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9th Circuit Allows Certain Consensual Liens to Be Avoided In Chapter 7 Bankruptcy; Still, the Devil Is In the Details

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In 2010, a realtor in bankruptcy sought to avoid a consensual nonpurchase-money lien she gave in her Mercedes Benz in exchange for a $22,000 loan because, in her words, that luxury automobile was "intrinsically a tool of her trade." While no one questioned the debtor's ability to (1) receive a discharge to be completely forgiven of her personal obligation to re-pay the loan or (2) exempt any equity that would otherwise protect her Mercedes Benz from being sold to satisfy claims of *unsecured* creditors, case law was then unsettled on her ability to *avoid* the *consensual lien* she gave in these circumstances. Ultimately, if the debtor could avoid the lien then even the *secured* creditor that lent her the $22,000 could not sell the car (pledged as collateral) and recover the proceeds.

In general, consensual liens pass through chapter 7 bankruptcy cases unaffected.[1] Still, section 522(f) of the Bankruptcy Code[2] allows certain consensual liens to be avoided in chapter 7 where: (1) the creditor received a non-possessory, nonpurchase-money security interest (*e.g.*, a security interest in exchange for a refinance loan);[3] (2) the debtor properly exempted an interest in the collateral under section 522(b) or applicable state law (where the state has opted out of the federal list of exemptions);[4] (3) the collateral is of a type specifically listed in section 522(f)(1)(B); and (4) the non-possessory lien is avoided only "to the extent" it impairs the debtor's exemptions and within certain limits.[5]

The bankruptcy court ultimately denied the debtor's motion and published a decision, ruling that: (a) California's "grubstake" or "wildcard" exemption (allowing debtors to *exempt* "any property" up to $25,340)[6] cannot be imported into narrow federal avoidance law, which only allows debtors to *avoid* liens impairing exemptions in specifically-enumerated property and within limits; and (b) case law shielding debtors from losing hammers, wrenches or other trade tools—with minimal resale value and "practically worthless in the hand of the creditor"—cannot be used as a sword for debtors to avoid consensual liens in automobiles with substantial resale value.[7]

The debtor appealed to the federal district court, which reversed the bankruptcy court and remanded the case back to the bankruptcy court to determine, factually, whether the debtor's Mercedes Benz is necessary for her trade.[8] The creditor then appealed to the United States Court of Appeals for the Ninth Circuit to resolve the differences in published opinions and to specifically clarify issues including: (1) whether California exemptions can be used to expand federal lien avoidance and, if so, how the conditions, limits and requirements of California law apply;[9] and (2) whether nonpossessory, nonpurchase-money security interests in "motor vehicles"—which are listed in the federal *exemption* subsection but not federal *avoidance* subsection—can be avoided under federal law.[10]

Ultimately, the 9th Circuit affirmed the district court ruling and required a factual determination about whether the car was actually necessary for the debtor's trade "or just a sweet

[1] *See, e.g.*, *Dewsnup v. Timm*, 502 U.S. 410, 418 (1992).
[2] Title 11 of the United States Code.
[3] 11 U.S.C. § 522(f). Notably, *purchase*-money security interests (*i.e.*, those obtained when financing the purchase of the collateral) cannot be avoided.
[4] Some have argued that state-created exemptions violate the U.S. Constitution requiring Congress—and only Congress—to enact uniform bankruptcy laws throughout the United States as the supreme law in the land. *See* U.S. Const. art. I, § 8, cl. 4 and art. VI, cl. 2. Case law on this issue is split. *Compare, e.g.,* cases suggesting that state-specific exemptions in bankruptcy are unconstitutional, *In re Wallace*, 347 B.R. 626 (Bankr. W.D. Mich. 2006), *In re Pontius*, 421 B.R. 814 (Bankr. W.D. Mich. 2009) and *In re Reinhart*, 460 B.R. 466 (Bankr. E.D. Mich. 2011), with cases suggesting they are constitutional, *Richardson v. Schafer (In re Schafer)*, 689 F.3d 601 (6th Cir. 2012), *In re Applebaum*, 422 B.R. 684 (9th Cir. BAP 2009) and *Sheehan v. Peveich*, 574 F.3d 248 (4th Cir. 2009), *cert. denied*, 130 S.Ct. 1066 (2010).
[5] 11 U.S.C. §§ 522(f)(2) and (f)(3).
[6] Cal. Civ. Proc. Code §§ 703.140(b)(1) and (b)(5) effective January 1, 2013.
[7] *In re Angie Garcia*, 433 B.R. 759, 761 (Bankr. C.D. Cal. 2010) *citing In re Harrell*, 72 B.R. 107, 110-11 (Bankr. N.D. Ala. 1987).
[8] *In re Angie Garcia*, 451 B.R. 909, 916 (C.D. Cal. 2011) *citing In re Taylor*, 861 F.2d 550, 553 (9th Cir. 1988) (requiring a debtor to prove that "the vehicle is necessary to the debtor's trade, and the state has opted out of the federal laundry list...")
[9] *See, e.g.*, Cal. Civ. Proc. Code § 703.140(a) requiring married debtors to file a spousal waiver before claiming the grubstake exemption in bankruptcy cases.
[10] Compare 11 U.S.C. § 522(d)(2), where Congress included motor vehicles in its list of available federal exemptions, with 11 U.S.C. § 522(f)(1)(B) that excludes motor vehicles from its list of property subject to federal lien avoidance (while including virtually every other category of asset from section 522(d)).

ride."[11] The 9th Circuit panel relied primarily on an earlier panel's decision from 1988, *In re Taylor*, that had otherwise been questioned or ignored by bankruptcy courts.[12] Notably, the *Taylor* panel acknowledged the "harshness" of its decision then and explained how its impact on future creditors would not be so severe since "effective October 1, 1987 the tools of the trade exemption [in Montana] was limited to $3,000."[13] Although Montana allows debtors to exempt certain personal property "without limitation," the Ninth Circuit panel in *Taylor* was apparently convinced that legislative limits for exempting tools of the trade would sufficiently protect creditors.[14] Similarly, Cal. Civ. Proc. Code §§ 703 and 704 both limit a debtor's right to exempt motor vehicles and trade tools,[15] yet the District Court insisted that avoiding liens "to the full amount permitted under California's wildcard exemption" is "constitutionally permissible."[16] Several other courts in the Ninth Circuit, focused closely on the plain language of section 522(f), have not been so generous. [17]

On remand, the creditor was given an opportunity to cross-examine the debtor and discovered: (1) it was unclear whether the debtor had a valid real estate agent's license;[18] (2) the debtor was not aware of any broker, employer or licensing body that ever required a specific car (or any car) for real estate activity; (3) the debtor admitted that any mid- to high-end vehicle (not just a Mercedes Benz) would be sufficient for real estate activity; and (4) the debtor has access to another comparable vehicle.

After the evidentiary hearing the parties entered into a settlement agreement whereby the debtor agreed to voluntarily withdraw her motion to avoid the creditor's lien. So, while the 9th Circuit clarified that lien avoidance is *possible* in chapter 7 for luxury automobiles (and other collateral), the devil remains in the details. Moving forward, creditors making nonpurchase-money loans should be particularly careful to assess facts surrounding any potential "necessity" claims by their borrowers in whatever collateral they pledge for a loan. Notably, many of these arguments will be determined at a later point (in bankruptcy), and based on specific facts existing at that time. Still, unless legislation passes to reduce this risk, creditors obtaining non-purchase money security interests in any collateral should beware.

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[11] *In re Angie Garcia*, 709 F.3d 861, 862 (9th Cir. 2013).
[12] *In re Taylor, supra*.
[13] *Id.* at 554 *citing* 1987 Mon. Laws 596.
[14] *Id.* and Mont. Code § 25-13-608.
[15] *See, e.g.*, Cal. Civ. Proc. Code §§ 703.140(b)(2), 703.140(b)(6), 704.010(a)(1) and 704.060(a)(1).
[16] *In re Angie Garcia*, 451 B.R. at 917.
[17] *See, e.g., In re Driscoll*, 179 B.R. 664 (Bankr. D. Or. 1995) and *In re Rawn*, 199 B.R. 733 (Bankr. E.D. Cal. 1996).
[18] Publicly-available documents suggest these licensing issues were remedied shortly after the evidentiary hearing and the debtor testified to these issues as being no more than a technical mistake.