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Recent Unanimous Supreme Court Decision Holds That Underwater Mortgages in a Chapter 7 Cannot be "Stripped off"

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The Issue and Background

Debtors David Caulkett and Edelmiro Toledo-Cardona ("Debtors") each filed for Chapter 7 bankruptcy relief with "underwater" junior mortgages held by Bank of America, N.A. ("Bank"). In other words, even if Debtors sold their property, the Bank would not receive any money because their homes were worth less than the amount owed to the senior lenders. Each Debtor used their bankruptcy case to "strip" the junior mortgages off of their properties. Lien stripping is when the bankruptcy court strips or nullifies a junior home mortgage from a home with a fair market value less than the amount of the senior mortgage(s). Lien stripping can severely limit lenders' collection rights depending on little more than fluctuations in property value.

Debtors moved to strip off the Bank's junior mortgage liens. In each case, the bankruptcy court granted the motions and voided the Bank's junior mortgages. The Bank appealed the decisions to the district court and the Eleventh Circuit. Both courts affirmed the bankruptcy court's rulings. The issue went to the Supreme Court.

Last week, the Supreme Court issued a consolidated opinion. The Court framed the issue as a determination of whether a debtor in a Chapter 7 bankruptcy proceeding may void junior mortgages under section 506(d) when the debt owed on the senior mortgage exceeds the present value of the property. To resolve the issue, the Court decided whether the Bank's claims were "secured" within the meaning of section 506(d).

The Decision

In a decision favorable to lenders, the Supreme Court reversed the judgments of the Eleventh Circuit in *Bank of America, N.A. v. Caulkett*, Nos. 13-1421, 14-163, 2015 WL 2464049 (June 1, 2015), finding that the Bankruptcy Code does not allow courts to strip off underwater mortgages in a Chapter 7 case.

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In *Caulkett*, Debtors argued that under a straightforward reading of section 506(a)(1) of the Bankruptcy Code, the Bank's claims were void. According to this statute, "[a]n allowed claim of a creditor secured by a lien on property…is a *secured claim* to the extent of the value of such creditor's interest in…such property," and "an *unsecured claim* to the extent that the value of such creditor's interest…is less than the amount of such allowed claim." 11 U.S.C. § 506(a)(1) (emphasis added). The Debtors argued that because the Bank's interest in the Debtors' properties was zero, the claims were not "secured."

The Supreme Court disagreed, basing its decision on the Supreme Court's twenty-three-year-old opinion in *Dewsnup v. Timm*, 502 U.S. 410 (1992). In *Dewsnup*, the Supreme Court held that a Chapter 7 debtor could not strip down a partially underwater lien under section 506(d). *Id.* at 412-13. The ruling in *Dewsnup* was based on the Supreme Court's construction of the term "secured claim" in section 506(d) to mean any claim secured by a lien and fully allowed pursuant to section 502. *Id.* at 417. Applying *Dewsnup*, the Supreme Court held there was no reason to deviate from its earlier opinion, even when a valuation might indicate that the junior lien is completely underwater.

Implications

The Supreme Court's *Caulkett* decision is a victory for lenders. Debtors with underwater second mortgages may consider filing for a Chapter 13, but mortgagees now have a viable argument that *Caulkett* should be extended to Chapter 13. Of course, from a practitioner's perspective, application of *Caulkett* in a Chapter 13 context is easier said than done. Regardless, the *Caulkett* decision should provide more certainty for mortgagees. Until the post-*Caulkett* interpretation dust settles in bankruptcy courts, lenders - especially those lenders whose liens do not reach equity in the debtor's property - should continue to vigorously advance their rights - including filing a proof of claim so that their claim is considered "fully allowed," under the Supreme Court's interpretation of section 506 of the Bankruptcy Code.

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