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Bankruptcy—A Fraudulent Conveyance Action and a Lis Pendens May Create a Lien Which Survives a Bankruptcy Discharge. Clark v. Bank of Bentonville.

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BANKRUPTCY—A FRAUDULENT CONVEYANCE ACTION AND A LIS PENDENS MAY CREATE A LIEN WHICH SURVIVES A BANKRUPTCY DISCHARGE. *Clark v. Bank of Bentonville*, 308 Ark. 241, 824 S.W.2d 358 (1992).

On April 14, 1986, Jack and Norma Clark conveyed certain real property in Benton County, Arkansas to Gary Clark, trustee of the Jack M. Clark trust.[1] At the time of the conveyance, the Clarks owed the Bank of Bentonville (the Bank) approximately $193,050 secured by two tracts of real estate.[2] Approximately one month after the conveyance to the trust, the Bank brought a foreclosure action against the Clarks which resulted in the sale of the two tracts of property securing the Clarks' bank loans.[3] The Bank also obtained deficiency judgments which totalled $193,650.[4]

On January 7, 1987, the Bank filed a complaint, along with a *lis pendens*[5] notice, in the Benton County Chancery Court to set aside the Clarks' transfer to the trust as a fraudulent conveyance.[6] Before a judgment was rendered by the chancery court in the fraudulent conveyance action, the Clarks filed for relief under Chapter 7 of the Bankruptcy Code[7] in the United States Bankruptcy Court for the Central District of California, San Bernardino Division.[8]

The Bank took no action to establish its status as a secured credi-

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1. Clark v. Bank of Bentonville, 308 Ark. 241, 243, 824 S.W.2d 358, 359 (1992).

2. *Id.* at 247, 824 S.W.2d at 361. Neither tract of real estate securing the Clarks' loans were at issue in this case. *Id.*

3. *Id.* at 248, 824 S.W.2d at 362.

4. *Id.*

5. "'*Lis pendens*' literally means a pending suit." 54 C.J.S. LIS PENDENS § 2 (1987). A notice of *lis pendens* is "a notice filed on public records for the purpose of warning all persons that the title to certain property is in litigation," and that, if they purchase the defendant's claim in the same, "they are in danger of being bound by an adverse judgment." BLACK'S LAW DICTIONARY 932 (6th ed. 1990). For Arkansas' codification of *lis pendens* requirements see ARK. CODE ANN. §§ 16-59-101 to -106 (Michie 1987).

6. 308 Ark. at 243, 824 S.W.2d at 359. A fraudulent conveyance action is a suit to recover a transfer made by a debtor with actual intent to hinder, delay or defraud a creditor or made for less than equivalent value when the debtor's debts are beyond the debtor's ability to pay as they became due. ARK. CODE ANN. § 4-59-204 (Michie 1991).

7. A Chapter 7 bankruptcy provides for the orderly liquidation of the debtor's assets by a bankruptcy trustee to satisfy creditors' claims. *See* 11 U.S.C. §§ 701-766 (1979 & Supp. 1992).

8. 308 Ark. at 243, 824 S.W.2d at 359.

tor in the bankruptcy[9] nor did it pursue the fraudulent conveyance action against the Clarks in the bankruptcy proceeding.[10] The Chapter 7 trustee, who could have elected to pursue the Bank's state law claim for the benefit of all of the Clarks' creditors,[11] also failed to take any such action in the bankruptcy.[12]

The Clarks received a discharge in bankruptcy on December 30, 1987.[13] Following the bankruptcy discharge, the Bank proceeded with its fraudulent conveyance action.[14] The Benton County Chancery Court granted judgment for the Bank and ordered that the fraudulently conveyed real property be sold and the proceeds applied to the Clarks' debt to the bank.[15] The Arkansas Supreme Court affirmed the chancery court decision.[16] The supreme court held that the filing of the *lis pendens* notice in the fraudulent conveyance action gave the Bank a pre-judgment lien on the real property.[17] The supreme court further held that even though the discharge in bankruptcy relieved the Clarks of any personal liability on the debt, the lien survived the discharge and the Bank was free to pursue an in rem action[18] to collect its debt.[19] *Clark v. Bank of Bentonville*, 308 Ark. 241, 824 S.W.2d 358 (1992).

The issue of whether a secured creditor has in rem rights against debtor's property after a bankruptcy discharge is inextricably inter-

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9. *Id.* at 244-45, 824 S.W.2d at 360.

10. *Id.* at 246, 824 S.W.2d at 361. *See, e.g.* Nebraska State Bank v. Jones, 846 F.2d 477, 478 (8th Cir. 1988) (holding that a single creditor lacks standing to pursue a fraudulent conveyance action in a bankruptcy). Additionally, the Bank in *Clark* was prohibited by the automatic stay of 11 U.S.C. § 362(a) (1979), which prohibits creditors from taking any action against the debtor's property during the pendency of the bankruptcy proceeding, from pursuing the fraudulent conveyance action during the pendency of the bankruptcy proceeding. 308 Ark. at 246, 824 S.W.2d at 361.

11. 308 Ark. at 246, 824 S.W.2d at 361. *See* 11 U.S.C. § 544(b) (1979) which states:

> (b) The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

12. 308 Ark. at 246, 824 S.W.2d at 361.

13. *Id.* at 243, 824 S.W.2d at 359.

14. *Id.*

15. *Id.* at 243-44, 824 S.W.2d at 359.

16. *Id.* at 244, 824 S.W.2d at 359.

17. *Id.* at 244, 824 S.W.2d at 360.

18. In rem is "a technical term used to designate proceedings or actions instituted *against the thing*, in contradistinction to personal actions, which are said to be in personam." BLACK'S LAW DICTIONARY 793 (6th ed. 1990).

19. 308 Ark. at 244, 824 S.W.2d at 360.

twined with the evolution of reaffirmation agreements.[20] The emergence of reaffirmation agreements can be traced back to the common law doctrine of "moral obligation."[21] At common law, it was generally believed "that a promise made in recognition of a moral obligation, arising out of a benefit previously received, was not enforceable."[22] However, exceptions to this general rule were developed. In the late eighteenth century, English attorneys began arguing that a bankrupt debtor had a moral obligation to repay discharged debts.[23] In *Trueman v. Fenton*,[24] a case decided by the English court in 1777, Lord Mansfield declared that a debtor was morally obligated to pay discharged debts, and a new promise to pay a discharged debt was sufficient consideration to revive the enforceability of the debt.[25]

Following the decision in *Trueman*, creditors began to use reaffirmation agreements to escape the effect of the bankruptcy discharge.[26] In 1849 in an effort to control the problem, the English Parliament declared all such reaffirmation agreements unenforceable.[27] However, just before reaffirmations were banned in England, their use began to grow in the United States.[28] Even after Congress passed the Bankruptcy Act of 1898, most states "either by statute or case law, recognized the theory that a discharge did not prohibit collection of the debt or erase the debt."[29] This meant that creditors were permitted to ignore the bankruptcy discharge and pursue post-bankruptcy litigation to collect the debt.[30]

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20. *In re* Ray, 26 B.R. 534, 537 (Bankr. D. Kan. 1983).

21. Timothy A. Hunt, Comment, *Reaffirmation Agreements: A Fight for Enforceability Under the New Bankruptcy Code*, 12 CUMB. L. REV. 431, 433 (1982).

22. *Id.* at 433-34.

23. Douglass G. Boshkoff, *The Bankrupt's Moral Obligation to Pay His Discharged Debts: A Conflict Between Contract Theory and Bankruptcy Policy*, 47 IND. L.J. 36, 39-44 (1971).

24. 98 Eng. Rep. 1232 (K.B. 1777). In *Trueman*, the debtor filed bankruptcy on January 19, 1775, at which time he owed a creditor money for the purchase of linen. In an effort to maintain his business relationship with the creditor, the debtor voluntarily agreed to reaffirm the debt. When the creditor attempted to enforce the agreement, the debtor refused to comply, arguing the agreement was intended as an evasion of the bankruptcy laws. *Id.* at 1232-33.

25. Hunt, *supra* note 21, at 434-35.

26. Hunt, *supra* note 21, at 435.

27. Hunt, *supra* note 21, at 435. *See also* 12 & 13 Vict. c. 106, § 204 (1849); *accord*, 24 & 25 Vict. c. 134, § 164 (1861).

28. *See* Hunt, *supra* note 21, at 435; Boshkoff, *supra* note 23, at 46.

29. Hunt, *supra* note 21, at 436. *See, e.g.*, Jersey City Ins. Co. v. Archer, 25 N.E. 338 (N.Y. 1890) (stating that the New York Code did not prohibit written reaffirmation of a discharged debt); Hill v. Trainer, 5 N.W. 926 (Wis. 1880) (holding that a promise by the debtor to pay a discharged debt is enforceable).

30. Hunt, *supra* note 21, at 436-37.

Relying on such case law and statutes, creditors often harassed debtors into paying the discharged debt.[31] Often creditors would file suit in state court in the hope that the debtor would rely upon the bankruptcy discharge and fail to appear in the subsequent action.[32] Creditors also used the threat of enforcing their in rem rights as a means of coercing the debtor into reviving his in personam obligation which had been discharged.[33]

In 1886 in *Long v. Bullard*,[34] the United States Supreme Court upheld the creditor's right to pursue its rights in rem against the property of the debtor notwithstanding the discharge of the personal liability of the debtor on the underlying debt.[35] In *Long*, a debtor in a bankruptcy proceeding claimed that certain real property, which was mortgaged to a creditor, was exempt from the creditors' claims pursuant to state law.[36] After the debtor was discharged, the creditor sought to foreclose its mortgage lien.[37] The debtor argued that the discharge of the debt in the bankruptcy prevented the creditor from taking post-discharge actions to collect the debt.[38] The Supreme Court held that the creditor's security interest was preserved notwithstanding the discharge of the underlying debt in the bankruptcy because no action was taken in the bankruptcy to avoid the lien.[39]

The survival of an unavoided lien post-discharge was codified by Congress in the Bankruptcy Act of 1898 and was followed by the courts until the passage of the Bankruptcy Reform Act of 1978 (the "Bankruptcy Code").[40] The plain language of § 522(c)(2) of the Bankruptcy Code provides that a lien which was not avoided during the bankruptcy proceeding survived the discharge.[41] However, following

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31. *See In re* Weathers, 15 B.R. 945, 950 (Bankr. D. Kan. 1981) ("This language [11 U.S.C. § 524(a)(2)] was designed to prevent creditors with avoided liens from harassing naive debtors with groundless threats of repossession.") *See also* Hunt, *supra* note 21, at 438.

32. Hunt, *supra* note 21, at 436-37.

33. *See* Boshkoff, *supra* note 23, at 37.

34. 117 U.S. 617 (1886).

35. *Id.* at 620-21.

36. *Id.* at 618.

37. *Id.*

38. *Id.* at 619-20.

39. *Id.* at 620-21.

40. 11 U.S.C. §§ 101—1330 (1988). *See, e.g.*, Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 582-83 (1935) ("[U]nless the mortgagee released his security in order to prove in bankruptcy for the full amount of the debt, a mortgage even of exempt property was not disturbed by bankruptcy proceedings").

41. 11 U.S.C. § 522(c)(2) (1979 & Supp. 1991) states:

(c) Unless the case is dismissed, property exempted under this section is not liable

the passage of the Bankruptcy Code some courts questioned whether a lien remained valid after the discharge of the debt.[42] Courts that took this position generally found that the language of 11 U.S.C. § 524(a)(2),[43] which prohibited collection efforts against the "property of the debtor," was clear and unambiguous in its intent to protect the debtor from in rem actions after the discharge of the debt.[44]

One of the early cases following the passage of the Bankruptcy Code which took the position that under the Bankruptcy Code a discharge of the debt rendered the lien invalid was *In re Williams*.[45] In *Williams*, a creditor attempted to assert its lien against the debtor's property post-discharge.[46] The debtor argued that under the Bankruptcy Code liens no longer survived discharge as they did under the Bankruptcy Act of 1898.[47] In support of their argument, the debtors in *Williams* pointed out the numerous ways the Bankruptcy Code provided for creditors to preserve their liens.[48] For example, even though a

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during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case, except —

. . .

(2) a debt secured by a lien that is -

(A)(i) not avoided under subsection (f) or (g) of this section or under section 544, 545, 547, 548, 549, or 724(a) of this title; and (ii) not void under section 506(d) of this title.

42. *See, e.g., In re* Williams, 9 B.R. 228, 234 (Bankr. D. Kan. 1981) (stating that unless a creditor takes affirmative action to preserve its lien prior to discharge, both the debt and the lien are extinguished); *In re* Ray, 26 B.R. 534, 536 (Bankr. D. Kan. 1983) (holding that a bank's lien on debtor's automobile, which was exempt from the bankruptcy estate, was not enforceable following the bankruptcy discharge).

43. Prior to its amendment by the Bankruptcy Act of 1984, Pub. L. No. 98-353 (1984), 11 U.S.C. § 524(a)(2) (1979) read as follows:

(a) A discharge in a case under this title —

. . .

(2) Operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, to collect, recover or offset any such debt as a personal liability of the debtor, or *from property of the debtor*, whether or not discharge of such debt is waived. (emphasis added).

See 3 COLLIER ON BANKRUPTCY § 524.01(3), 524.16 (15th ed. 1992).

44. *See In re* Ray, 26 B.R. 534 (Bankr. D. Kan. 1983). In *Ray*, the court held that a bank's lien on debtor's automobile, as to which debtor had been granted an exemption, was unenforceable after debtor's discharge. *Id.* at 536. The bank in *Ray* did not seek relief from the automatic stay, abandonment, reaffirmation, nor did it participate in any court action or proceeding to obtain possession of its collateral prior to debtor's discharge. *Id.*

45. 9 B.R. 228 (Bankr. D. Kan. 1981).

46. *Id.* at 230.

47. *Id.*

48. *Id.* at 231.

creditor was prohibited from taking action outside the bankruptcy proceeding against debtors or their property, the creditor could seek relief from the stay pursuant to 11 U.S.C. § 362(d) and proceed in state court with its action.[49] Alternatively, a creditor could proceed with those same actions in the bankruptcy court under the expanded jurisdiction granted to the bankruptcy court pursuant to 28 U.S.C. § 1471.[50] The creditor also has the option of seeking a reaffirmation agreement from the debtors, abandonment of the collateral pursuant to 11 U.S.C. § 554(b), disposition of the collateral to it pursuant to 11 U.S.C. § 725, or any combination of these alternatives.[51] The debtors further argued that when a creditor failed to avail itself of the Code's lien preservation methods, the creditor lost its in rem rights upon discharge.[52]

In finding that a lien no longer survived the discharge, the *Williams* court looked at the language of the Bankruptcy Code.[53] At the time of the court's decision in *Williams*, § 524(a)(2) of the Bankruptcy Code provided that a creditor was enjoined from acts to collect "from property of the debtor."[54] This language differed from § 524(a)(2)'s predecessor, § 14f of the Bankruptcy Act of 1898, which prohibited attempts to collect debts as "personal liabilities" of the debtor.[55] The court found that the language of § 522(c)(2),[56] which provides that a lien on property which is not avoided in the bankruptcy proceeding survives the discharge, conflicted with the language of § 524(a)(2),[57] which prohibited acts post-discharge to collect from the property of the debtor.[58]

After determining that the language of the Bankruptcy Code was

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49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* at 230.
53. *Id.* at 231.
54. 11 U.S.C. § 524(a)(2) (1979), *supra* note 43.
55. § 14f of the Bankruptcy Act of 1898 in part stated:
An order of discharge shall —

. . .

(2) enjoin all creditors whose debts are discharged from thereafter instituting or continuing any action or employing any process to collect such debts as *personal* liabilities of the bankrupt. [emphasis added].

9 B.R. at 231.
56. 11 U.S.C. § 522(c)(2) (1979), *supra* note 41.
57. 11 U.S.C. § 524(a)(2) (1979), *supra* note 43.
58. 9 B.R. 228, 232 (Bankr. D. Kan. 1981).

in conflict, the *Williams* court held that the conflict could only be resolved by finding that without reaffirmation of the debt by the debtors during the bankruptcy, the lien did not survive the discharge.[59] The court found that the plain meaning of the language of § 524(a)(2), which prohibits post-discharge collection attempts "from the property of the debtor," clearly showed an intent by Congress that a lien securing a debt which was not reaffirmed in the bankruptcy proceeding did not survive the discharge.[60]

The majority of courts declined to follow the reasoning of the court in *Williams*[61] and today, *Williams* is clearly a minority view.[62] Most courts today hold that the Bankruptcy Code and its legislative history, which indicates a specific intent by Congress to adopt the rule set forth in *Long v. Bullard*,[63] plainly establish that valid liens that have not been disallowed or avoided survive the bankruptcy discharge of the underlying debt.[64] The House Report in connection with § 522(c)(2) states that "[t]he bankruptcy discharge will not prevent en-

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59. *Id.*

60. *Id.* at 232-33. *See also* U.S. Code Cong. & Admin. News 1978, 6321, 6322 ("[I]n effect, the discharge *extinguishes* the debt, and creditors may not attempt to avoid that."). (emphasis added).

61. *E.g.*, *In re* Anderson, 95 B.R. 506, 508 (Bankr. S.D. Ohio 1988) (holding that an attorney's equitable common law charging lien survives discharge); Estate of Lellock v. Prudential Ins. Co. of Am. (*In re* Lellock), 811 F.2d 186, 190 (3rd Cir. 1987) (stating that a lien on a life insurance policy survives the discharge of the debt); *In re* Cassi, 24 B.R. 619, 626 (Bankr. N.D. Ind. 1982) ("[A] valid, pre-filed lien that is not otherwise avoided during the bankruptcy proceedings is not extinguished by the discharge and remains enforceable *in rem*"); *In re* Andrews, 22 B.R. 623, 626 (Bankr. D. Del. 1982) (explaining that because of the debtor's failure to take timely actions to avoid an avoidable judicial lien, the lien survived the discharge); *In re* Weathers, 15 B.R. 945, 949 (Bankr. D. Kan. 1981) (holding that the debtor's homestead, which secured a debt to a creditor, was liable for the debt after the discharge where the mortgage lien was not voided or avoided under the provisions of the Bankruptcy Code).

62. *See* Estate of Lellock v. Prudential Ins. Co. of Am. (*In re* Lellock), 811 F.2d 186 (3rd Cir. 1987), in which the court declined to follow the decision of the court in *In re* Ray, 26 B.R. 524 (Bankr. D. Kan. 1983), and *In re* Williams, 9 B.R. 228 (Bankr. D. Kan. 1981). The court stated that it would "follow the majority of courts which hold that the Bankruptcy Code and its legislative history plainly establish the better rule of law — that valid liens that have not been disallowed or avoided survive the bankruptcy discharge of the underlying debt." *Id.* at 189.

63. 117 U.S. 617, 620-21 (1886).

64. *Id.* at 620-21. *See also* Owen v. Owen, 111 S. Ct. 1833, 1835-36 (1991) (holding that if a judicial lien that is avoidable under the provisions of the Bankruptcy Code impairs an exemption it may be avoided so that it does not survive the discharge even if state law defines the exempt property in such a way as to specifically exclude property encumbered by such liens); Farrey v. Sanderfoot, 111 S. Ct. 1825, 1829 (1991) ("[I]t was well settled when § 522(f) was enacted that valid liens obtained before bankruptcy could be enforced on exempt property, . . . including otherwise exempt homestead property.").

forcement of valid liens. The rule of *Long v. Bullard* . . . is accepted with respect to the enforcement of valid liens on nonexempt property as well as on exempt property."[65] In 1984 in an effort to clear up the confusion surrounding the language of § 524(a)(2), Congress amended § 524(a)(2)[66] and removed the language which troubled the Court in *Williams, i.e.*, the language prohibiting post-discharge collection "from the property of the debtor."[67]

Courts rejecting the reasoning in *Williams* have held that a wide variety of liens may survive the discharge of the debtor's personal liability. For example, a lien on a life insurance policy was held to survive a bankruptcy discharge, even though at the time of the assignment of the policy to the creditor the debtor had no interest in it because the policy had not matured.[68] A purchase money security interest in goods sold by a creditor to a debtor is another lien that was found by a court to survive the discharge.[69] Common law liens, such as an equitable lien in the nature of attorney's common law charging lien,[70] and statutory liens, such as those granted to hospitals that provide medical services to the debtor,[71] have also been held to survive a bankruptcy discharge. Even liens that are avoidable in the bankruptcy proceeding can survive the discharge if the debtor fails to take timely action to avoid them.[72]

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65. H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 361 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6317. *See also* S. REP. NO. 95-989, 95th Cong., 2d Sess. 76 (1978), *reprinted in* U.S.C.C.A.N. 5787, 6317.

66. Bankruptcy Act of 1984, Pub. L. No. 98-353 (1984).

67. The current version of 11 U.S.C. § 524(a)(2) (1979 and Supp. 1991) reads as follows:

(a) A discharge in a case under this title —

. . .

(2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived;

See also 3 COLLIER ON BANKRUPTCY § 524.01(1), at 524-27 (15th ed. 1992).

68. *See, e.g.*, Estate of Lellock v. Prudential Ins. Co. of Am. (*In re* Lellock), 811 F.2d 186, 189 (3rd Cir. 1987).

69. *See, e.g., In re* McNeil, 128 B.R. 603, 607 (Bankr. E.D. Pa. 1991) (stating that a secured interest in consumer goods survives the discharge in bankruptcy); *In re* Pierce, 29 B.R. 612, 614-15 (Bankr. E.D.N.C. 1983) (holding that a purchase money security interest survives the discharge).

70. *See, e.g., In re* Anderson, 95 B.R. 506, 508 (Bankr. S.D. Ohio 1988) (stating that an attorney's equitable, common law charging lien is valid and survives discharge).

71. *See, e.g., In re* Smith, 119 B.R. 714, 720 (Bankr. D.N.D. 1990) ("Although judgments and judgment liens may be avoided by the discharge and may also be voided under section 522(f) as an impairment of exemption, valid statutory liens are neither effected by discharge or exemption declarations.").

72. *See In re* Andrews, 22 B.R. 623, 626 (Bankr. D. Del. 1982) (holding that creditor's

A 1991 United States Supreme Court decision appears to provide debtors with a method of protecting their property from in rem actions by creditors post-discharge. In *Johnson v. Home State Bank*,[73] a bank began an action to foreclose its mortgage on the debtor's farm.[74] While the foreclosure action was pending, the debtor filed a Chapter 7 bankruptcy.[75] The Bankruptcy Court discharged the debtor's personal liability on the notes to the bank.[76] However, after the discharge the bank continued its previously filed foreclosure action and obtained an in rem judgment against the debtor.[77] Prior to the foreclosure sale, the debtor filed a Chapter 13 bankruptcy, listing the debt to the bank as a claim to be paid through the Chapter 13 plan.[78] The bank objected to the debtor's proposed payment of its claim through the Chapter 13 plan.[79] The bank argued that because the debtor's personal liability had been discharged, the bank no longer had a "claim" against the debtor subject to rescheduling under Chapter 13.[80] The United State Supreme Court held that the bank's lien was a claim that could be satisfied through the Chapter 13 plan.[81] Therefore, the bank's remedies were limited to payments under the Chapter 13 plan and the debtor's property was free and clear of the bank's claim or interest.[82]

Although the majority of courts allow a creditor to pursue post-discharge enforcement of a valid lien on debtor's property,[83] creditors

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judicial liens on debtor's real estate survived bankruptcy proceedings when debtor failed to timely file a complaint to avoid the liens before discharge order was entered). *Compare*, Nobel v. Yingling, 29 B.R. 998, 1002 (Bankr. D. Del. 1983) (stating that debtor is not required to take any action prior to discharge to avoid judicial liens under the lien avoidance provisions of the Bankruptcy Code).

73. 111 S. Ct. 2150 (1991).

74. *Id.* at 2152.

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *See* 11 U.S.C. § 1327(b), (c) (1979), which states:

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

(c) Except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is *free and clear of any claim or interest of any creditor provided for by the plan.* (emphasis added).

83. *See In re* Weathers, 15 B.R. 945, 948 (Bankr. D. Kan. 1981) ("[W]ith the exception of Judge Pusateri's decision [in *In re* Williams, 9 B.R. 228 (Bankr. D. Kan. 1981)], it appears that in all cases decided under the Code, the courts have held that liens survived discharge.").

are prohibited from taking any action to subject the debtor to personal liability.[84] Any action taken by a creditor to subject the debtor to personal liability may cause the imposition of penalties against the creditor, such as debtor's attorneys fees and costs incurred in defending the suit.[85]

In order to prevent a lien from surviving the discharge of the debtor, most courts have held that the debtor must take some affirmative action to avoid the lien during the bankruptcy proceeding.[86] "A secured creditor must, of course, respond to an attempt by [a] trustee or debtor to . . . avoid his lien."[87] However, a secured creditor has no affirmative duty during the bankruptcy proceedings to ensure that its valid pre-bankruptcy lien survives.[88] Most courts have also held that even if the secured creditor chooses not to file a claim in the debtor's bankruptcy or pursue any other remedies available to it under the Bankruptcy Code,[89] the creditor may still enforce its lien against the debtor's property post-discharge.[90]

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84. *See* 11 U.S.C. § 524(a)(1) (1979), which states:

(a) A discharge in a case under this title —

(1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived.

85. *See, e.g., In re* Pierce, 29 B.R. 612, 615 (Bankr. E.D.N.C. 1983) (holding that a creditor attempting to collect a discharged debt as a personal liability of debtor was liable to the debtor for attorney's fees and costs incurred in defending the action).

86. *See In re* Dickinson, 24 B.R. 547, 550 (Bankr. S.D. Cal. 1982) (stating that a valid lien created pre-bankruptcy survives the debtor's discharge notwithstanding the creditor's inactivity during the bankruptcy proceeding); *In re* Thomas, 102 B.R. 199, 202 (Bankr. E.D. Cal. 1989) ("[I]t is incumbent upon the debtor, not the creditor, to take the steps necessary to expunge any liens rendered unenforceable by the former's discharge in bankruptcy."). For a discussion of the minority view, see *In re* Williams, 9 B.R. 228, 234 (Bankr. D. Kan. 1981) (holding that unless a creditor takes affirmative action to preserve its lien prior to discharge, both the debt and the lien are extinguished and the creditor loses its in rem rights).

87. *See, e.g., In re* Pierce, 29 B.R. 612, 614 (Bankr. E.D.N.C. 1983) ("[T]he secured creditor need only respond to a formal challenge to the security interest.").

88. *See, e.g., In re* McNeil, 128 B.R. 603, 607 (Bankr. E.D. Pa. 1991) (holding that a valid lien survived debtor's discharge notwithstanding creditor's failure to take any action to preserve the lien during the bankruptcy proceeding).

89. *See, e.g.*, Newman v. First Security Bank of Bozeman, 887 F.2d 973, 976 (9th Cir. 1989) (stating that the bankruptcy discharge has no effect on a valid pre-petition lien even if the secured creditor chooses not to file a claim or otherwise assert any interest in its security during the bankruptcy proceeding).

90. *See In re* Bouchelle, 98 B.R. 81, 82 (Bankr. M.D. Fla. 1989) (finding that a creditor who did not attend the § 341(a) first meeting of creditors nor file a proof of claim was allowed to enforce its lien against the debtor's property post-discharge); *In re* Pierce, 29 B.R. 612, 614 (Bankr. E.D.N.C. 1983) (holding that a secured creditor need only respond to a formal challenge

Because the creation and validity of a creditor's lien on a debtor's property is determined by state law,[91] the Arkansas Supreme Court in *Clark v. Bank of Bentonville*[92] first considered whether Arkansas law gave the Bank a lien on the Clarks' property.[93] The general rule in Arkansas is that a creditor obtains a specific lien on the personal property fraudulently conveyed by the debtor when the creditor files a complaint to set aside the fraudulent conveyance.[94] *Stix v. Chaytor*,[95] a case which was decided by the Arkansas Supreme Court in 1891, was one of the first cases in which this principal was recognized. In *Stix*, a creditor brought an action to subject goods fraudulently sold by a debtor to the payment of a judgment in favor of the creditor.[96] The court held that the filing of a complaint and the service of summons issued upon it created a lien in favor of the creditor on so much of the merchandise as was in existence.[97]

At the time of the decision in *Stix*, the granting of a lien upon the commencement of a fraudulent conveyance action was recognized by the courts as a reward for those creditors who were diligent in their pursuit of fraudulently conveyed property.[98] It gave diligent creditors priority in the distribution of the proceeds from the goods recovered,

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to its security interest thus the listing of a secured creditor in the debtor's bankruptcy schedules as unsecured does not require any response by the secured creditor); *In re* Weathers, 15 B.R. 945, 949 (Bankr. D. Kan. 1981) ("[W]hen the reason the secured claim is not allowed is because no party in interest ever requested allowance, then the lien is not void."). *See also* 11 U.S.C. § 506(d)(2), which states:

> (d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless —
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> . . .
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> (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

3 COLLIER ON BANKRUPTCY § 506.07, at 506-63 (15th ed. 1992).

91. *See In re* Claussen, 118 B.R. 1009, 1016 (Bankr. D.S.D. 1990) (holding that the existence and perfection of a lien is determined by state law).

92. 308 Ark. 241, 824 S.W.2d 358 (1992).

93. *Id.* at 244, 824 S.W.2d at 360.

94. *Id.*

95. 55 Ark. 116, 17 S.W. 707 (1881).

96. *Id.* at 117, 17 S.W. at 708. In *Stix* the debtor, while indebted to the plaintiff, conveyed his business and his inventory to his wife. However, the debtor continued to operate the business as he did before the conveyance. *Id.*

97. *Id.* at 122, 17 S.W. at 708.

98. Doster v. Manistee Nat'l. Bank, 67 Ark. 325, 339, 55 S.W. 137, 142 (1900) ("[T]he creditor who exercises superior diligence in [uncovering fraudulent conveyances] by first bringing his suit and proceeding to uncover such assets is entitled to the proceeds. This seems to us to be eminently just. . . .").

regardless of the priority of other judgments.[99] Many courts felt that a creditor should not be allowed to "lie idle until others have by their superior diligence discovered the fraud and commenced proceedings in equity to thwart it by obtaining the cancellation of the conveyance, and then step forward and reap the first fruits of their diligence."[100] This rule sometimes had the effect of elevating the rights of a junior lienholder who took the first steps to recover the property fraudulently conveyed above the rights of a senior lienholder.[101]

In 1912 the Arkansas Supreme Court reaffirmed its decision in *Stix*[102] in *Boyd v. Arnold*,[103] which involved an action by a creditor to recover a promissory note assigned by an insolvent debtor to his father.[104] In *Boyd*, the debtor borrowed money from his father to enter a business partnership.[105] The business burned, and a large portion of the goods were destroyed.[106] The partners sold the remaining goods to a third person in exchange for two promissory notes of equal value payable to each of the partners.[107] The debtor assigned his promissory note to his father in satisfaction of the borrowed money.[108] The father collected on the promissory note, and certain creditors of the partnership brought an action against the father to recover the money collected by him.[109] The court held that general creditors, by filing a complaint to cancel a fraudulent conveyance, acquired a specific lien on the personal property conveyed and thereby gained a priority in the distribution of the funds recovered over other creditors of the partnership.[110]

In another 1912 decision, *Goodrich v. Bagnell Timber Co.*,[111] the Arkansas Supreme Court was faced with a case very similar to *Clark v. Bank of Bentonville*.[112] In *Goodrich*, the debtor conveyed all of his

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99. *Id.*

100. A. C. FREEMAN, A TREATISE OF THE LAW OF JUDGMENTS, § 954, at 2007 (5th ed. 1925).

101. HENRY CAMPBELL BLACK, A TREATISE ON THE LAW OF JUDGMENTS, § 455, at 558 (1881).

102. Stix v. Chaytor, 55 Ark. 116, 17 S.W. 707 (1891).

103. 103 Ark. 105, 146 S.W. 118 (1912).

104. *Id.* at 106-07, 146 S.W. at 119.

105. *Id.* at 106, 146 S.W. at 119.

106. *Id.*

107. *Id.*

108. *Id.* at 106-07, 146 S.W. at 119.

109. *Id.*

110. *Id.* at 107, 146 S.W. at 119.

111. 105 Ark. 90, 150 S.W. 406 (1912).

112. 308 Ark. 241, 824 S.W.2d 358 (1992).

real and personal property to his wife while a suit to collect a debt was pending in the court.[113] Upon obtaining a judgment in the pending suit, the creditor brought an action to cancel the conveyance as a fraudulent conveyance.[114] Sixteen months later, the debtor filed a bankruptcy petition.[115] The court held that the creditor, by filing its suit to cancel the fraudulent conveyance, acquired a specific lien on the property alleged to have been fraudulently conveyed.[116] This specific lien entitled the creditor to priority in the distribution of the proceeds from the property.[117] The court further held that the suit by the bankruptcy trustee to recover the property "would not defeat [the creditor's] right to have [the] proceeds applied to the payment of its claim in the distribution of the [debtor's assets]."[118]

In reaching its decision in *Clark*, the Arkansas Supreme Court expanded the general rule set out in *Stix* and *Arnold* to cover fraudulent conveyance actions to recover real property.[119] Unlike *Clark*, both *Stix* and *Arnold* involved actions to recover personal property.[120] In *Clark*, the court held that in fraudulent conveyance actions by creditors to recover real property, the creditor obtains a specific lien on the property when a notice of *lis pendens* is filed with the complaint.[121] This lien becomes effective at the time of the filing of the notice of *lis pendens* and prior to a judgment of the court in favor of the creditor.[122]

The court in *Clark* further held that the lien created by the filing of the notice of *lis pendens* survived the discharge of the Clarks' debt in the bankruptcy.[123] In reaching this decision, the court followed the rule established in *Long*[124] and set forth in 11 U.S.C. § 522(c)(2).[125] The court pointed out that although the Clarks were aware of the

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113. 105 Ark. at 92, 150 S.W. at 406.

114. *Id.*

115. *Id.* at 93, 150 S.W. at 406. This is similar to *Clark*, in which the fraudulent conveyance occurred fourteen months before the bankruptcy proceedings were begun. *Clark*, 308 Ark. at 245, 824 S.W.2d at 360.

116. 105 Ark. at 93, 150 S.W. at 406.

117. *Id.*

118. *Id.*

119. 308 Ark. at 244, 824 S.W.2d at 360.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. Long v. Bullard, 117 U.S. 617 (1886).

125. 11 U.S.C. § 522(c)(2) (1979 & Supp. 1991), *supra* note 41.

Bank's fraudulent conveyance action,[126] they did not take any steps to avoid the lien created by the filing of the *lis pendens* during the bankruptcy proceeding.[127]

The Clarks argued that the "bank should have taken affirmative action to preserve its lien in the bankruptcy proceeding."[128] The court rejected the Clarks' argument that the failure of the Bank to contest its listing as an unsecured creditor in the Clarks' bankruptcy or to take affirmative action to assert its lien rendered the lien void.[129] Instead, the court adopted the majority rule that the debtor, not the creditor, has the burden of contesting the lien.[130] Because the Clarks didn't take any action to avoid the Bank's lien, the court held that pursuant to 11 U.S.C. § 522(c)(2), the Bank's lien survived the discharge.[131]

The Clarks also argued that under the doctrine of res judicata, the Bank could not assert its lien post-discharge.[132] The Clarks argued that "the bank should have either objected to [the Clarks'] discharge, established its status as a secured creditor, or pursued its fraudulent conveyance action during the bankruptcy proceeding."[133] The court rejected all of these arguments.[134] First, the court found that the Bank could not have objected to the Clarks' discharge pursuant to 11 U.S.C. § 727 (a)(2)(A) because the fraudulent conveyance occurred more than one year prior to the filing of the bankruptcy.[135]

Second, the court rejected the Clarks' argument that the Bank had

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126. 308 Ark. at 245, 824 S.W.2d at 360.

127. *Id.* at 246, 824 S.W.2d at 360.

128. *Id.* at 245-46, 824 S.W.2d at 360.

129. *Id.* at 246, 824 S.W.2d at 360.

130. *Id.* at 246, 824 S.W.2d at 360-61. *See In re* Thomas, 102 B.R. 199 (Bankr. E.D. Cal. 1989), *supra* note 86 and accompanying text.

131. 308 Ark. at 244, 824 S.W.2d at 360. *See In re* Dickinson, 24 B.R. 547, 550 (Bankr. S.D. Cal. 1982) ("[I]t is a long-established principle that unless avoided in the bankruptcy proceedings, valid liens will be preserved notwithstanding the discharge of the debtor.").

132. 308 Ark. at 244-45, 824 S.W.2d at 360.

133. *Id.*

134. *Id.* at 245, 824 S.W.2d at 360.

135. *Id. See* 11 U.S.C. § 727(a)(2)(A) (1988), which states:

(a) The court shall grant the debtor a discharge, unless —

. . .

(2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed —

(a) property of the debtor, within *one year* before the date of the filing of the petition. (emphasis added).

See also COLLIER ON BANKRUPTCY, §§ 727.02(2), 727.12 (15th ed. 1992).

a duty to establish its secured status during the bankruptcy proceeding.[136] In rejecting the Clarks' argument, the court looked at language in 11 U.S.C. § 506(d)(2)[137] and found that the failure of a creditor to file a proof of claim or otherwise assert its lien does not avoid an otherwise valid lien.[138]

Third, the court found that the Bank lacked standing to pursue its fraudulent conveyance action in the bankruptcy proceeding.[139] The court stated that the Bankruptcy Code does not give the Bank the power to directly pursue a cause of action to set aside a fraudulent conveyance.[140] The court also pointed out that the Bank was prohibited by the automatic stay of 11 U.S.C § 362(a) from acting against the Clarks' property during the pendency of the bankruptcy proceeding.[141] Although the trustee may choose to pursue a creditor's unsecured state law claim pursuant to 11 U.S.C. § 544(b),[142] "such an action is an exercise of the avoidance power for the benefit of all creditors."[143] Since the Bank did not have standing as a single creditor to pursue the

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136. 308 Ark. at 245, 824 S.W.2d at 360. *See also In re* Dickinson, 24 B.R. 547 (Bankr. S.D. Cal. 1982). In *Dickinson*, a group of doctors filed a state court action to enforce a lien created prior to the debtor's bankruptcy filing. *Id.* at 548-49. The doctors were listed as unsecured creditors on the debtor's bankruptcy schedules and the debt was discharged in the bankruptcy proceeding. *Id.* at 549. The court noted that although the debtor's attorney was aware of the existence of the liens, no action was taken by the debtor to avoid the liens during the bankruptcy proceeding. *Id.* at 549-50. The court held, therefore, that the liens survived the discharge of the debtor's debt. *Id.*

137. 308 Ark. at 246, 824 S.W.2d at 360-61. 11 U.S.C. § 506(d)(2) (Supp. 1991) states:

> (d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless —
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> . . .
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> (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

138. 308 Ark. at 246, 824 S.W.2d at 361. *See also In re* Weathers, 15 B.R. 945, 949 (Bankr. D. Kan. 1981) ("[W]hen the reason the secured claim is not allowed is because no party in interest ever requested allowance, then the lien is not void.").

139. *Id.* at 246, 824 S.W.2d at 361.

140. *Id.*

141. *Id. See also, In re* Weathers, 15 B.R. 945, 949 (Bankr. D. Kan. 1981) (explaining that during the bankruptcy proceeding, a creditor is stayed pursuant to 11 U.S.C. § 362(a) from taking any actions against property of the estate or property of the debtor).

142. 11 U.S.C. § 544(b) (1988) states:

> (b) The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

143. 308 Ark. at 246, 824 S.W.2d at 361.

fraudulent conveyance action during the bankruptcy proceeding,[144] res judicata did not prohibit the Bank's subsequent state court action.[145]

With its decision in *Clark v. Bank of Bentonville*, the Arkansas Supreme Court expanded its previous holdings in *Boyd*[146] and *Stix*[147] and held that a creditor obtains a lien on real property when the creditor files a notice of *lis pendens* with a complaint to recover a fraudulent conveyance.[148] This decision has the effect of giving the creditor a nonconsensual lien on real property prior to any court adjudication. In essence, the court has devised a method by which an unsecured creditor may be transformed to a secured creditor with a lien that survives the bankruptcy discharge. In reaching this conclusion, the Supreme Court of Arkansas greatly expanded the generally understood notice function of a notice of *lis pendens*.[149]

Further, the *Clark* decision gives creditors another weapon to coerce debtors into repaying discharged debts. By threatening to foreclose a lien on the debtor's real property, creditors may be able to force the debtor to reaffirm the debtor's personal obligation on a previously discharged debt.[150]

Additionally, because creditors routinely file notices of *lis pendens* when commencing actions against debtors involving real property, the *Clark* decision also means that attorneys for debtors in bankruptcy proceedings must now take affirmative action to discover *lis pendens* notices that have been filed against the debtor. Debtors' attorneys must also take action in the bankruptcy to avoid the lien, if possible, so that it will not survive the discharge.[151]

It may also become necessary for debtors to immediately file a Chapter 13 bankruptcy proceeding following a Chapter 7 bankruptcy

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144. *See* Nebraska State Bank v. Jones, 846 F.2d 477, 478 (8th Cir. 1988) (stating that a single creditor lacks standing to pursue a fraudulent conveyance action).

145. 308 Ark. 246, 824 S.W.2d at 361.

146. Boyd v. Arnold, 103 Ark. 105, 146 S.W. 118 (1912).

147. Stix v. Chaytor, 55 Ark. 116, 17 S.W. 707 (1891).

148. 308 Ark. at 244, 824 S.W.2d at 360.

149. *See* 54 C.J.S. Lis Pendens § 3 (1987) ("[T]he purpose of *lis pendens* or notice of *lis pendens* is to give effective notice to third persons of pendency of litigation affecting property. . . ."). Other courts have rejected the argument that the filing of a notice of *lis pendens* creates a lien. *See, e.g., In re* Ressler, 61 B.R. 403, 406 (Bankr. E.D. Tenn. 1986) (indicating that the entry of a judgment in chancery court did not create, much less perfect, a lien, even though the creditor had filed notice of *lis pendens*); *In re* Miller, 39 B.R. 145, 147 (Bankr. W.D. Mo. 1984) ("[T]he filing of a *lis pendens* notice under the [Alaska] statute does not create a lien.").

150. *See* Hunt, *supra* note 21, at 432.

151. *See supra* note 86 and accompanying text.

proceeding in order to avoid foreclosure of a lien on the debtor's real property after the Chapter 7 discharge.[152] Once a debtor has discharged its unsecured debts in the Chapter 7 proceeding, it may be forced to repay the debts secured by liens on real property through a Chapter 13 plan. This will greatly minimize the benefits of the legislatively intended "fresh start" for debtors receiving a bankruptcy discharge.

Finally, the decision in *Clark* will also adversely affect general creditors of a debtor who do not pursue the fraudulent conveyance. When a trustee recovers fraudulently conveyed real property, the proceeds from the sale of the property recovered go for the benefit of all creditors. Pursuant to the holding of this case, a creditor who commences a fraudulent conveyance action and files a notice of *lis pendens* has priority in the distribution of the proceeds. This means that the creditor will get paid in full before any distribution is made to other creditors, thereby diminishing the pool of assets available to general creditors of the debtor.

By improving the priority status of unsecured judgment creditors, the *Clark* decision provides a definite incentive to creditors to discover fraudulent conveyances by the debtor and to take actions to avoid those conveyances. Additionally, it places debtors' attorneys on notice that affirmative action should be taken to discover the filing of *lis pendens* notices and to avoid the resulting liens in the bankruptcy proceeding.

Mary Krikorian

152. Johnson v. Home State Bank, 111 S. Ct. 2150 (1991).