Roger Bernhardt*