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From the Bankruptcy Courts: The Trustee's Avoiding Powers and Conditional Attachment Liens-Can Two People Wear the Same Shoes?

Benjamin Weintraub

Alan N. Resnick
Maurice A. Deane School of Law at Hofstra University

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THE TRUSTEE'S AVOIDING POWERS AND CONDITIONAL ATTACHMENT LIENS—CAN TWO PEOPLE WEAR THE SAME SHOES?

A recent case in the Southern District of New York, *In re DeLancey*,[1] raises interesting questions about a lien obtained by writ of attachment when a bankruptcy petition is filed before the lienor obtains a money judgment against the debtor.

DeLancey, the individual debtor, was the principal of a corporation involved in the roofing business in Allentown, Pennsylvania. In April 1984, Nazario, a creditor of both the corporation and DeLancey, commenced an action against Mr. and Mrs. DeLancey and the corporation in federal district court to collect unpaid debts for materials furnished. On the same day, Nazario caused a preliminary writ of attachment to be levied against certain equipment and proceeds because the debtor was not served personally with the summons and complaint.

On May 11, 1984, another creditor, United States Fidelity & Guaranty Company (USF&G), filed financing statements under Article 9 of the Uniform Commercial Code to perfect a security interest in the assets of Mr. and Mrs. DeLancey. The financing statements, as well as a judgment note, were filed as a result of USF&G's issuance of payment and performance bonds on behalf of the debtor and the corporation.

When various creditors sued both the debtor and the corporation in October 1984, the state court ordered that certain equipment be sold and the proceeds held in escrow by a bank pending a determination of the relative rights in the assets. On March 13, 1985, the Pennsylvania court held that DeLancey, not the corporation, was the owner of the equipment that was sold. The proceeds of the sale held in escrow were only $44,217, which was less than the amount owed to Nazario and only a small fraction of the sum owed to USF&G.

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* Counsel to the law firm of Levin & Weintraub & Crames, New York City; member of the National Bankruptcy Conference.

** Benjamin Weintraub Distinguished Professor of Bankruptcy Law, Hofstra University School of Law, Hempstead, New York; Counsel to Berkman, Henoch, Peterson, Kadin, Peddy & Scarcella, Garden City, New York; Member of the National Bankruptcy Conference.

[1] Case No. 85-B-20100 (S.D.N.Y. Dec. 20, 1988) (slip op.).

DeLancey filed a bankruptcy petition commencing a chapter 7 liquidation case on March 5, 1985. At that time, Nazario's attachment lien had priority, under Pennsylvania law, over the subsequently perfected lien of USF&G. If bankruptcy had not ensued and Nazario had eventually obtained a money judgment in its action, Nazario's priority over USF&G would have enabled Nazario to collect the entire escrow fund. However, state law provides that a lien obtained by order of attachment is inchoate and conditional on obtaining a money judgment. If a judgment cannot be obtained, the conditional lien is dissolved.[2] Under these facts, what are the relative rights of the parties as to the proceeds of the equipment held in the escrow fund?

Relative Rights of the Parties

This question was first raised in the context of a motion for summary judgment by the trustee in connection with his turnover action against the bank to recover the escrow funds. The trustee argued that Nazario's attachment lien was voidable under Section 544(a)(1) of the Bankruptcy Code,[3] the so-called strong-arm clause, because the lien was "unperfected" in that it was conditional on obtaining a money judgment that cannot be obtained because of the bankruptcy. Thus, the attachment lien dissolved and, according to the trustee's argument, the trustee may preserve the attachment lien for the benefit of the estate under Section 551 of the Code.[4] The result of this reasoning, according to the trustee, is that the trustee stands in the priority position of Nazario and defeats the junior security interest of USF&G.

Summary judgment was denied in part because of factual issues that had to be resolved, but the bankruptcy court granted partial summary judgment to the extent that the bank was directed to turn over the escrow funds to the trustee.[5] Although the court did

[2] See *In re* Savidge, 57 Bankr. 389, 391 (D. Del. 1986).

[3] 11 U.S.C. § 544(a) provides:

> The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists. . . .

[4] 11 U.S.C. 551 provides:

> Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

[5] *In re* DeLancey, 77 Bankr. 424 (S.D.N.Y. 1987).

not resolve the priority dispute between the trustee and USF&G, it did confirm that Nazario's lien was inchoate or unconditional because it did not obtain a money judgment.

In a subsequent motion to reclassify the claim of USF&G as an unsecured claim, the trustee again took the position that Sections 544(a)(1) and 551 allow the trustee to avoid the "unperfected" inchoate attachment lien while preserving it for benefit of the estate, thereby giving the trustee priority over USF&G's lien.

In response, USF&G argued that the inchoate or conditional attachment lien of Nazario is dissolved and therefore unavailable for preservation under Section 551. USF&G contended that the trustee is subrogated under Section 551 to the unsecured status of Nazario's inchoate or conditional lien which was "unperfected" and dissolved because no money judgment was entered in favor of Nazario prior to bankruptcy. Since the trustee may not preserve Nazario's lien for the benefit of the estate, according to USF&G's argument, its perfected security interest became the senior lien that is effective against the trustee.

The bankruptcy court noted that the rationale behind the automatic preservation of avoided liens pursuant to Section 551 is that "the estate should benefit from each avoidance rather than promoting the priority of unavoidable junior secured interests who would otherwise improve their positions at the expense of the estate."[6]

The court pointed out, however, that the trustee's rights resulting from preservation of the avoided lien are not without limitation.

> [T]he trustee who avoids and then preserves a senior secured claim cannot acquire greater rights in the property in question than those to which the trustee succeeded. . . . Thus, when under state law, the avoided lien which is sought to be preserved is inferior to subsequent valid liens, the inferior lien cannot be enhanced by its preservation under 11 U.S.C. § 551. If the avoided lien will sink below other liens against the estate, the trustee who stands in the shoes of the inferior avoided lien will likewise sink while in those shoes, because 11 U.S.C. § 551 does not create a floating lien for trustees.[7]

Focusing on the status of Nazario's attachment lien on the date on which the debtor filed the bankruptcy petition, which is when the trustee's strong-arm powers arise under Section 544(a), the bankruptcy court concluded that Nazario held a "valid unperfected attachment lien which was superior to USF&G's

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[6] *In re* DeLancey, slip op. at 6.
[7] *Id.*

subsequent in time lien which was perfected by filed UCC Financing Statements."[8]

The conclusion that Nazario's lien had priority over USF&G's security interest under Pennsylvania law led to the next question: What effect did the bankruptcy petition have on the attachment lien?

Effect of Bankruptcy Petition on Attachment Lien

The bankruptcy court found the district court decision in *In re Savidge*[9] helpful in its analysis. The attachment lien in *Savidge* was inchoate when the debtor filed a bankruptcy petition and a subsequent judicial lien creditor, not the trustee, objected to the secured status of the attachment lienor in the bankruptcy case. The attachment lienor argued that Section 546(b) of the Code allowed it to "perfect" the inchoate attachment lien after the debtor filed the bankruptcy petition. Pursuant to Section 546(b), the trustee's avoiding powers under Sections 544, 545, and 549 of the Code are "subject to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection." By obtaining a money judgment after bankruptcy, the attachment lienor will "perfect" the lien and the attachment lienor's priority will date back to the prebankruptcy time when the attachment lien was first obtained. Thus, upon such perfection the attachment lien becomes unavoidable as against the trustee. Moreover, Section 362(b)(3) provides an exception to the automatic stay to permit postpetition perfection of a lien to the extent that the trustee's avoiding powers are subject to Section 546(b).

The district court in *Savidge* rejected these arguments and held that the bankruptcy discharge of the debt owed to the attachment lienor made it impossible for the lienor to ever obtain a money judgment against the debtor. Therefore, the inchoate attachment lien could never be perfected and, under state law, it dissolved. The attachment lienor must be treated as an unsecured creditor. The district court also held that Section 546(b) was inapplicable to perfection of an attachment lien designed solely to secure jurisdiction.

> We hold that this type of unperfected lien, created by ITT's writ of domestic attachment in order to compel the appearance of the defendant and wholly dependent upon the subsequent recovery of a judgment on the attachment process, is not the type of "interest in property" which can be perfected

[8] *Id.* at 7.

[9] *In re* Savidge, 57 Bankr. 389 (D. Del. 1986).

under Section 546(b) after the debtor files for bankruptcy.[10]

The bankruptcy court in *DeLancey* did not discuss the rejection of the *Savidge* holding by the Court of Appeals for the Ninth Circuit in *In re Wind Power Systems, Inc.*[11] The court of appeals stated as follows:

> [T]he *Savidge* opinion cites no case law in support of its conclusion, and the logic of its application by the bankruptcy court would also overturn a strong line of cases in this court allowing prepreference lien creditors to proceed to judgment [citations omitted]. . . . As a matter of policy, the *Savidge* result is undesirable. Had the *Savidge* creditor been allowed to proceed to judgment, it would have taken priority over the trustee's judicial lien. The bankruptcy court's result provides an incentive for strategic bankruptcy filings which distort rights among creditors from what they would be outside bankruptcy proceedings.[12]

The bankruptcy court in *DeLancey*, by not following the *Wind* decision, in essence rejected the court of appeals's view that a "conditional attachment" lien could be effective even if the underlying claim is discharged. In a previous decision,[13] the court held that DeLancey was not entitled to a discharge of any debts because of his failure to keep or preserve records from which his financial condition might be ascertained and for failure to explain satisfactorily a loss of assets.[14] Therefore, Nazario was free to obtain a money judgment after the bankruptcy case and, once obtained, the attachment lien would ripen into a judgment lien that would have priority over USF&G's security interest and the trustee's hypothetical judicial lien created by Section 544(a)(1). Although the bankruptcy court did not mention Section 546(b), that section should leave no doubt that the trustee's rights under the Section 544(a)(1) strong-arm clause are subject to Nazario's ability to perfect the inchoate attachment lien by obtaining the postpetition judgment. Moreover, the automatic stay should not interfere with Nazario's action to obtain the judgment because of the exception contained in Section 362(b)(3).

The court in *DeLancey* correctly held that the trustee may not use Section 551 to preserve Nazario's attachment lien for the benefit of the estate and to reduce USF&G's status to that of an unsecured creditor. "In the event that Nazario obtains a judgment against the nondischarged debtor, such lien will ripen into a vested lien to the extent of the attached

[10] *Id.* at 391.

[11] 841 F.2d 288 (9th Cir. 1988).

[12] 841 F.2d at 293.

[13] *In re* DeLancey, 58 Bankr. 762 (S.D.N.Y. 1986).

[14] See 11 U.S.C. §§ 727 (a)(3), 727(a)(5).

funds. Manifestly, the trustee may not stand in Nazario's shoes to defeat perfected lien creditors who are junior to Nazario."[15]

Conclusion

Although we agree with the court's holding and analysis, we nonetheless question the metaphor used by the court to explain its reasoning:

> Unfortunately for the trustee, Nazario's shoes are too large for his feet. . . . Although the trustee has attempted to try on Nazario's shoes in order to preserve assets for the benefit of unsecured creditors, this court finds that the shoes don't fit. This finding is consistent with the old maxim that the same shoe does not fit every foot.[16]

But we believe that Nazario's shoes would fit the trustee. The denial of discharge means that Nazario could and would continue to recover a money judgment against DeLancey regardless of the existence of the attachment lien. Even unsecured creditors pursue judgments against a nondischarged debtor. In any event, once a money judgment is obtained, the attachment lien would have priority over USF&G's perfected security interest under state law. If permitted to do so, the trustee would dance very nicely in those shoes to reduce USF&G to unsecured creditor status. The shoes would fit well.

It is more accurate to say that the Bankruptcy Code limits the trustee's right to wear Nazario's shoes to ascertain whether or not they fit. Since Nazario may continue to pursue a judgment to "perfect" its lien, and the ripened lien will have priority over a hypothetical judicial lien creditor who obtained the judicial lien on the date of bankruptcy, there is no basis under the Code for avoidance of Nazario's lien unless Nazario fails to obtain a judgment. In essence, the trustee's strong-arm power under Section 544(a)(1) does not provide the strength needed to remove Nazario from its shoes. If there is no basis for avoiding the lien under the Code, Section 551 has no application and does not allow the trustee to preserve the lien for the benefit of the estate. Whether or not Nazario's shoes fit the trustee, the trustee may not wear them as long as Nazario is still wearing them.

Perhaps a more accurate picture of the court's reasoning in *DeLancey* could have been painted with the comment that "one pair of shoes cannot be worn by two people at the same time."

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[15] *In re* DeLancey, slip op. at 10.
[16] *Id.*