

## Can a Secured Creditor Enforce a Lien on Real Estate Even When Its Bankruptcy Claim Has Been Disallowed?

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In an opinion that appears to give lenders some breathing room, the Ninth Circuit Bankruptcy Appellate Panel (“B.A.P.”) held the answer is “yes.” *Bank of NY Mellon v. Lane (In re Lane)*, 589 B.R. 399 (B.A.P. 9th Cir. 2018). Specifically, the *Lane* court held that a debtor cannot use 11 U.S.C. section 506(d)<sup>1</sup> to avoid a secured creditor’s lien on real estate even if debtor’s objection to the claim was sustained by the bankruptcy court. In other words, the lien on real estate is not eliminated just because the bankruptcy claim was not sustained by the bankruptcy court. An extra step, a determination of the merits of the underlying debt, must be taken in order to avoid the lien. Below is a closer look at the Ninth Circuit B.A.P.’s analysis.

### 1. Facts

Richard Lane (“Debtor”) filed a Chapter 13 petition under the Bankruptcy Code on May 18, 2011. Debtor’s schedules listed his principal residence in California (the “Property”), valuing it at \$420,000.00. The Bank of New York Mellon (“BONY”) filed a \$676,361.19 secured proof of claim (the “Claim”) regarding the Property. Attached to the Claim were copies of the original deed of trust, the promissory note endorsed in blank, and the recorded assignment of the note and deed of trust to BONY in January 2011.

The Debtor filed a form objection to the Claim under 11 U.S.C. section 502(b) (the “Claim Objection”), arguing that the Debtor was the person entitled to enforce payment and that BONY failed to establish standing. The Debtor did not point out who he alleged was the true party entitled to enforce the Note and did not serve that party with any bankruptcy paperwork. The Debtor requested that the claim be disallowed in its entirety, and the Claim Objection warned that failure to respond could result in an order disallowing the Claim.

BONY never responded. The Bankruptcy Court then entered a default order on December 29, 2011 (the “Order”), disallowing the claim in its entirety. Debtor made no payments to BONY during the case and BONY never moved for relief from stay. On November 12, 2015, the

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<sup>1</sup> (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--

- (1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or
- (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.

11 U.S.C. section 506(d).

Bankruptcy Court entered a discharge order. Three months later, a final decree was entered and the case was closed.

In April of 2016, BONY reopened Debtor's bankruptcy case and moved to set aside the Order. The Bankruptcy Court denied the motion. Meanwhile, Debtor filed a motion for summary judgment in an adversary proceeding against BONY, seeking to void the first lien of trust under section 506(d). The Bankruptcy Court granted Debtor's Motion for Summary Judgment and held BONY's lien was void based on, among other things, the plain language of section 506(d), the claim was previously disallowed, that section 506(d)'s exception did not apply, and that *HSBC Bank USA, Nat'l. Assoc. v. Blendheim (In re Blendheim)*, 803 F.3d 477 (9th Cir. 2015) (hereinafter "Blendheim") controlled the outcome.

## 2. Analysis

The Ninth Circuit B.A.P. began its analysis by examining the inter-play between section 506(d), 502(b)(1)<sup>2</sup>, and its previous holding in *Blendheim*. In *Blendheim*. In that case, the Ninth Circuit B.A.P. allowed a debtor to void a secured creditor's lien under section 506(d) because disallowance of the creditor's claim was based on, in part, a substantive objection under section 502(b)(1) regarding forgery of a note. Under these circumstances, the B.A.P. ruled that section 506(d)(2) did not preclude disallowance.

Following this analysis, the Ninth Circuit B.A.P. held in *Lane* that standing was a procedural objection (like an untimely filing), and therefore *Blendheim* did not apply to void the lien under section 506(d). First, unlike an objection based on untimely filing, BONY filed a proof of claim, received proper notice of the Claim Objection, and had the opportunity to contest the disallowance of the Claim. Second, an objection based upon standing is substantive in nature. Although standing does not concern a note's validity, it does concern the claimant's ability to enforce the note. Indeed, standing is a legitimate non-bankruptcy defense through which a claim under the applicable law is rendered unenforceable.

The Ninth Circuit B.A.P., however, ultimately ruled that *Blendheim* did not apply and avoidance of BONY's lien was impermissible because Debtor's objection did not concern the merits of the underlying debt on the note. For example, the debtor's objection in *Blendheim* determined the validity of the debt because the objection was based upon forgery of the note. Accordingly, disallowance determined the validity of the debt. In comparison, Debtor's standing

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<sup>2</sup> (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that--

(1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured . . . .

objection did not determine the merits of the debt because standing concerned only BONY's right to enforce the note. Debtor never attacked the validity of the underlying loan documents. Nor did Debtor dispute receiving the \$560,000.00 loan for the property. In fact, Debtor acknowledged throughout the bankruptcy proceedings that he owed "someone" money for the loan, and that a first-position lien secured the debt against the Property. Accordingly, BONY's lien remained intact.

### **3. Take-Aways**

*Lane* provides practitioners with several key takeaways for those who find themselves in a similar situation. First, practitioners should examine whether a debtor's claim objection determines, in whole or in part, the merits of the underlying debt. If a claim determines a debt's validity, then a debtor can likely use section 506(d) to avoid a lien. Otherwise, a secured creditor is in luck, and the lien will likely ride through a debtor's bankruptcy.

Second, practitioners in the financial services industry should likely focus on *Lane's* analysis regarding the inter-play between BONY's note, the lien (mortgage) and the debt itself because of its implications in alternative contexts. Although related to each other, loan instruments such as notes and mortgage obligations exist independently. For example, a note may evidence a debt, but unenforceability of a note does not render the underlying obligation void. For example, a standing determination concerns only the ability to collect on a debt under a breach of a note, i.e., enforcing a creditor's rights under a note. Failure to prove standing does not determine the validity of a debt under a note, but rather whether a creditor can enforce its rights pursuant to the instrument. Second, a lien secures a debt and not necessarily a note. Although breach of a note is often a precursor to foreclosing on collateral under a mortgage, the triggering mechanism under both instruments is a debtor's failure to pay its debt. Accordingly, regardless of whether an original obligee can prove standing under a note, the creditor is still entitled to foreclose on the collateral under a mortgage.

The third item practitioners have to focus on is the relationship of the Bankruptcy Code to the substantive real estate law of the forum state. The *Lane* court was clearly pointed out that California law holds that a deed of trust follows the note it secures and that secured liens pass through bankruptcy court unaffected. And noting the Debtor's objection that BONY was not the party to enforce the loan instruments, the *Lane* court also pointed out the failure of the Debtor to serve the party who allegedly did have the power to enforce the loan instruments.

### **4. Conclusion**

*Lane* provides some clarity under section 506(d) and gives some secured creditors breathing room as debtors now face the tall task of invalidating the underlying debt in connection with a note when attempting to void a lien under section 506(d). Said another way, *Lane* stands for the proposition that a substantive objection to a bankruptcy claim that is sustained does not permit a bankruptcy court to strip the lien from the real estate pursuant to section 502(b)(1) and 506(d). There are certainly some questions left hanging by *Lane* such as what if the Debtor had served the proper party entitled to enforce the instruments, but the bottom line is that creditors

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have a case that holds that debtors have to prove underlying validity to strip off a lien, even when a bankruptcy claim is not an allowed secured claim.