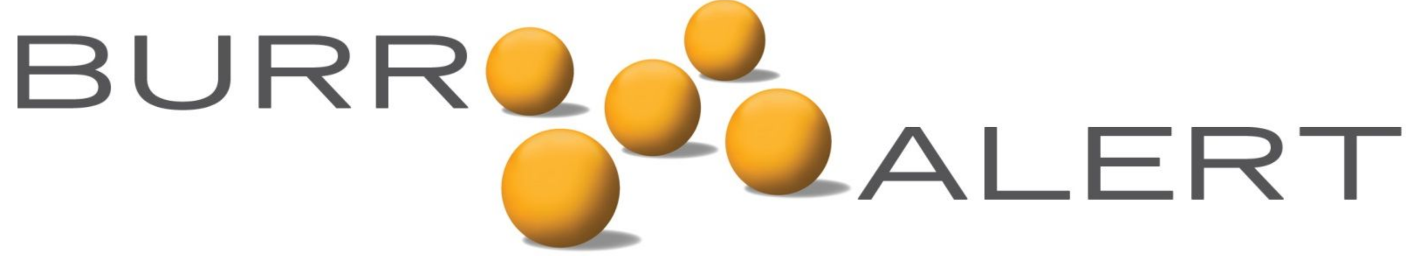

DRAWING A BRIGHT LINE IN THE FOG:
Eleventh Circuit Precedent for Challenging *McNeal*

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As most mortgage lenders know by now, on May 11, 2012, the Eleventh Circuit issued an unpublished decision in *McNeal v. GMAC Mortgage, LLC (In re McNeal)*, 477 Fed. App'x 562, holding that a chapter 7 debtor can "strip off" (extinguish) a lien that is no longer secured by the current value of the collateral pursuant to 11 U.S.C. § 506(d). This ruling may cause surprise, if not confusion, for most mortgage lenders, considering that since the inception of bankruptcy law in America over one hundred years ago, liens have generally survived a bankruptcy liquidation case untouched.[1] Notwithstanding the perplexities of *McNeal*, there is still hope for a reversal. This article will explore some of the inequities that result from a bankruptcy court's application of *McNeal* in the context of valuing property in bankruptcy, and point to the Eleventh Circuit's own precedent as grounds for challenging the decision in *McNeal*.

MUCH ADO ABOUT NOTHING: THE PRECEDENTIAL EFFECT OF MCNEAL

McNeal is not binding on any bankruptcy court in the Eleventh Circuit. As bankruptcy courts following *McNeal* have recognized, *McNeal* is only persuasive authority.[2] In her decision in *In re Malone*, Judge Diehl provides a well-reasoned analysis of the flawed reasoning of *McNeal* in light of the clear and binding precedent from the United States Supreme Court in *Dewsnup v. Timm*, 502 U.S. 410, 418 (1992). As Judge Diehl implies, the Eleventh Circuit likely misconstrued the Supreme Court's holding in *Dewnsup*:

> The Supreme Court's precise holding in *Dewsnup* was "we hold that § 506(d) does not allow [the debtor] to 'strip down' respondent's lien, because respondent's claim is secured by a lien and has been fully allowed pursuant to § 502." *Dewsnup*, 502 U.S. at 417, 112 S.Ct. 773. *Dewsnup*'s specific holding is regarding the operation of § 506(d). The operation of § 506(d) is the exact issue before this Court. Therefore, applying *Dewsnup*'s statutory

[1] *See Dewsnup v. Timm*, 502 U.S. 410, 418 (1992). Prior to the Supreme Court's decision in *Dewsnup*, some jurisdictions allowed lien stripping under the 1978 Bankruptcy Act. *Matter of Folendore*, 862 F.2d 1327 (11th Cir. 1989). Prior to 1978, however, "a lien on real property passed through bankruptcy unaffected." *Dewsnup*, 502 U.S. at 418. Some bankruptcy courts have found an end-run around the Supreme Court's general prohibition against lien strips in chapter 7 cases by allowing a lien strip in a subsequently filed chapter 13 case – the so-called "chapter 20" case. *See, e.g., In re Jennings*, 454 B.R. 252 (Bankr. N.D. Ga. 2011).

[2] *In re Malone*, 489 B.R. 275, 285 (Bankr. N.D. Ga. 2013) (J. Diehl); *In re Williams,* 488 B.R. 492, 496-97 (Bankr. M.D. Ga. March 15, 2013) (J. Walker); *In re Bertan*, 2013 WL 216231 (Bankr. S.D. Fla. 2013) (J. Cristol); *see also* Fed. R. App. P. 32.1.

> interpretation of § 506(d) to prevent Debtor from voiding Citibank's lien seems appropriate and required.[3]

Rather than apply the Supreme Court's interpretation of the key statutory provision, 11 U.S.C. § 506(d), the Eleventh Circuit followed its prior decision in *Folendore*, 862 F.2d 1327 (11th Cir. 1989), which predated *Dewsnup*. In *Folendore*, the Eleventh Circuit held that a chapter 7 debtor can strip liens under its interpretation of 11 U.S.C. § 506(d), an interpretation that was later considered and outright rejected by the Supreme Court in *Dewsnup*. Judge Diehl, like other bankruptcy judges, nonetheless followed the rule in *McNeal* because of "deference" to the Eleventh Circuit.[4]

Focusing on the Supreme Court's analysis of a lien "strip down," where a debtor seeks to strip down a partially secured mortgage lien to the value of the property, the Eleventh Circuit distinguished *Dewsnup* only where a debtor seeks to "strip off" or extinguish a lien that is wholly unsecured based upon the value of the property. The only factual difference between *Folendore* and *Dewsnup* value of the underlying collateral – a distinction that does not exist in either Court's holding.[5] In *Dewsnup*, the bankruptcy court assigned a value to the collateral that exceeded the value of the first mortgage lien and partially secured the second mortgage lien. In *Folendore*, the bankruptcy court assigned a value to the collateral below the value of the first mortgage lien so that the second mortgage lien was wholly unsecured. Applying the "prior panel precedent rule," under which the Eleventh Circuit may depart from a prior panel decision only when a Supreme Court decision is "clearly on point," the *McNeal* court found that

> [b]ecause *Dewsnup* disallowed only a "strip down" of a partially secured mortgage lien and did not address a "strip off" of a wholly unsecured lien, it is not "clearly on point" with the facts in Folendore or with the facts at issue in this appeal.[6]

In *Malone*, Judge Diehl provides a cogent analysis of the Eleventh Circuit's inconsistent application of the "prior panel precedent rule" in *McNeal*, which deserves further reading.[7] Suffice it to say that both *Folendore* and *Dewsnup* analyzed the same type of relief requested by the same type of party under the same exact law. The Eleventh Circuit's distinction between *Folendore* and *Dewsnup* is overstated, to say the least. As a result, the unfortunate outcome of *McNeal* is that a bankruptcy court may reach a different result regarding whether to strip a lien based upon the same facts, with the singular distinction being the value of the underlying collateral.

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[3] 489 B.R. at 282.

[4] *Id.* at 285.

[5] *Compare Folendore*, 862 F. 2d at 1539 ("[S]ection 506(d) allows the voiding of a lien when a court has not disallowed the claim."), *with Dewsnup*, 502 U.S. at 417 ("[W]e hold that § 506(d) does not allow petitioner to 'strip down' respondents' lien, because respondents' claim is secured by a lien and has been fully allowed pursuant to § 502.").

[6] 477 Fed. App'x at 564.

[7] *See* 489 B.R. at 283-84.

It is peculiar that bankruptcy courts, like the court in *Malone*, find *McNeal* so persuasive in light of the Supreme Court's complete rejection of the statutory analysis used in *Folendore* and later in *McNeal*. Despite its label as "persuasive" authority, some bankruptcy courts, ironically, are not very persuaded by *McNeal*. As Judge Walker states in *In re Williams*,

> This Court, too, will follow *McNeal*, even though the Court is persuaded *McNeal* was wrongly decided. . . . Nevertheless, the Eleventh Circuit has authorized strip off of a wholly unsecured claim pursuant to § 506(d). Although McNeal is not binding, the Court cannot simply ignore a decision of the Eleventh Circuit, especially one that holds that a prior published (and therefore precedental) decision remains good law.[8]

Despite any misgivings, pursuant to Federal Rule of Appellate Procedure 32.1, bankruptcy courts are bound only by published decisions of the Eleventh Circuit, not by the reasoning, let alone the holding, in unpublished decisions. Prior to *McNeal*, bankruptcy courts assumed that *Folendore* did not survive *Dewsnup*.[9] Some bankruptcy courts in the Eleventh Circuit have even seemed reluctant to follow *Dewsnup* with no appealing alternatives to offer debtors amidst the housing crisis: "public policy concerns may favor modification of the rights of secured creditors in economic crises such as the present one, where a significant number of homes are worth less than the senior liens encumbering them (let alone the junior liens)."[10]

After *McNeal*, bankruptcy courts have been "persuaded" by *McNeal* that the holding in *Folendore* survived *Dewsnup* in the case of wholly unsecured mortgage liens. But did *Folendore* really survive *Dewsnup*? This question has not been unequivocally decided in the Eleventh Circuit. Even though *McNeal* answers this question in the affirmative, the Eleventh Circuit left this question open to debate by not publishing its decision. Bankruptcy courts are, therefore, free to answer this question in the negative based on the Eleventh Circuit's own reasoning in *McNeal*:

> Although the Supreme Court's reasoning in *Dewsnup* seems to reject the plain language analysis that we used in *Folendore*, there is, of course, an important difference between the holding in a case and the reasoning that supports that holding.[11]

By issuing its unpublished decision in *McNeal*, the Eleventh Circuit appears to have struck a balance between the temporary need to address the national housing crisis, especially in Florida where homeowners have arguably suffered the most, and the temporariness of that need. By issuing a merely persuasive decision that lien stripping is stilled allowed in the Eleventh Circuit, the Circuit Court has left the door open for a potential change in the law after an end to the housing crisis. In other words,

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[8] 488 B.R. at 496-97, referring to the decision in *Folendore*.

[9] *See In re Gerardin*, 447 B.R. 342, 345 (Bankr. S.D. Fla. 2011) (interpreting *Dewsnup* to generally prohibit lien stripping in chapter 7 cases); *In re Hoffman*, 433 B.R. 437, 440 (Bankr. M.D. Fla. 2010) (same).

[10] *Gerardin*, 447 B.R. at 345 (quoting *In re Hoffman*, 433 B.R. at 440).

[11] 477 Fed. App'x at 564.

choosing not to publish *McNeal* may have been the desired effect, so that mortgage lenders could later successfully challenge *McNeal* when the circumstances warrant a change in the law. At the risk of assuming too much about the psychology of the judiciary, the seeming deliberateness of the Eleventh Circuit's decision to not publish *McNeal* may indicate its readiness for a challenge from a lower court under different circumstances.

One should also evaluate the persuasive effect of *McNeal* in the context of historical jurisprudence. *Dewsnup* was decided twenty years prior to *McNeal*, which appears to be the first and only Circuit to have distinguished *Dewsnup* on the basis of the value of underlying collateral.[12] It should go without saying that if Congress intended to grant chapter 7 debtors the ability to extinguish mortgage liens, it could have very well enacted legislation to overturn *Dewnsup*. "Congress has had many years to overturn *Dewsnup* by legislative action but has enacted no statutory change. Until it does, *Dewsnup* remains the law of the land."[13] Additionally, the Eleventh Circuit Court decision has already published an opinion that provides precedent for reconsideration of the very distinction that the Eleventh Circuit relies so heavily upon in *McNeal* – the valuation process.

DICKERSON: *LESSONS FROM THE PAST*

On June 1, 1993, the Supreme Court decided the case of *Nobleman v. American Savings Bank*, 508 U.S. 324, in which the Court held that a chapter 13 debtor cannot "strip down" a partially secured home mortgage lien to the value of the collateral under 11 U.S.C. § 1322(b)(2).[14] The Supreme Court did not expressly limit its holding to partially secured home mortgage liens, or distinguish its holding based upon the value of the underlying collateral.[15] Nevertheless, a majority of Circuit Courts, including the Eleventh Circuit in the case of *In re Tanner*, 217 F.3d 1357 (11th Cir.2000), have distinguished *Nobleman* on the basis of the bankruptcy court's valuation of the underlying collateral, allowing chapter 13 debtors to "strip off" wholly unsecured home mortgage liens.[16]

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[12] *In re Talbert*, 344 F.3d 555, 560 (6th Cir. 2003) ("The Supreme Court's reasoning for not permitting 'strip downs' in the chapter 7 context applies with equal validity to a debtor's attempt to effectuate a chapter 7 'strip off.' "); *Ryan v. Homecomings Financial Network*, 253 F.3d 778, 782 (4th Cir. 2001) ("The Court's reasoning in *Dewsnup* is equally relevant and convincing in a case like ours where a debtor attempts to strip off, rather than merely strip down, an approved but unsecured lien."); *Laskin v. First National Bank of Keystone (In re Laskin)*, 222 B.R. 872, 876 (9th Cir. BAP 1998) ("Further, whether the lien is wholly unsecured or merely undersecured, the reasons articulated by the Supreme Court for its holding in Dewsnup . . . are equally pertinent."); *Wachovia Mortgage v. Smoot*, 478 B.R. 555, 565 (E.D.N.Y.2012) ("Although the lien at issue in *Dewsnup* was secured by at least some equity in the debtor's property, that factual distinction is not relevant. What is relevant is the Supreme Court's construction of § 506(d).").

[13] *Gerardin*, 447 B.R. at 345.

[14] *Nobleman*, 508 U.S. at 329-30.

[15] *See id.* at 328-29 ("Petitioners were correct in looking to § 506(a) for a judicial valuation of the collateral to determine the status of the bank's secured claim. . . . [H]owever, that determination does not necessarily mean that the 'rights' the bank enjoys as a mortgagee, which are protected by § 1322(b)(2), are limited by the valuation of its secured claim.").

[16] *See, e.g., In re Bartee*, 212 F.3d 277, 290 (5th Cir. 2000); *In re McDonald*, 205 F.3d 606, 611 (3d Cir. 2000); *In re Tanner*, 217 F.3d 1357, 1360 (11th Cir.2000).

One month after deciding *Tanner*, the Eleventh Circuit issued its opinion in the case of *In re Dickerson*, 222 F.3d 924, criticizing its prior decision to sanction "strip offs" of home mortgage liens in chapter 13:

> However, were we to decide this issue on a clean slate, we would not so hold. We find persuasive the district court's reasoning that providing "anti-modification" protection to junior mortgagees where the value of the mortgaged property exceeds the senior mortgagee's claim by at least one cent, as prescribed by the Supreme Court's decision in *Nobelman v. American Savings Bank*, 508 U.S. 324, 113 S.Ct. 2106, 124 L.Ed.2d 228 (1993), but denying that same protection to junior mortgagees who lack that penny of equity, ***places too much weight upon the valuation process***. As we have noted "[v]aluation outside the actual market place is inherently inexact." *Rushton v. Commissioner of Internal Revenue*, 498 F.2d 88, 95 (5th Cir. 1974). ***Given the unavoidable imprecision and uncertainty of the valuation process, we think that choosing to draw a bright line at this point is akin to attempting to draw a bright line in the fog.***[17]

The Eleventh Circuit nevertheless upheld its prior ruling in *Tanner* based on the prior panel precedent rule.[18] At the very least, the Eleventh Circuit's tone in *Dickerson* appears regretful, as if the Eleventh Circuit issued *Dickerson* (which adds nothing to the jurisprudence of *Tanner*) to signal to the judiciary its regret in deciding *Tanner* in a published, therefore binding, opinion.

Twelve years later, in *McNeal*, the Eleventh Circuit again placed "too much weight upon the valuation process" by holding that chapter 7 debtors, while prohibited from stripping partially secured mortgage liens, are allowed to strip wholly unsecured mortgage liens. However, unlike *Tanner* and *Dickerson*, the Court can still decide the chapter 7 lien strip issue "on a clean slate" – by publishing a decision reversing *McNeal*, which is not yet controlling authority under the prior precedent rule. Again, at the risk of assuming too much about the psychology of the judiciary, one could argue that the Eleventh Circuit might be taking a more tempered approach in *McNeal* to issuing decisions with a potentially pervasive impact on the course of mortgage lending in the Circuit. As noted above, the housing crisis does not appear to be permanent, and one could argue that the temporal nature of an unpublished decision such as *McNeal* supports the position that the Eleventh Circuit may *want* to disapprove of *McNeal* under a different set of circumstances.

For example, it may seem equitable to allow a chapter 7 debtor, in an attempt to keep a home, to make a deal with the first mortgagee to reaffirm its debt, but strip off an "unsecured" second mortgage lien outside of the debtor's budget. Admittedly, the primary purpose of bankruptcy is to promote a fresh start for the honest but unfortunate debtor. But even in this seemingly equitable circumstance, equity doesn't equal fairness. Under state law, the second mortgagee has as much right to its lien as the first mortgagee, especially if the debtor is retaining the benefits of the mortgage loan (i.e. retaining the home) but avoiding all risks by receiving a chapter 7 discharge of personal liability and extinguishing the lien at the

[17] *Dickerson*, 222 F.3d 924, 926 (11th Cir. 2000).
[18] *Id.*

same time. In this hypothetical, *McNeal* would allow the debtor to reaffirm the first mortgage debt and extinguish the second mortgage debt, thereby creating an unintended preference in favor of the first mortgage lender. This preference becomes more pronounced as the housing market recovers and home values rise. As the Eleventh Circuit points out in *Dickerson*, the availability of lien stripping turns on the existence of a mere "penny of equity" in the second mortgage loan. A second mortgage loan may be "unsecured" one year but partially secured the next year, depending on slight fluctuations in the housing market and the evidence available to a bankruptcy judge in determining the value of the property. Depending on the timing of a bankruptcy petition and the housing market on any one given day, a mortgage lender may be either impervious or vulnerable to a lien strip. Under *McNeal*, a debtor could certainly file bankruptcy when the value of his home bottoms out and strip his second mortgage lien. On the other hand, if the value of his home begins to rise again, it is seriously doubtful whether a second mortgagee could seek to reopen the bankruptcy case to "reinstate" its lien that later becomes partially secured by the rising value of the home.

The foregoing paragraph addresses a hypothetical debtor who seeks to retain his home – an endeavor that is arguably supported by the fresh start policy underpinning bankruptcy law. Would a bankruptcy court also follow *McNeal* in stripping a second mortgage lien if the same debtor surrendered the home to a first mortgagee? Such relief would appear to be contrary to the policy of assisting the honest but unfortunate debtor, and would undeniably create a preference in favor of a first mortgagee without serving any apparent bankruptcy purpose.

In response to such concerns, the hypothetical debtor might argue that stripping the second mortgagee's lien under these circumstances does not harm or prejudice the second mortgagee, whose lien would eventually be extinguished upon foreclosure by the first mortgagee. However, a second mortgagee risks losing its lien only when the first mortgagee seeks to foreclose, which could take years. In the meantime, the second mortgagee has a right to foreclose its own lien, gain possession of the property, and attempt to recoup its debt by, for example, renting the property and applying the rents to the unpaid account. This hypothetical situation is not far from reality, as *McNeal* has been applied to strip liens held by condominium associations.[19] It is no secret that condominium associations find immense value in foreclosing their liens, obtaining title to condominium units, and renting surrendered or abandoned units to pay delinquent association fees while waiting for a first mortgagee to foreclose.

Second mortgage lienholders have the same incentive to take advantage of either delayed foreclosures or rising market values, the prospect of which is extinguished upon a lien strip. At the very least, a second mortgagee is entitled to any excess sale proceeds at the time of foreclosure. In a case in which a debtor surrenders the property and receives a chapter 7 discharge, it is hardly equitable for the second mortgagee to lose its potential recovery upon foreclosure of the property, especially when the outcome depends solely upon a single determination of value that could fluctuate from year to year, or even day to day. As the Fourth Circuit has recognized,

[19] *In re Aliu-Otokiti*, 2013 WL 1163782 (Bankr. M.D. Fla. March 19, 2013); *In re Almeida*, 2013 WL 1163777 (Bankr. M.D. Fla. March 18, 2013).

> in many cases junior lien holders may have little or no opportunity to recover all or even a part of their unsecured claims. Nevertheless, the parties bargained for their positions with knowledge that a superior lien existed. Under this Chapter 7 proceeding, they are entitled to their lien position until foreclosure or other permissible final disposition is had. Likewise, we are acutely aware that in the volatile, modern real estate market, substantial price variations occur with weekly or monthly regularity.[20]

COST-BENEFIT ANALYSIS: IS IT WORTH THE FIGHT?

The benefit of a lien stripping prohibition. In most Circuits, a debtor has an option to "ride-through" bankruptcy without making a decision whether to reaffirm a secured claim or surrender collateral. In effect, a debtor is making a decision: to keep a creditor's collateral but be dissolved of any personal liability related to the collateral. Some might call this decision as eating your cake and having it too. However, in the Eleventh Circuit, a debtor is barred from making this decision, at least without the consent of the creditor.[21]

Prior to *McNeal*, debtors could be required to reaffirm (assuming feasibility of such an endeavor) the debt secured by a lien in second priority, notwithstanding the fact that such lien may be wholly "unsecured." In other words, value existed for second mortgagees in being able to exercise this right to require reaffirmation, even if no value existed in the collateral: if the borrower wanted to retain collateral, he could be required to reaffirm the secured debt, regardless of the value of the home. This is not always a poor financial decision for debtors, especially in cases where *McNeal* becomes less equitable, i.e. when the value of the property may be increasing to the point of securing mortgages in second priority. If a debtor wants to retain the upside risk of rising property values, he should not be able to leave second lien holders in the lurch. On the other hand, debtors have viable remedies that counter a mortgage lender's ultimatum to reaffirm the mortgage debt. A debtor can certainly surrender the collateral, or if debtor has regular income, he can retain the home by reorganizing his debts through a chapter 13 plan. Even though a debtor in the Eleventh Circuit can strip off a wholly unsecured second mortgage lien in a chapter 13 case, the debtor is still required to devote his projected disposable income to fund payments to unsecured creditors, including the holder of an extinguished second mortgage lien. Therefore, prior to *McNeal*, the second mortgage lienholder could expect some recovery if the borrower filed for bankruptcy.

The cost of challenging *McNeal*. The logistical problem with challenging *McNeal* through the appellate process, and despite the foregoing descriptions of potential recoveries for wholly unsecured lienholders, is that wholly unsecured liens have little to no potential for recovery in real dollar value. Also, the housing market is only slowing recovering, so that it may be hard to evidence the fact that your collateral will sufficiently increase to secure a wholly unsecured mortgage lien. Even if a second mortgagee had

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[20] *Ryan v. Homecomings Financial Network*, 253 F.3d 778, 783 (4th Cir. 2001).

[21] Certainly many creditors, either through informed business decisions or mere complacency, allow debtors to make this decision even in the Eleventh Circuit, and there is legal precedent to support such a decision. *In re Elibo*, 447 B.R. 359 (Bankr. S.D. Fla. 2011). However, a debtor may not "ride through" without the consent of the secured creditor. Id.

evidence that the value of its collateral was increasing in a manner that highlights the unfairness of *McNeal*'s holding, it is doubtful that such increase would justify the costs of an appeal. A microscopic view of the costs of challenging *McNeal* as compared with the potential recovery in any one given case, however, overlooks the potential recovery to a mortgage lender on a much larger scale. While it may not make sense for a lender to account for appellate costs in comparison with potential recovery on any one given mortgage loan, it may make sense to "sacrifice" a particular mortgage loan account for the sake of an entire underperforming portfolio – or to analyze the costs and benefits of a challenge to *McNeal* in the context of future lending relationships in Florida, Georgia, or Alabama. No one can predict how long *McNeal* will remain good law, and the longer *McNeal* remains "persuasive," the less likely the Eleventh Circuit will reconsider it. The only difference between the persuasive and binding nature of *McNeal* at the present time is its publication. Once the Eleventh Circuit publishes a *McNeal*-like decision, the prior panel precedent rule will make such a decision controlling in the Eleventh Circuit until challenged to the Supreme Court, at which point appellate costs may be too burdensome to justify saving a wholly unsecured mortgage lien regardless of how one justifies the costs. Simply stated, mortgage lenders should not lose sight of the forest for the trees when considering whether to embark on an appeal to the Eleventh Circuit.

As a final thought on this discussion of challenging *McNeal*, the Eleventh Circuit in *Dickerson* questioned the prudence of the majority view declining to follow the *Nobleman* decision in prohibiting lien strips of wholly unsecured mortgages. The same argument for overturning *McNeal* supports overturning these decisions – that the availability of lien stripping in bankruptcy should not depend upon the "unavoidable imprecision and uncertainty of the valuation process."[22] The Supreme Court has yet to decide a lien stripping case in context of a wholly "unsecured" mortgage, probably because of the logistical problems alluded to in the prior paragraph. Armed with the right incentives and resources though, a mortgage lender could change the tide of lien stripping in bankruptcy.

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No representation is made that the quality of legal services to be performed is greater than the quality of legal services performed by other lawyers.

[22] *Dickerson*, 222 F.3d at 926.