Clients&FriendsMemo

Seventh Circuit Provides Rare Guidance On "Statutory Liens"

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On April 21, 2022, the U.S. Circuit Court of Appeals for the Seventh Circuit issued a decision interpreting the Bankruptcy Code's definitions of "statutory lien" and "judicial lien," holding that a lien imposed by the Chicago Municipal Code was "judicial" rather than "statutory" because it arose partly as the result of a "quasi-judicial" process rather than "solely by force of a statute." *In the Matter of Mance*, No. 21-1355, 2022 WL 1182416 (7th Cir. April 21, 2022). In the Seventh Circuit's view, the fact that a "quasi-judicial" process functioned as an "essential prerequisite" to the imposition of the lien and determined the amount of the lien was sufficient for it to qualify as a "judicial" rather than a "statutory lien," notwithstanding that the lien was ultimately imposed automatically by operation of a municipal ordinance rather than directly by a court order.

Statutory liens are an important tool in municipal finance, because unlike some other types of liens, they are not cut off by Section 552 of the Bankruptcy Code in the event of a municipal issuer's bankruptcy.[1] Whether a municipal investor will qualify as a "secured" or "unsecured" creditor in a municipal bankruptcy therefore may depend on whether that investor's lien qualifies as a "statutory lien." Notwithstanding the importance of "statutory liens" to municipal finance, however, judicial decisions on the nature of "statutory liens" are relatively rare, particularly at the federal appellate court level. The Seventh Circuit's *Mance* decision now adds to the relatively small library of appellate court decisions that can offer issuers and investors guidance on the nature of "statutory liens."

Background

The *Mance* appeal arose out of a long-running series of cases—including the U.S. Supreme Court's 2021 decision in *Chicago v. Fulton*[2] —in which the City of Chicago (the "City") impounded motor vehicles for various parking- and driving-related infractions. The Chicago Municipal Code provides that any vehicles so impounded "shall be subject to a possessory lien in favor of the City in the

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[1] *See* 11 U.S.C. § 552(a) ("[P]roperty acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case").

[2] *See* Ingrid Bagby, Michele C. Maman, Casey John Servais, & Eric G. Waxman, *Stand Pat, Don't Act: U.S. Supreme Court Holds that Mere Retention of Debtor Property Does Not Violate Bankruptcy Code Section 362(a)(3)*, PRATT'S JOURNAL OF BANKRUPTCY LAW (April/May 2021), *available at* https://www.cadwalader.com/uploads/media/Pratt_reprint_cadwalader.pdf.

amount required to obtain release of the vehicle." M.C.C. § 9-92-080(f). The issue in this particular appeal was whether the City's possessory lien on a vehicle that it had impounded should be deemed a "judicial lien" or a "statutory lien" under the Bankruptcy Code. If the lien was found to be "judicial" rather than "statutory," then it would be avoidable pursuant to a provision of the Bankruptcy Code authorizing individual debtors to avoid liens on motor vehicles. *See* 11 U.S.C. §§ 522(f), (d)(2).

Definitions and Examples of "Statutory" and "Judicial" Liens

The Seventh Circuit concluded that the lien under the Chicago Municipal Code was "judicial," not "statutory." In doing so, it applied the Bankruptcy Code's definitions of "judicial lien" and "statutory lien."

Specifically, the Bankruptcy Code defines a "judicial lien" as one "obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding." 11 U.S.C. § 101(36). By contrast, a "statutory lien" is defined as a lien "arising solely by force of a statute on specified circumstances or conditions . . . , but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute." 11 U.S.C. § 101(53). The Seventh Circuit noted that, under these definitions, the classification of a lien depends on the events that must occur before the lien attaches, with a "statutory lien" arising "solely by force of a statute," and a "judicial lien" resulting from some type of "legal or equitable process or proceeding."

As an example of a "statutory lien," the Seventh Circuit cited a mechanics' lien, which by statute attaches to improved property once payment for a mechanic's work on the property is due and goes unpaid. Such a mechanics' lien may require a filing with a county clerk in order to be perfected, but this filing requirement, in the Seventh Circuit's view, did not constitute the type of "legal or equitable process or proceeding" that would convert the lien from a "statutory" to a "judicial lien."

By contrast, the "textbook" example of a "judicial lien," in the Seventh Circuit's view, was a court-ordered money judgment, where a court must enter judgment for the winning creditor before the lien can arise.

"Quasi-Judicial" Proceedings Give Rise to a Judicial Lien

With these definitions and examples in mind, the Seventh Circuit next turned to the specific procedures required in order for the City to obtain a lien on an impounded vehicle. The Court acknowledged that these procedures fell "somewhere in between" the easy examples of a mechanics' lien and a money judgment, but ultimately determined that the "quasi-judicial" nature of the required procedures placed the impoundment lien on the "judicial" rather than the "statutory" side of the line.

Among other things, before an impoundment lien can be imposed, the Chicago Municipal Code requires the underlying traffic violations to undergo an administrative process through which they become "final determinations of liability." As part of this administrative process, the vehicle owner can contest the charged violation in an in-person proceeding or by writing. If the vehicle owner is unsuccessful in this first phase of the process, the vehicle owner can also file an appeal under the Illinois Administrative Review Law. Only after the owner has lost the appeal does the traffic violation become a "final determination."

Following a "final determination," more legal process is required in order for the City to impound the vehicle if the fines go unpaid. The City must issue a notice to the vehicle owner, and the owner has the right to petition for a hearing to prove that she is not liable for the fines. Only after the owner failed to prevail at such a hearing would the City be able to impound the vehicle, at which point the impoundment lien would attach.

Notably, the Seventh Circuit acknowledged that the last step of lien attachment was "automatic," with the lien attaching automatically by operation of the ordinance upon impoundment of the vehicle, "without further action by a judge or quasi-judicial official." The City therefore had some basis to argue that the impoundment lien was a "statutory lien." The Seventh Circuit concluded, however, that it could not simply "ignore all the prior legal process that must occur before the City's possessory lien arises." In light of this prior legal process, the Court concluded that the impoundment lien did not arise "solely by statute," and instead was dependent on a "legal . . . process or proceeding." Therefore, the lien was a "judicial" rather than a "statutory lien."

Distinguishing the Third Circuit's *Schick* Case

In response to an argument by the City that the position ultimately adopted by the Seventh Circuit would create a circuit split, the Seventh Circuit attempted to distinguish the Third Circuit's decision in *In re Schick*, 418 F.3d 321 (3d Cir. 2005). The *Schick* case had some superficial similarities to *Mance*, because it addressed a New Jersey statute that imposed a lien on a motorist's property in the event the motorist failed to pay certain surcharges related to underlying traffic violations, including for reaching a certain number of violation points.

The Seventh Circuit nonetheless identified what it viewed as a "critical difference" between the processes leading to the liens in *Schick* and in *Mance*. Specifically, the New Jersey statute in *Schick* pertained only to surcharges, not to the underlying vehicle violations that were subject to judicial proceedings. The Third Circuit therefore concluded that "the underlying traffic proceeding charging the driver with a motor vehicle offense [was] too remote to constitute the required judicial process or proceeding necessary to find a judicial lien." On that basis, the Third Circuit concluded that the resulting lien was a "statutory lien."

In *Mance*, by contrast, the Seventh Circuit concluded that the statutory structure did not separate the underlying vehicle violation that was subject to quasi-judicial proceedings from any related fees (analogous to the "surcharges" at issue in *Schick*). Indeed, in *Mance* the amount of the lien itself was determined in the underlying quasi-judicial proceedings, and this lien amount included additional fees and penalties incurred in the course of those proceedings, whereas in *Schick* the amount of the surcharges was dictated separately by "statute and administrative regulations" and not determined by the underlying proceeding against the driver. The Seventh Circuit therefore concluded that in *Mance*, unlike in *Schick*, the quasi-judicial proceedings were "essential prerequisites for a valid impoundment lien," and were "not too far removed from the impoundment lien" for it to qualify as a "judicial lien."

The Seventh Circuit's method of distinguishing *Schick* suggests that, in determining whether a particular lien is "statutory" or "judicial," it may not be sufficient to perform a binary analysis of whether or not judicial proceedings play a role in the creation of the lien. Instead, it is necessary to analyze the precise relationship between any judicial proceedings and the creation of the lien, including how far "removed" the judicial proceedings are from the ultimate creation of the lien.

It will be interesting to see whether the City accepts the Seventh Circuit's attempt to distinguish *Mance* from *Schick*, or instead seeks review by the U.S. Supreme Court on the theory that *Mance* has created a circuit split between the Seventh and Third Circuits.

Tax Liens as Statutory Liens

In response to another argument by the City, the Seventh Circuit sought to reconcile its interpretation of the distinction between "judicial" and "statutory liens" with legislative history indicating that Congress intended for tax liens to qualify as "statutory liens." The City pointed out that federal tax liens result from judicial and quasi-judicial processes, such that under the Seventh Circuit's analysis in *Mance* they should technically qualify as "judicial" rather than "statutory liens," contrary to Congressional intent.

In a somewhat puzzling analysis, the Seventh Circuit conceded that "[t]ax liens are unquestionably statutory," but then suggested that the status of tax liens as statutory was not really a function of the definitions in the Bankruptcy Code and instead resulted from Congress's prerogative to "single out a particular category of liens and classify it." The Seventh Circuit's analysis on this point is arguably in tension with the general principle that statutory text should control over legislative history, because Congress "singled out" tax liens and "classified" them as statutory only in the legislative history. As such, the Seventh Circuit's interpretation of the Bankruptcy Code's statutory definitions of "judicial lien" and "statutory lien" should arguably override that Congressional classification. Given that the status of tax liens was not directly at issue in *Mance*, however, the Seventh Circuit's statements on this issue are arguably not binding, and the exact status of tax liens in light of the *Mance* analysis may need to await a future decision.

Takeaways

In bankruptcy, holding a "statutory lien" can make all the difference between being a secured creditor entitled to payment in full and being an unsecured creditor entitled only to pennies on the dollar (if that). And yet, as *Mance* illustrates, whether a particular lien qualifies as a "statutory lien" can be a surprisingly fact-intensive question, notwithstanding the deceptive simplicity of the Bankruptcy Code's definitions. In particular, the fact that the final step in imposing the lien occurs by operation of statute may not be sufficient for the lien to qualify as a "statutory lien" if judicial or quasi-judicial proceedings preceded this final, statutory step.

Mance therefore serves as a reminder that municipal issuers and investors alike should engage in a careful and nuanced analysis of exactly what type of lien is likely to be created by a particular transaction before issuing or investing in municipal debt. *Mance* helpfully provides some additional guidance on this issue, but is likely far from the final word on the matter.

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