

Bankruptcy and Judgment Liens: Traps for the Unwary

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When searching a title or reviewing the results of a title search, the title examiner may discover that the current property owner, or a previous owner, has been involved in a bankruptcy proceeding while owner of the property. Often the property owner's bankruptcy was preceded by the entry of a number of judgments in favor of the owner's creditors which served as precipitating factors for the bankruptcy proceeding. In determining whether the pre-bankruptcy judgments remain attached as liens against the subject property, the title examiner's limited knowledge of the effect of bankruptcy proceedings on judgment liens against the debtor's property may create traps for the title examiner in rendering the title opinion. Those traps may be avoided by a better understanding of the effect of bankruptcy proceedings on judgment liens which attach prior to the filing of the bankruptcy, and by disclosing the bankruptcy issues and seeking the advice of a knowledgeable bankruptcy attorney or the title insurer.

The property owner facing a significant judgment or numerous judgments or demands by creditors will seek the protection of the bankruptcy courts by filing a voluntary petition, or may have an involuntary petition filed by his or her creditors. All debts owed by the debtor at the time the petition is filed are called "prepetition" debts. The principal goal of the debtor once in bankruptcy is to obtain relief from as many pre-bankruptcy obligations as possible. The principal and most commonly known way by which the debtor accomplishes this goal in bankruptcy proceedings is the obtaining of a discharge. Under each of the bankruptcy chapters, a debtor may obtain a discharge of some of all of the debtor's indebtedness if the debtor meets the statutory requirements for the discharge pursuant to 11 U.S.C. Section 727, 944, 1141, 1228 or 1328.

The effect of a discharge is described in 11 U.S.C. Section 524, which provides:

1. A discharge in a case under this title-
 - a) voids any judgment to the extent that such judgment is a determination of the personal liability of the debtor with respect to any [pre-petition] debt discharged under ... this title...;
 - b) 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 ...;

The effect of Section 524 (a) of the Bankruptcy Code is to provide the debtor with a discharge from **personal liability** for most pre-petition debts under the applicable provisions of the bankruptcy code, including debts evidenced by a pre-bankruptcy judgment.

It further protects the debtor from any court action...to collect, recover, or offset any discharged debt as a **personal liability** of the debtor. Because of the language in Section 524 (a)(1) stating that the discharge "voids any judgment", a title examiner with a limited knowledge of the Bankruptcy Code may assume that the effect of a discharge is also to

void the judgment lien against the real property of the debtor, when the judgment was obtained prior to the debtor's bankruptcy case. Accordingly, the title examiner may fail to report the existence of pre-bankruptcy judgment lien on the title report or opinion, which would be a serious error.

The United States Supreme Court has held that a creditor's right to foreclose on a lien survives the bankruptcy proceedings notwithstanding the discharge of personal liability of the debtor pursuant to 11 U.S.C. Section 524(a). *See Johnson v. Homestate Bank*, 501 U.S. 78, 82-83, 111 S. Ct. 2150, 2153, 115 L. Ed. 2d 66, 73-74 (1991). Thus, the mere fact that a property owner has obtained a discharge of a prepetition indebtedness, which was reduced to judgment prior to bankruptcy, does not mean that the pre-bankruptcy judgment lien against the owner's property has been wiped out by the bankruptcy. Instead, in order to avoid the bankruptcy trap, a knowledgeable title examiner must investigate further to determine if other action has been taken during the course of the debtor's bankruptcy proceedings in order to expunge the judgment lien from the debtor's property.

Other actions which may occur during the course of a bankruptcy proceeding which would have the effect of removing the lien as a lien against the real property owned by the debtor include a sale of the debtors real property during the pendency of the bankruptcy proceeding "free and clear of liens" pursuant to applicable court order under 11 U.S.C. Section 363 (f); avoidance of the judgment lien pursuant to the avoidance powers of the trustee; "stripping" of the lien pursuant to a confirmed bankruptcy plan; and avoidance of the judgment lien by the debtor pursuant to 11 U.S.C. Section 522(f). However, even if the diligent title examiner discovers the occurrence of any of these events in the course of the debtor's bankruptcy proceedings, further questions must be asked or the unwary title examiner may fall into another bankruptcy trap.

It would seem logical to assume that the entry by a bankruptcy court of an order allowing a piece of real property to be sold free and clear of liens pursuant to 11 U.S.C. Section 363(f), and a subsequent sale of that property by the trustee or the debtor, would be sufficient to remove a pre-bankruptcy judgment as a lien on the real property conveyed. However, the order has that effect only if the sale, which occurred, was conducted in accordance with the specific terms regarding the manner of sale, sale price, and identity of purchasers in the court order authorizing the sale. For example, if the order authorizes a sale of the property free and clear of liens to John Smith for \$250,000.00, and the property is in fact sold to John Smith or another for a lesser price, the sale may be ineffective to remove the judgment liens and voidable.

In addition, if the order authorizes a sale by auction, further bankruptcy orders may be required to confirm the sale after auction. Accordingly, once a title examiner discovers a sale of a property during bankruptcy "free and clear of liens", an effort should be made to obtain as much information as possible regarding the terms of the order authorizing the sale and the circumstances of the actual sale, and that information should be forwarded to a knowledgeable bankruptcy attorney or to the title insurer for a determination of whether

the sale was sufficiently in compliance with the terms of the court's order to remove the pre-bankruptcy judgment liens.

If the title examiner discovers that the property was conveyed by the debtor or trustee during the pendency of the bankruptcy and the property examiner cannot obtain any evidence of a court order allowing the sale "free and clear of liens", the conveyance will be invalid to convey the property free and clear of judgment liens unless the sale was made by the trustee or the bankruptcy debtor in the ordinary course of the business of the bankruptcy debtor **and** the requirements of Section 363(f) of the Bankruptcy Code are met. The title examiner should not rely upon statements of the debtor or the trustee to determine whether or not a sale of real property allegedly "in the ordinary course of business" of the debtor is sufficient to remove the attached judgment liens from the property. Instead, the title examiner should convey all information known to a knowledgeable bankruptcy attorney or to the title insurer to make such a determination. In any event the matter should be reported to the title insurer who will often require a court order clarifying that the sale was authorized and sufficient pursuant to Section 363 to remove the liens, or may require a legal opinion that the sale had the intended effect.

The trustee may avoid certain liens by using the trustee's avoidance powers under the Bankruptcy Code, thereby removing the attachment of the liens to the property. Any avoidance by the trustee of the lien pursuant to the Bankruptcy Code requires entry by the court of an order avoiding the liens.

In addition, the debtor may "strip" the liens from the property in a confirmed bankruptcy plan, or may have judgment liens avoided under the circumstances described in 11 U.S.C. 522(f). Both events require an order of the Bankruptcy court confirming the bankruptcy plan or avoiding the lien. However, the mere existence of an order confirming a bankruptcy plan with "lien stripping" provisions, or an order avoiding a lien pursuant to Section 522(f) as to a particular piece of property, may not be sufficient to avoid the lien.

In Chapter 12 and in Chapter 13 bankruptcy cases, neither the avoidance of judgment liens by the debtor pursuant to Section 522 (f) (1) (A) nor the stripping of liens pursuant to a confirmed plan is final unless and until the debtor completes the Chapter 12 or Chapter 13 bankruptcy plan, and obtains a discharge pursuant Sections 1228 or 1328 of the Bankruptcy Code. Accordingly, any order confirming a plan with "stripping" provisions or avoiding a lien against real property pursuant to Section 522(f)(1)(A) should be reviewed by a knowledgeable bankruptcy attorney or by the title insurer to determine whether the bankruptcy order has the effect of actually avoiding judgment liens and removing them as liens against the property of the bankruptcy debtor.

It should be noted that if a debtor has obtained a discharge in bankruptcy, and a pre-judgment lien which attached to the debtor's real property prior to bankruptcy has not been avoided or otherwise removed from the property during the pendency of the bankruptcy, the debtor may, under certain circumstances, be able to have the bankruptcy attorney reopen the case to remove the lien pursuant to Section 522(f) of the Bankruptcy Code if the property is of the type which could be exempted pursuant to applicable state

or bankruptcy law. For that reason, the property owner should be afforded the opportunity to determine whether removal of the lien is feasible prior to being required to pay the lien at or prior to closing of the transaction.

Finally, it should also be noted that a bankruptcy proceeding by a property owner may have the effect of extending the duration of a judgment lien on the real property if the judgment lien survives the bankruptcy proceeding. 11 U.S.C Section 108(a) may have the effect of extending the duration of a judgment lien at least 30 days after the expiration of the bankruptcy case if the lien otherwise would have expired during the course of the bankruptcy proceeding. In addition, some states have laws, which toll the statute of limitation for a judgment lien during the period in which a creditor is enjoined from enforcing his lien during the pendency of a bankruptcy proceeding. See, for example, N.C. Gen Stat. Sections 1-23 and 1-234 (a full discussion of which is contained in the February 2001 Investors Title News Article entitled "Tolling of North Carolina Ten Year Statute of Limitations for a Judgment Lien While Debtor is in Bankruptcy" by W.A. Foley, III, found within the "news" link on the invittle.com website). Failure by the title examiner to take in to account any such tolling in determining whether a judgment lien has expired would be a serious mistake.

In short, the determination of whether pre-bankruptcy judgment liens remain attached to property of a judgment debtor who has been through a bankruptcy proceeding is a process fraught with traps for the title examiner. A consultation with a knowledgeable bankruptcy attorney and a call to the title insurer with full disclosure of the bankruptcy information is essential to protect the interests of the title examiner, the person rendering the title opinion, the title insurer, the lender, the buyer and the seller of the real property.