

In the United States Bankruptcy Court

for the Northern District of Iowa

RONALD O'BRIEN
PHYLLIS O'BRIEN
Debtor(s).

Bankruptcy No. 98-00545-C

Chapter 13

ORDER RE DEBTORS' OBJECTION TO CLAIM

This matter came on for hearing before the undersigned on September 17, 1998 on Debtors' Objection to Claim. Debtors Ronald and Phyllis O'Brien were present at the hearing represented by their attorney Thomas McCuskey. Creditor Custom Creations, Inc. was not present but did brief the issues presented at the hearing. After the presentation of evidence and argument, the Court took the matter under advisement. This is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(B), (K).

STATEMENT OF THE CASE

Custom Creations, Inc. filed a Proof of Claim asserting a secured claim of over \$35,000 based on a mechanic's lien judgment of \$12,500 and asserted attorneys fees of \$19,749.45. Debtors object that the amount related to attorney fees should not be included in the secured claim. They also argue Custom Creations' lien should attach only to non-homestead real estate.

FINDINGS OF FACT

On September 23, 1997, Custom Creations received a judgment against Debtors in Linn County District Court. The judgment foreclosed Custom Creations' mechanic's lien in the amount of \$12,500, with interest as provided by law. The court took the issue of attorney fees under advisement. Custom Creations documented attorney fees of \$19,749.45 and the matter was deemed fully submitted on September 29, 1997. The debt arose from cabinetry and woodwork at Debtors' residence. Custom Creations completed its work on the residence November 17, 1995; Debtors received a certificate of temporary occupancy December 22, 1995.

Debtors filed their Chapter 13 petition February 26, 1998. By stipulated order, this Court lifted the automatic stay to allow the parties to pursue and conclude the state court proceedings to assess and award attorney fees. The Linn County District Court, Judge L. Vern Robinson presiding, entered an order on September 10, 1998 concluding that "a reasonable attorney fee in this case is the sum of \$10,000. Judgment is entered accordingly."

According to their proposed plan filed February 26, 1998, Debtors intend to pay Custom Creations a monthly payment over thirty years. In paragraph 2, the plan states that its claim is secured by equity in

Debtors' two rental houses. The plan also contains a provision, in paragraph 9, avoiding all liens encumbering exempt property pursuant to §522(f).

Debtors argue the secured amount of Custom Creations' claim cannot be enlarged postpetition in detriment of third-party rights. They also assert that Custom Creations' lien can be shifted from their homestead real estate to their rental real estate.

Custom Creations argues that the attorney fee portion of the state court judgment is included within its secured claim, even though it remained unliquidated on the date Debtors filed their Chapter 13 petition. It further asserts its lien is statutory, rather than judicial, and not avoidable under §522(f). Custom Creations also argues its claim is excepted from the homestead exemption as preacquisition debt (incurred prior to Debtors' occupancy of the property), and as debt for work done for improvement of the homestead. It does not agree that Debtors may shift its lien from the homestead to non-homestead real estate.

AMOUNT OF SECURED CLAIM

An allowed claim secured by a lien on property is a secured claim. 11 U.S.C. §506(a). When a debtor objects to allowance of a claim, the Court determines the amount of the claim as of the date of the filing of the petition, and allows the claim in that amount unless, among other things, it is unenforceable under applicable law. 11 U.S.C. §502(b)(1). The Court may estimate the amount of any unliquidated claim. 11 U.S.C. §502(c)(1).

At the filing of Debtors' petition, Custom Creations held a judgment on its mechanic's lien in the amount of \$12,500, plus interest, and an unliquidated claim for attorney fees. The Court need not estimate the amount of attorney fees as the Linn County District Court has now determined the amount to be \$10,000, with judgment entered accordingly September 10, 1998. Debtors do not dispute that Custom Creations holds a secured claim based on the judgment on its mechanic's lien of \$12,500, plus interest to the time of filing the petition. They argue, however, that the attorney fee award of \$10,000 is not included in the secured claim because the judgment for that amount did not exist until after the filing of their petition in bankruptcy.

Under the broad definition of "claim" in §101(5), unliquidated amounts, including a prepetition right to payment of attorney fees, are includable in a creditor's claim. In re Hemingway Trans., Inc., 954 F.2d 1, 7 (1st Cir. 1992) (including attorney fees in general unsecured claim under prepetition indemnity clause); In re Byrd, 192 B.R. 917, 919 (Bankr. E.D. Tenn. 1996) (including attorney fees which arose postpetition within creditor's secured claim based on a prepetition security agreement). The definition of "claim" is broad enough to encompass a prepetition, unliquidated, contingent right to payment even though the contingency trigger does not occur until postpetition. Hemingway Trans., 954 F.2d at 8. Secured creditors holding either nonconsensual or consensual liens are entitled to fees which accrue prepetition. In re Brentwood Outpatient, Inc., 43 F.3d 256, 261 (6th Cir. 1994), cert. denied, 514 U.S. 1096 (1995).

The validity of a lien for attorney fees must be determined by the law of the state. Security Mortgage Co. v. Powers, 278 U.S. 149, 153 (1928). In In re Gordon, 164 B.R. 706, 708 (Bankr. S.D. Fla. 1994), the court determined that under Florida law a mechanic's lien covers attorney fees which are therefore included in the creditor's secured claim. The claimant was entitled to attorney fees by statute. Id. While the amount of attorney fees was under advisement, the debtor filed a petition in bankruptcy. Id. The court stated that had the issue not been deferred, the attorney fees would have been part of the

judgment. Id.; see also Zalay v. Ace Cabinets, 700 So.2d 15, 18 (Fla. App. 1997) (holding attorney fees and costs awarded under mechanic's lien statute are included in the lien).

Iowa Code sec. 572.32 states: "In a court action to enforce a mechanic's lien, if the plaintiff furnished labor or materials directly to the defendant, the plaintiff, if successful, shall be awarded reasonable attorney fees." Prior to the 1983 enactment of this section, Iowa cases reflected a concern for the rights of third parties when attorney fees were awarded in mechanic's lien actions. Rohlin Constr. Co. v. Lakes, Inc., 252 N.W.2d 403, 408 (Iowa 1977); Spieker v. Cass County Fair Ass'n, 249 N.W. 415, 416 (Iowa 1933). Subsequent to enactment of sec. 572.32, the Iowa Supreme Court applied the statute to find a mechanic's lien enforceable against real estate in the principle amount, together with interest and attorney fees. Clemens Graf Droste Zu Vischering v. Kading, 368 N.W.2d 702, 716 (Iowa 1985). The court held the mechanic's lien, including attorney fees, had priority in a subsequent purchaser's quiet title action. Id.

Based on the foregoing, the Court concludes Custom Creations' mechanic's lien includes attorney fees, even though the amount of the attorney fees remained unliquidated at the time Debtors filed their bankruptcy petition. Custom Creations' allowed claim encompasses both the \$12,500 judgment entered prepetition, plus interest to the petition date, and the \$10,000 judgment for attorney fees entered postpetition. This entire allowed claim is a secured claim in this case based on the fact that it constitutes a mechanic's lien under Iowa law. The entire amount of the claim is secured under §506(a) which states a claim based on an enforceable lien is secured to the extent of the value of the estate's interest in the property. According to Debtors' schedules, as pointed out in Custom Creations' brief, the value of the real estate to which the mechanic's lien attaches, Debtor's residence, is \$309,000 and liens with priority over Custom Creations' lien total \$150,000. Custom Creations is oversecured.

Custom Creations foreclosed on its mechanic's lien and brought it to judgment prepetition. Under Iowa law, this gives Custom Creations a lien based on the judgment itself, in addition to the mechanic's lien. Iowa Code §624.23 (judgments are liens upon the defendant's real estate at the time of the rendition of the judgment). To create a judgment lien there must be a final valid and subsisting judgment, rendered by a duly authorized court, for payment of a defined and certain amount. Schuling v. Tilley, 454 N.W.2d 899, 900-01 (Iowa Ct. App. 1990); Slack v. Mullenix, 66 N.W.2d 99, 101 (Iowa 1954). Custom Creations' judgment lien extended only to the \$12,500 judgment entered prepetition. At the time of the filing of the petition, the Linn County District Court had not yet entered a final judgment for a certain amount on the claim for attorney fees.

Custom Creations' mechanic's lien rights exceed its judgment lien rights as to the amount of the lien. The mechanic's lien extends to the right to attorney fees, even though the amount of attorney fees was unliquidated at the time Debtors' filed their bankruptcy petition. Custom Creations' judgment lien exceeds the mechanic's lien in one respect. The mechanic's lien attaches to the land upon which is situated the building for which Custom Creations furnished materials or performed labor. Iowa Code §572.5. The judgment lien attaches to all Debtors' real estate, both their residence and rental real estate. Iowa Code §624.23.

Logically, Custom Creations' chooses to assert its right to a secured claim under the mechanic's lien rather than under its less expansive judgment lien. Therefore, the Court need not consider the judgment lien. The Court will determine the protections to which Custom Creations is entitled under the Bankruptcy Code based solely on its mechanic's lien.

AVOIDANCE OF LIEN

Debtors' Plan apparently proposes to avoid Custom Creations' lien on their homestead. Pursuant to §522(f), Debtors may avoid most judicial liens to the extent the lien impairs an exemption. The language of §522(f) yields a four-part test for avoidance of a lien:

- (1) There must be an exemption to which the debtor "would have been entitled" under subsection (b) of §522;
- (2) The property must be listed on the debtor's schedules and claimed as exempt;
- (3) The lien at issue must impair the claimed exemption; and
- (4) The lien must be either a judicial lien or another type of lien specified by the statute.

In re Morgan, 149 B.R. 147, 152 (B.A.P. 9th Cir. 1993).

Taking the fourth element first, the lien Debtors seek to avoid must be a judicial lien. A judicial lien is a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding." 11 U.S.C. §101(36). An Iowa court has found that a mechanic's lien is a statutory lien within the meaning of 11 U.S.C. §101(53). In re Souers, 163 B.R. 346, 349 (Bankr. S.D. Iowa 1994) (considering avoidance of involuntary transfer). A judicial lien is specifically excluded from the definition of statutory lien in §101(53).

The Supreme Court of Iowa has stated that a mechanic's lien is purely statutory in nature. Carson v. Roediger, 513 N.W.2d 713, 715 (Iowa 1994). Based on similar law in Idaho, the court in In re Koski, 149 B.R. 170, 177 (Bankr. D. Idaho 1992), found that a mechanic's lien, as a statutory lien, is not avoidable under §522(f). See also In re Keane, 7 B.R. 844, 851 n.5 (Bankr. N.D. Iowa 1980) (stating in dicta §522(f) does not apply to statutory liens such as mechanic's liens). In Koski, a prepetition state court decision enforced the mechanic's lien. 149 B.R. at 177. The court held that the judicial decision did not change the mechanic's lien from a statutory lien to a judicial lien. Id.; cf. In re Miller, 8 B.R. 672, 673-74 (Bankr. N.D. Iowa 1981) (holding judgment in foreclosure does not transform mortgage lien into avoidable judicial lien).

The Court concludes Custom Creations' mechanic's lien is not a "judicial lien" and therefore is not avoidable under §522(f). A mechanic's lien in Iowa is purely statutory in nature. The fact that Custom Creations resorted to a state court adjudication to enforce its mechanic's lien does not transform the mechanics' lien into a judicial lien. The mechanic's lien was in existence as a valid lien prior to the state court judgment of foreclosure. The state court decision merely enforced the lien; it did not create the lien. See Koski, 149 B.R. at 177.

Custom Creations' lien is also not avoidable under §522(f) because it secures debt contracted prior to acquisition of the homestead as well as debt incurred for material furnished or labor provided for improvement of the homestead. Iowa Code §561.21(1), (3). As pointed out in In re Streeper, 158 B.R. 783, 788 (Bankr. N.D. Iowa 1993), the homestead is not exempt from such debt, regardless of whether the creditor has a judgment on the debt or a judgment lien. Because the homestead is not exempt from those types of debts, the homestead is subject to liens based on those debts. Id. Even if Custom Creations' lien was avoidable, the homestead would not be exempt from the underlying debt. Therefore, the first element under §522(f) cannot be met. Debtors would not be entitled to exempt their homestead from the claim held by Custom Creations in the absence of the lien.

SHIFTING LIEN TO NON-EXEMPT REAL ESTATE

Custom Creations' mechanic's lien, which includes attorney fees, attaches to Debtors' homestead real estate which is the property for which it did work or furnished material. Iowa Code §572.5; In re Keane, 7 B.R. 844, 851 n.5 (Bankr. N.D. Iowa 1980) (stating it is clear a homestead can be subject to a mechanic's lien in Iowa). Because Custom Creations succeeded in its action to foreclose the mechanic's lien, it also has a judgment lien which attaches to all Debtors' real estate. Iowa Code §624.23. This judgment lien does not encompass the \$10,000 attorney fee judgment entered postpetition. Custom Creations argues that it is entitled to retain its lien on Debtors' homestead. Debtors argue Custom Creations' secured claim is sufficiently protected by its judicial lien covering their rental real estate, if the mechanic's lien is removed from the homestead.

In Iowa, a homestead liable for contractual debt may be sold only "after exhausting all other property pledged by the same contract for the payment of the debt." Iowa Code §561.21(2). Likewise, the homestead may be sold to satisfy preacquisition debt only to the extent "a deficiency remain[s] after exhausting the other property of the debtor, liable to execution." Iowa Code §561.21(1). No such condition is attached to satisfaction of debt "incurred for work done or material furnished exclusively for the improvement of the homestead" under §561.21(3). Thus, there is no statutory requirement that Custom Creations satisfy its lien out of non-homestead property before enforcing it against Debtor's homestead.

This Court has considered the removal of liens or the shifting of lien rights from one property to another in In re Knief, No. 96-21301D (Bankr. N.D. Iowa Sept. 19, 1997) (Chapter 12 confirmation issue), and In re Dolezal, Adv. No. 96-6211-W (Bankr. N.D. Iowa June 16, 1997) (adversary proceeding seeking authority to sell property in Chapter 13 case). In Knief, the Court refused to allow Chapter 12 debtors to use the doctrine of marshaling to remove an oversecured creditor's lien on certain personal property, thereby reducing the creditor's equity cushion. Slip op. at 5. The debtor wished to apply insurance proceeds from the creditor's collateral toward payments to unsecured creditors. Id. The creditor would retain its lien on real property. Id. In Dolezal, the Court refused to allow the sale of a portion of an oversecured creditor's collateral to apply the proceeds against a junior lienor's claim. Slip op. at 4. The Court would not allow the debtor to reduce the secured creditor's lien for the benefit of a junior creditor. Id.

Under federal and Iowa law, the doctrine of marshaling is an equitable doctrine which may apply when two creditors seek satisfaction out of the assets of their joint debtor, and one of the creditors can resort to two funds but the other has recourse to only one of the funds. The former creditor may be required to first seek satisfaction from the fund to which the latter creditor has no claim. In re Oxford Dev., Ltd., 67 F.3d 683, 686 (8th Cir. 1995); Mead v. City Nat'l Bank, 8 N.W.2d 417, 420 (Iowa 1943). The doctrine is only applied if it can be done without injustice. It is not intended to deprive any secured creditor of the benefit of its security so far as it is necessary for the creditor's protection. Marshaling cannot impair a superior or equal security interest.

The issue of retention of a secured creditor's lien more appropriately arises in the context of confirmation of Debtors' plan. See Knief, slip op. at 3 (applying §1225(a)(5)). Under §1325(a)(5), if a secured creditor does not accept the plan, the debtor must either surrender the collateral or provide that the creditor "retain the lien securing such claim" and receive the allowed amount of such claim. "The lien" to be retained need not invariably be the exact lien on the exact collateral as it existed prebankruptcy. Harmon v. United States, 101 F.3d 574, 583 (8th Cir. 1996) (applying identical language of §1225(a)(5)). A debtor may not, however, deny a secured creditor the benefit of the lien for which it bargained. In re Graham, 123 B.R. 330, 332 (Bankr. W.D. Mo. 1990) (construing §1325

(a)(5)(B)). A plan cannot be confirmed where it proposes to take from a secured creditor all or a portion of its collateral. Id.; see In re Hanna, 912 F.2d 945, 950 (8th Cir. 1990) (rejecting plan provision replacing lien on livestock with second mortgage on real estate); In re Ames, 973 F.2d 849, 851 (10th Cir. 1992) (same), cert. denied, 507 U.S. 912 (1993). Oversecured creditors are entitled to maintain their economic status quo. In re Underwood, 87 B.R. 594, 598 (Bankr. D. Neb. 1988).

Custom Creations' mechanic's lien attaches to Debtors' homestead real estate. Its judgment lien further reaches Debtors' rental real estate. Iowa law does not require Custom Creations to exhaust non-homestead real estate prior to enforcing its mechanic's lien against Debtors' homestead property. Debtors may not invoke the doctrine of marshaling to force Custom Creations to forego its lien on the homestead. Nor may Debtors use the cram down provisions of §1325(a)(5) to remove Custom Creations' lien from their homestead.

SUMMARY

Custom Creations' mechanic's lien includes both the \$12,500 prepetition judgment and the \$10,000 attorney fee judgment entered postpetition. This lien attaches to Debtors' homestead real estate. The equity in Debtors' homestead exceeds the amount of the mechanic's lien making Custom Creations an oversecured creditor. The judgment enforcing the mechanic's lien created a judgment lien which allows the \$12,500 award on foreclosure of the mechanic's lien to also attach to all Debtors' non-homestead real estate. These liens define Custom Creations' allowed secured claim.

Debtors may not avoid Custom Creations' lien on their homestead. The lien is a statutory lien, not a judicial lien. Furthermore, the lien arises from a debt which predated Debtors' acquisition of the homestead and which was incurred for work done or materials furnished for improvement of the homestead. Custom Creations is entitled to retain its lien on the homestead. Debtors may not use the doctrine of marshaling or the cram down provisions of §1325(a)(5) to shift the lien from the homestead to non-homestead real estate.

WHEREFORE, Debtors' Objection to Claim is DENIED.

FURTHER, Custom Creations, Inc. holds a claim for the principle amount of \$12,500 plus attorney fees of \$10,000 secured by Debtors' homestead, and further secured by Debtors' non-homestead real estate to the extent of the principle \$12,500.

FURTHER, Debtors may not avoid Custom Creations' lien on their homestead or shift the lien solely to their non-homestead real estate.

SO ORDERED this 1st day of October, 1998.

PAUL J. KILBURG

Paul J. Kilburg
U.S. Bankruptcy Judge