

## Lien Avoidance: How To Maximize Exemptions When Filing Chapter 7 Bankruptcy

I was recently asked to explain the difference between a lien avoidance and lien stripping, and I am happy to oblige. Here is part 1.

A lien can be thought of as a right to retain the lawful possession of the property of another until the owner fulfills a legal duty to the person holding the property. In common terms, you can think of a lien as a debt for which your property is collateral – for example your mortgage is a common lien. In bankruptcy, lien holders are generally considered secured creditors, which changes the way they are compensated in bankruptcy proceedings. At the risk of oversimplifying the scenario, secured creditors are generally guaranteed the value of the debt or the value of the collateral, whichever is less.

There are ways in bankruptcy to avoid or eliminate liens against your property by removing the secured status and thus reassigning the debt as unsecured. Both lien stripping and lien avoidance are directly supported by the bankruptcy code. Today I will talk a little about lien avoidance, and leave the stripping for another day.

The bankruptcy code calls for discharge of ‘*in personam*’ liability (personal liability); however, ‘*in rem*’ liability (property liability) remains. What this means is that, in cases of secured debt, your personal liability to the debtor is discharged but your property as collateral is not. That is, secured debts such as unavoided liens can pass through a bankruptcy discharge. Thus even after discharge, your creditor may still foreclose or repossess the property.

The good news is that in certain cases a lien avoidance can remove the secured status of a lien, which removes the *in rem* liability and thus the ability of the creditor to foreclose or repossess the property. The reason for this is simple. Chapter 7 bankruptcy exists for those people burdened by their debt such that they cannot recover from it. Explicit in the bankruptcy code is the means to facilitate a fresh start for the debtor. A chapter 7 bankruptcy filing does not leave a debtor destitute, and instead affords the right to certain exempt property deemed necessary to successfully move forward.

You can see how the presence of a secured lien would impact these exemptions. If a consensual lien passes through bankruptcy discharge intact, it would undermine an exempt asset deemed necessary by the bankruptcy code for a fresh start. The debtor would be placed in the unfortunate position of having to decide whether to relinquish the securing property to the creditor or keep the burden of the original debt.

With certain liens, the bankruptcy code permits lien avoidance to protect your exempt assets from such secured debts that impair the exemption. What does this mean? Well, simply speaking, the lien must encroach on your allowed exemption for that property in order for lien avoidance to apply. If you like numbers, then the following examples may help to clarify.

Consider that your home is currently valued at \$250,000, with a mortgage balance of \$100,000 and a judicial lien against the property for \$50,000. As a reminder, the homestead exemption allowance in Arizona is \$150,000. After the mortgage is repaid, there is a remaining equity of \$150,000. This is not enough equity to both repay the judicial lien and allow for the homestead exemption. If the lien were to pass through bankruptcy

it would reduce the amount of your exempt equity, which is provided under the bankruptcy code. Thus the lien may be avoided in chapter 7 or 13 bankruptcy.

To complicate things, a lien can also be partially avoided. Consider again the above scenario. Let's pretend that the housing crisis did not hit quite as hard(wishful thinking?), and the current value of your home is actually \$275,000. In this case after the \$100,000 remaining mortgage balance is paid, there is a remaining equity of \$175,000. If you were to pay the entire \$50,000 judicial lien, there would not be sufficient equity remaining to maximize your homestead exemption. However, the entire \$175,000 is not exempt under the bankruptcy code. In this case, the lien is reduced to \$25,000 and the remaining portion of that lien may be avoided.

Don't get too excited, as not all liens can be avoided. If that was the case, you can just imagine that bankruptcy would invalidate all mortgage debt that impacted exemptions, because remember that a mortgage is a type of lien. Specifically, only judicial liens (such as a judgment or garnishment) or non-possessory, non-purchase money security interests in household goods may be avoided.

A qualified bankruptcy attorney can determine whether your lien qualifies for avoidance. If not, there may be other options to consider, such as lien stripping. As always, if you have any questions feel free to contact me at my Phoenix bankruptcy office.