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Elizabeth Filardi

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Lien Preservation Does Not Give Trustee Right to Collect All Debt

Elizabeth Filardi, J.D. Candidate 2010

In *Morris v. St. John National Bank*, 516 F.3d 1207 (10th Cir. 2008), the Tenth Circuit addressed the issue of whether a bankruptcy trustee who successfully avoids a lien and preserves the in rem security interest for the bankruptcy estate under the powers granted to him by the Bankruptcy Code automatically assumes all the rights the original lienholder may have against the debtor. The Court, affirming the decisions of the bankruptcy court and bankruptcy appellate panel, concluded the trustee did not automatically assume all the rights the original lienholder may have against the debtor. *Id.* at 1212. The Court determined that although the Bankruptcy Code does place the trustee in the shoes of the lienholder in certain respects, it does not include a right to contractual promises for future payments. *Id.* at 1210–11.

Morris provides important insight into the trustee's limited preservation powers under the bankruptcy code in light of the distinction between property rights and mere contract rights. First, the following discussion will explore the two Bankruptcy Code provisions that empower the trustee to avoid liens and preserve them for the bankruptcy estate. Second, the following discussion will look at the specific circumstances of the lienholder and debtor in *Morris* and how the bankruptcy appellate panel and Tenth Circuit analyzed the relevant Bankruptcy Code sections. Finally, the discussion will examine the distinction between property rights and mere contract rights presented in *Morris* and also in the parallel context of subordination agreements.

Lien Avoidance and Preservation Under the Bankruptcy Code

Before the enactment of the Bankruptcy Code, liens generally passed through bankruptcy unaffected. *Morris*, 516 F.3d at 1209; see *Farrey v. Sanderfoot*, 500 U.S. 291, 298 (1991) (noting “liens and other secured interests [ordinarily] survive bankruptcy”). However, the Code created exceptions to this rule, including two provisions that empower the trustee to avoid liens and preserve them for the bankruptcy estate. First, §544 affords trustees the power to avoid “any transfer or obligation a creditor with an unsatisfied judicial lien on the debtor’s property could avoid under relevant state bankruptcy laws.” 11 U.S.C. § 544(a)(1) (2006). Also known as the “strong arm clause,” the trustee is given the power to act as a hypothetical lien creditor. *Robinson v. Howard Bank (In re Kors, Inc.)*, 819 F.2d 19, 22 (2d Cir. 1987). Under this provision, the trustee has the ability to avoid liens that are unsatisfied or unperfected as of the date of the commencement of the case. 5 COLLIER ON BANKRUPTCY, ¶ 544.02, at 544-5 (Alan N. Resnick, et al. eds., 15th ed. Rev. 2006). In addition, state law determines whether a creditor’s security interest is unperfected and therefore avoidable under §544. *In re Gaiser*, No. 05-19138, 2007 WL 643314, at *2 (Bankr. D. Kan. Mar. 2, 2007); see *Robinson*, 819 F.2d at 22–23 (noting state law is used to determine the lien creditor’s rights and priorities). As a result, when a creditor has not taken the necessary steps under state law to perfect its interest, and put other creditors on notice of its interest, the trustee will be able to avoid its interest. See *In re Bachtel*, No. 08-31845, 2008 WL 4348691, at *2 (Bankr. N.D. Ohio Sept. 22, 2008).

Second, after the lien is avoided pursuant to §544, §551 provides that any transfer or lien avoided is preserved for the benefit of the estate. 11 U.S.C. § 551 (2006). Section 551 states “any transfer avoided under section [544] . . . or any lien void[ed] . . . is preserved for the benefit of the estate but only with respect to property of the estate.” 11 U.S.C. § 551 (2006). Moreover,

§551 automatically preserves for the benefit of the estate any interest avoided under §544. *Robinson*, 819 F.2d at 23.

The result of §551 is twofold. First, the trustee, on behalf of the bankruptcy estate, assumes the original lienholder's position in the line of secured creditors. *Morris*, 516 F.3d at 1210. By allowing the trustee to assume the original lienholder's position, §551 prevents junior lienholders from improving their position in the line of creditors at the expense of the estate. *Id.* (noting Congress wanted to assure that the avoidance of a lien did not "simply benefit junior lienholders who would otherwise gain an improved security position and might, when the estate is limited, prove the only beneficiaries of the trustee's actions"); see *Rodriguez v. Whatcott (In re Walker)*, 389 B.R. 746, 750 (Bankr. D. Colo. 2008). Second, the trustee "steps into the shoes of the former lienholder" and assumes the same rights in the "collateralized property that the original lienholder enjoyed." *Morris*, 516 F.3d at 1210. However, until *Morris*, there was some discrepancy over the limits of the trustee's statutory power to displace lienholders. The question remained open as to whether assuming the position of the displaced lienholder included enforcing the lien over and above the value of the collateralized property. *Id.*

Morris v. St John National Bank: Case Background

In *Morris*, Christopher and Catherine Haberman ("the Debtors") borrowed \$3,050 from St. John National Bank ("the Bank"), using their 1980 Pontiac Trans Am ("Trans Am") as security. *Morris*, 516 F.3d at 1208. On the date the debtors filed for bankruptcy, they still owed the bank \$3,237.50 on the loan, but the fair market value of the Trans Am was only \$2,000. *Id.* Subsequently, the bankruptcy trustee discovered that the bank failed to perfect its security interest in the Trans Am. *Id.* The trustee filed an adversary action to avoid the unperfected

security interest under §544(a) and preserve the avoided lien for the estate pursuant to §551. *Id.* The bankruptcy court determined that the trustee could avoid the bank's lien on the Trans Am under §544(a). *Id.* at 1209. While §551 automatically preserved the lien for the benefit of the estate, the issue that arose was whether §551 permitted the trustee to recover the full amount owed or whether the trustee was limited to the value of the bank's security interest in the Trans Am itself. *Id.* The trustee argued that he "became" the displaced lienholder and ascended to all its rights upon avoidance of the unperfected lien pursuant to §544. *Id.* at 1212. Accordingly, he asserted that §551 permitted him to recoup the full value of the loan rather than just the fair market value of the Trans Am. *Id.* In addition, although the difference between the two amounts was only \$1,237.50, the trustee maintained that the issue was one that reoccurred frequently and merited clarification since it pertained to "the core of [trustees'] statutory rights and duties." *Id.* at 1209.

Both the bankruptcy court and bankruptcy appellate panel rejected the trustee's argument that §§544 and 551 permitted him to recoup the full value of the loan rather than just the fair market value of the Trans Am. The bankruptcy court ruled that a trustee who avoided an unperfected lien pursuant to §544(a) and preserved it for the bankruptcy estate under §551 acquired only the value of the lien on the secured property itself. *Id.*

The bankruptcy appellate panel affirmed. It held that "[o]nce the trustee avoided the bank's lien, he inherited the Bank's position prior to avoidance and could not expand that position by enforcing the lien over and above the value of the collateral." *Id.* (quoting *Morris v. St. John Nat'l Bank (In re Haberman)*, 347 B.R. 411, 416–17 (10th Cir. Bankr. App. Panel 2006)). In addition, the bankruptcy appellate panel determined that *Morris v. Vulcan Chem. Credit Corp. (In re Rubia)*, 257 B.R. 324 (10th Cir. Bankr. App. Panel 2001) was controlling in

this case. In *Rubia*, the bankruptcy appellate panel was faced with a factual situation similar to the circumstances presented in *Morris*. *Morris*, 347 B.R. at 415. Here, the debtor received a loan from a bank and used his car as security. *Rubia*, 257 B.R. at 325–26. After filing for bankruptcy, the debtor continued to possess the car and make payments to the creditor toward his loan. *Id.* at 326. Subsequently, the trustee avoided the creditor’s lien on the property and moved to recover the payments the debtor made to the creditor after he filed for bankruptcy. *Id.* The Court held that the trustee was not entitled to the post-bankruptcy petition payments. *Id.* at 328. Under §551, the Court determined that the trustee held the same lien position the creditor had prior to the avoidance of the lien on the car. *Id.* at 328 (citing *Retail Clerks Welfare Trust v. McCarty (In re Van de Kamp’s Dutch Bakeries)*, 908 F.2d 517, 519 n.2 (9th Cir. 1990) (“[A] trustee that avoids an interest succeeds to the priority that the interest enjoyed over competing interests.”)). The court also noted that if the car was not worth the full value of the outstanding loan, the trustee’s rights were limited to the rights of the creditor if the loan was not avoided. *Id.* at 325. In this case, the bank was entitled to the value of the car if it perfected its interest. As a result of the controlling nature of *Rubia*, the bankruptcy appellate panel in *Morris* held that the trustee could only recover the \$2,000 fair market value of the Trans Am for the bankruptcy estate.

On *de novo* review, the Tenth Circuit affirmed both the bankruptcy court and bankruptcy appellate panel’s decisions. *Id.* at 1212. It concluded that a trustee who avoids a lien pursuant to §544 (a) and preserves it for the bankruptcy estate under §551 is limited to the value of the lien and does not acquire the bank’s right to collect any debt amount beyond the value of the security interest. *Id.* Consequently, the trustee’s recovery was limited to the \$2,000 value of the secured

interest on the debtor's car, and he could not recoup the full \$3,237.50 owed on the value of the loan at the time of the bankruptcy filing. *Id.* at 1210.

The Tenth Circuit reasoned that while §551 provides that the trustee could succeed to the bank's in rem security interest in the car, the power to preserve "liens" and "transfers" does not embrace the bank's unsecured right to receive loan payments above and beyond the value of the car. *Id.* Section 551 states that only "liens" and transfers" may be taken by the trustee for the benefit of the estate. *Id.* As defined in §101(51), a transfer includes liens and other dispositions of property interest, including "the creation of a lien; the retention of title as security interest; the foreclosure of a debtor's equity of redemption; or each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest in property." *Id.* (quoting 11 U.S.C. § 101(54) (2006)). The Tenth Circuit noted that although the term "transfer" includes additional dispositions of property interest, the definition does not include contractual promises to future payments. *Id.* The trustee does not have the ability to take purely contractual interests for the benefit of the estate under §551. *Id.*; see 5 COLLIER ON BANKRUPTCY, ¶ 551.02, at 551-1 (Alan N. Resnick, et al. eds., 15th ed. Rev. 2006) (noting section 551 preserves only liens and transfer and does not preserve any other rights of the displaced lienholder).

Consequently, the Tenth Circuit concluded the debtors' contractual promise to make future loan payments to the bank, above and beyond the value of the Trans Am, was neither a lien nor any other transfer of interest in property. *Id.* at 1211. Similar to the reasoning in *Rubia*, the Court noted that if the debtors defaulted on their loan prior to bankruptcy, the bank could only claim the interest in the Trans Am and would be left with a "mere unsecured contractual promise" for the remainder of the loan. *Id.* at 1212; see *Rubia*, 257 B.R. at 325–26. In

conclusion, the powers of the trustee under §551 allow him to take for the estate the value of the Trans Am. The power to take “liens” and “transfers” does not include “a right to deprive the bank of a separate contractual right to be repaid for its debt above and beyond the security interest.” *Id.*

The Distinction between Property and Contractual Rights In the Context of Subordination

Agreements

Morris provides important insight into the line between property rights and mere contract rights. The court distinguished the contractual right to future payments on a loan from the independent and present property rights created by a lien. *Id.* at 1211. This distinction rests on the fact that a “promise to pay” is technically a “personal obligation” while a lien “grants an interest in the property” and is “enforced against the [property].” *Hafemann v. Gross*, 199 U.S. 342, 347 (1905). As the Tenth Circuit noted, the distinction is also based on the fact that property relations are not conducted between two parties but “between . . . all . . . persons” since society as a whole recognizes a transfer of interest in property. *Id.* at 1211 (quoting 1 ARTHUR J. CORBIN, CORBIN ON CONTRACTS §1.3 (rev. ed. 1993)). The contractual right embodied in a promise to pay a future sum is “distinct and independent from the present property right created and recognized by society when one is given an interest in property such as a lien.” *Id.* (quoting 1 ARTHUR J. CORBIN, CORBIN ON CONTRACTS §1.3 (rev. ed. 1993)).

The distinction presented in *Morris* parallels the cases refusing to allow the trustee to use the §551 lien preservation power to assert rights under subordination agreements. Notably, the distinction between the property rights that §551 preserves for the trustee and the contractual rights that do not pass to the trustee is of critical importance in cases involving second lien

financing, where the trustee avoids the senior lien but wishes to assert the priority rights established by a subordination agreement entered into between the senior and junior lienholders. For example, in *Robinson v. Howard Bank (In re Kors, Inc.)*, 819 F.2d 19, 23 (2d Cir. 1987), the Second Circuit held that although an avoided security interest belonged to the bankruptcy estate pursuant to §551, the displaced lienholder retained its interest in the contractual subordination agreement with the debtor. *Id.* at 23–24. Here, a company had two financiers for a plastic manufacturing business sign a contract in which they agreed to subordinate their respected interests to the bank’s security interest. *Id.* at 21. When the company filed for bankruptcy, the trustee discovered that the bank failed to perfect its security interest, and the trustee, pursuant to §544(a), avoided the bank’s lien and preserved it for the benefit of the estate under §551. *Id.* at 22. However, the issue arose whether the trustee had the ability to retain the subordination agreement rights of the displaced lienholder. Affirming both the district court and bankruptcy appellate panel decisions, the Second Circuit held that the trustee’s powers under §544 and §551 do not extend to a subordination agreement. *Id.* at 23. The Court reasoned that while §544 allows the trustee to “step into the shoes of the hypothetical lien creditor” to avoid unperfected liens, he may only use §551 to preserve those rights that existed against the debtor. *Id.* The subordination agreement was not part of the bank’s unperfected security interest. The bank interest on the collateralized property was “separate and distinct” from the rights it possessed under the subordination agreement with the other business lenders. *Id.* at 24.

The same rationale was applied in *Morris*. The debtors’ contractual promise to make future loan payments to the bank was independent of the bank’s security interest in the Trans Am. *Morris*, 516 F.3d at 1211–12. Sections 544 and 551 empowered the trustee to avoid the bank’s security interest in the Trans Am and to take for the estate the value of the unperfected

transfer or lien. However, the trustee did not have the additional power to assume all of the bank's rights and interest, including independent contractual promises that cannot be considered "transfers of property." *Id.* at 1214.

Conclusion

Morris provides a useful determination of the limits of §551 and the trustee's statutory powers under the Bankruptcy Code in general. The Bankruptcy Code created exceptions to the rule that liens generally passed through bankruptcy unaffected. *Morris*, 516 F.3d at 1209. However, before *Morris*, the statutory limits on some of the trustee's statutory powers under §551 had some ambiguity. *Morris* establishes that a contract promise to make future loan payments to a bank is "neither a lien nor any other transfer of interest in property." *Morris*, 516 F.3d at 1211. A trustee who avoids a lien pursuant to §544 (a) and preserves it for the bankruptcy estate under §551 is limited to the value of the lien and does not acquire the bank's right to collect any debt amount beyond the value of the security interest. *Id.* at 1212. In order to provide this conclusion, *Morris* provides important insight into the line between property rights and mere contract rights. This distinction rests on the fact that a "promise to pay" is technically a "personal obligation" while a lien "grants an interest in the property" and is "enforced against the [property]." *Id.* (quoting *Hafemann v. Gross*, 199 U.S. 342, 347 (1905)). This distinction also of critical importance in cases involving subordination agreements. Consequently, *Morris* provides important limits of the trustee's power under the Code.