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Lien on Me

By Dennis M. Ryan and C.J. Harayda

Climbing from Junior to Senior

Consensual Lien Subrogation, Avoidance Issues under § 522(f)

Dennis M. Ryan
Faegre Baker Daniels LLP; Minneapolis

C.J. Harayda
Faegre Baker Daniels LLP; Minneapolis

Dennis Ryan is a partner and C.J. Harayda is an associate in Faegre Baker Daniels LLP's Finance and Restructuring Group in Minneapolis.

What happens to the nature of a debt and priority of its associated lien when, rather than buying the obligation, a junior secured creditor pays off in full the debt owed to a senior secured creditor? If the junior creditor has not specifically purchased the obligation from the senior creditor, the debtor may argue that payment of the obligation discharges the senior lien, and although the junior creditor's lien moves into first place, it secures only the original junior obligation—not the full indebtedness. This could have even more significant negative repercussions where the junior creditor holds a nonconsensual lien on property of the debtor that would otherwise be exempt.

In re Carter Decision

Since the enactment of the Bankruptcy Code in 1978, § 522(b) has given debtors the ability to exempt certain property from their bankruptcy estates. Under § 522(f), debtors have the power to avoid certain liens that would otherwise impair an exemption they would be entitled to under § 522(b).[1] In particular, a debtor may use § 522(f)(1) to avoid judgment liens. Recently, the Eighth Circuit Bankruptcy Appellate Panel (BAP) affirmed the bankruptcy court's determination that a consensual lien was not converted into a judgment (nonconsensual) lien or discharged where the junior judgment lienholder paid off the senior secured creditor in connection with levying upon the collateral. Instead, the judgment lienholder became subrogated to the secured creditor's rights, which included an unavoidable consensual lien.

In *Carter v. Estate of Heimer (In re Carter)*, the debtor asked the court to avoid a judgment creditor's entire lien on the debtor's Cadillac Escalade SUV under § 522(f)(1).[2] The judgment lienholder had paid off the balance of the loan from the secured creditor totaling approximately $21,299. Iowa law, applied in this case, specifically provides that personal property subject to a security interest may be taken on attachment or execution issued against the debtor if the judgment lienholder pays the secured party the amount of the secured party's debt, including accrued interest.[3] Iowa law further provides that when the judgment lienholder pays the secured party, the judgment lienholder is subrogated to the rights of the secured party.[4] After the judgment lienholder had paid the secured party, the debtor filed for chapter 7 and sought to avoid the interest of the judgment lienholder in the vehicle. The judgment lienholder argued that it actually held two liens after paying off the secured party: (1) a consensual lien in the amount of $21,299 and (2) its original judgment lien.[5] The judgment lienholder acknowledged that its original judgment lien remained subject to possible avoidance under § 522(f).[6] The BAP sided with the judgment lienholder and found that it had been subrogated to all of the secured party's rights. Therefore, it was now the holder of a consensual lien on the vehicle, not subject to avoidance under § 522(f)(1). The BAP did not examine the issue of whether the remaining judgment lien was avoidable or whether the judgment lienholder could force a sale of the vehicle when the debtor was not in default on the obligation that the vehicle secured.[7]

Lien Subrogation and Expansion of § 509(a)

The issue of lien subrogation in the context of a bankruptcy case is a familiar one. Subrogation is encountered in at least two situations in bankruptcy

1 11 U.S.C. § 522(b), (f).
2 *In re Carter*, 466 B.R. 468 (8th Cir. B.A.P. 2012).
3 Iowa Code § 626.34.
4 Iowa Code § 626.37.
5 *In re Carter*, 466 B.R. at 470.
6 *Id.*
7 *Id.* at 471 n. 3.

where a party becomes subrogated to the rights of a secured creditor. The more typically encountered forms of subrogation, however, have some marked differences from what took place in the *In re Carter* case.

One type of subrogation encountered in the Bankruptcy Code is set forth in § 509(a),[8] which allows an "entity" that is liable with the debtor on a claim of a creditor to pay off such claim and be subrogated to the rights of such creditor to the extent of the entity's payment.[9] Thus, when a co-obligor satisfies his or her obligation to a secured creditor on a debt for which he or she is jointly liable with the debtor, the co-obligor steps into the secured creditor's shoes. The party seeking subrogation through § 509(a) must not be primarily liable for the debt with the debtor.[10] Accordingly, this Code section is primarily used by sureties and guarantors.[11] The co-obligor's claim, however, remains subordinated to the claim of the secured creditor whom he or she paid to the extent that any part of the secured creditor's debt remains outstanding.[12] Thus, the co-obligor may completely step into a secured creditor's shoes or possibly may only partially step into the secured creditor's shoes. The ability of a party to step into a secured creditor's shoes in a consensual transaction such as this was recognized even before the enactment of the Bankruptcy Code.[13]

Subrogation under § 509(a) operates in a similar manner to the transaction at issue in *In re Carter*, but there is one significant difference: In a subrogation under § 509(a), all parties to the transaction (the debtor, co-obligor and creditor) are parties to a consensual transaction. The subrogation in *In re Carter*, however, involved a nonconsensual transaction where the party satisfying the debt was able to accede to the consensual rights of the lender, despite the fact that the secured party did not agree to be paid off and despite the debtor's subsequent objections to the transfer of the creditor's rights. In essence, the BAP and the provisions of the Iowa Code expanded § 509(a) to a nonconsensual lienholder.

A second occurrence of subrogation under the Code is found under § 522(i),[14] which arises after a debtor has avoided a lien under § 522(f). Once the debtor has avoided the lien, including judgment liens, the debtor steps into the shoes of the avoided lienholder under § 522(i),[15] which, of course, protects the value of the avoided interest from being lost to a junior creditor that would otherwise rise in priority if the lien simply were extinguished—a great benefit to the debtor.

Other States' Subrogation Statutes

Many states have statutes that deal with subrogation of a junior lienholder for a senior secured creditor. While not identical to the Iowa statute at issue in *In re Carter*, these similarly operate to allow a judgment lienholder to be subrogated to the rights of a secured creditor rather than extinguishing—or changing the nature of—the senior lien.

One analogous statute is found in Oklahoma. Oklahoma Statute 42 § 19 provides that a party who has a lien inferior to another upon the same property may redeem the property by paying off the superior lien and is then subrogated to the superior lienholder's rights.[16]

Louisiana Article 1829 also provides for the subrogation by operation of law of one creditor for another.[17] The statute is broad enough to encompass any subrogation by operation of law and, in fact, the comments to the statute specifically anticipate situations where one creditor pays off another creditor and could be subrogated to the other creditor's rights.[18]

The obvious differences with the Louisiana and Oklahoma statutes, or similar statutes, is that they do not require a judgment lienholder to pay off the senior lienholder in connection with execution on the property subject to the secured creditor's lien. Despite this, they do present bases under which a judgment lienholder could step into the shoes of a secured creditor and maintain the consensual nature of the lien to prevent avoidance under § 522(f)(1).

Practical Implications for Judgment Lienholders and Secured Creditors

Although the above discussion provides some food for thought regarding subrogation rights of nonconsensual lienholders, there are practical implications as well that judgment lienholders seeking to enforce their liens (and steer clear of avoidance under § 522(f)(1)) should evaluate. Consider what actually happened then in *In re Carter*. The judgment lienholder held a judgment for approximately $30,230 and paid the secured creditor $21,299 to satisfy the secured creditor's lien and execute on the collateral. The value of the collateral is not set forth in the opinion.

In exchange, the judgment lienholder steps into the shoes of the secured creditor and all of the secured creditor's rights. The secured creditor now has had its entire debt prepaid (including the accrued interest) by the judgment lienholder. The judgment lienholder conceded that its judgment lien was potentially avoidable. If avoided, the judgment lienholder would have an unsecured claim in the amount of $30,230. In sum, the secured creditor has received payment in full satisfaction of its claim, and the judgment lienholder paid $21,299 for a $21,299 secured claim and retained a $30,320 unsecured claim.

From the judgment lienholder's perspective, this is not a particularly good deal because the transaction gives it no immediate economic gain. However, there is some potential gain for the judgment lienholder. First, since it is subrogated to all of the rights of the secured creditor, it is now entitled to the stream of payments from the debtor related to the collateral. It is possible that the value of the stream of payments exceeds $21,299. The debtor had not yet defaulted on the loan secured by the Cadillac and might continue to make payments. Further, if the debtor did eventually default, it is possible that the judgment lienholder could utilize § 9-620 of the Uniform Commercial Code (UCC) (as adopted by Iowa in this case) and accept the collateral in satisfaction of

8 11 U.S.C. § 509(a).
9 The term "entity" includes person, estate, trust, governmental unit and U.S. Trustee. 11 U.S.C. § 101(15).
10 *Celotex Corp. v. Allstate Ins. Co. (In re Celotex Corp.)*, 289 B.R. 460, 473 (Bankr. M.D. Fla. 2003).
11 *See, e.g., Adams v. Parker (In re Parker)*, 10 B.R. 562 (Bankr. M.D. Ala. 1981) (co-signor on debt subrogated to rights of secured creditor).
12 11 U.S.C. § 509(c).
13 *French Lumber Co. v. Commercial Realty & Fin. Co.*, 195 N.E.2d 507, 509 (Mass. 1964) (refinancing creditor was subrogated to rights of original secured creditor).
14 11 U.S.C. § 522(i).
15 *Id.*; *In re Newcomb*, 2010 WL 383838 (Bankr. D. Mass. Jan. 26, 2010).
16 Okla. Stat. Ann. tit. 42 § 19.
17 La. Civ. Code Ann. art. 1829.
18 *Id.* at cmt. (d).

the debt.[19] If the collateral's value exceeded $21,299, then the judgment lienholder would reap a financial benefit from being subrogated to the secured creditor and exercising its rights under UCC § 9-620.

Any potential financial gains that the judgment lienholder could receive through the subrogation dealt with in *In re Carter* comes with a fair amount of risk and requires an initial payment by the judgment lienholder. If the collateral is worth less than the debt—not uncommon with a depreciating asset like a personal vehicle—then the judgment lienholder might recover less than the amount it paid to the secured creditor. Additionally, there are transactional costs that reduce the judgment lienholder's recovery, regardless of what the collateral is worth. In sum, electing to pay the secured lienholder and be subrogated to that creditor's rights likely does not create a windfall for the judgment lienholder.

The secured creditor is the party that truly comes out best in this scenario. First, it has had its entire debt satisfied, including the accrued interest. Thus, rather than having an outstanding debt to a potentially risky borrower with collateral that may or may not satisfy the debt, the secured creditor now has the cash and no risk of collection. Second, the secured creditor no longer has to incur any transaction costs related to reaffirming the debt, collection, filing a claim or foreclosing on the property. It is the secured creditor (and its counsel), therefore, who should keep its eyes open for statutes and opportunities similar to the one under Iowa law in *In re Carter*.

Conclusion

While *In re Carter* may or may not have direct application to the rights of lienholders under your state's statutes, at the very least it demonstrates the interesting ballet that state statutes, the Bankruptcy Code and UCC Article 9 perform in sorting out the various priorities and rights of creditors. It also highlights how this interplay may expand the rights otherwise available to creditors under the Bankruptcy Code and how that may in turn impact debtors' rights. abi

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19 Iowa Code § 554.9620.