Chapter 7 lien-stripping post-*Caulkett*

On June 1, 2015, the United States Supreme Court ruled that a junior mortgage lien may not be stripped in a Chapter 7 Bankruptcy. *Bank of Am., N.A. v. Caulkett*, 135 S. Ct. 1995, 1997 (2015). The opinion was brief (only seven pages) and unsurprising. The Supreme Court concurred with 10 of the 11 Circuit Courts that had already ruled this was not allowed. However, the Court did leave a trail of breadcrumbs that could lead to this rule changing in the future.

The Court did not address the practice of Chapter 13 Bankruptcy lien-stripping, which indicates its continued viability. To date, all Circuit Courts have validated this practice. Thus, this decision seems to validate the status quo. Please see below for more in depth analysis of the Court's decision.

Justice Thomas delivered the opinion for a unanimous court (though three Justices chose not to join as to a footnote, discussed *infra*). The question presented was whether Section 506(d) of the bankruptcy code permitted a junior mortgage to be stripped when the value of the senior mortgage exceeded the value of the collateral, thus rendering the property wholly underwater. *Bank of Am., N.A. v. Caulkett*, 135 S. Ct. 1995, 1997 (2015). Notably, this opinion was restricted in application to Chapter 7 Bankruptcy.

Section 506(d) of the Bankruptcy Code allows a debtor to void a lien on his property "[t]o the extent that [the] lien secures a claim against the debtor that is not an allowed secured claim." 11 U. S. C. §506(d). All parties agreed that the junior mortgage was allowed.[1] *Caulkett*, 135 S. Ct. at 1998. Rather, the litigation arose regarding whether the junior mortgage was 'secured'. *Id.* The code itself seems to suggest that the junior mortgage is not secured. *Id.* This is because a secured debt is only secured to the extent that there is an interest in the property. *Id.* at 1998-1999. Thus, the Code indicates that if ones interest in a property is zero, as the junior mortgage holders interest is, they cannot be a secured creditor. *Id.* at 1999.

Unfortunately for the Debtors, the Court had previously defined what 'secured' meant in *Dewsnup v. Timm*. *Caulkett*, 135 S. Ct. at 1999. There, the Court determined that if a claim "has been 'allowed' pursuant to §502 of the Code and is secured by a lien with recourse to the underlying collateral, it does not come within the scope of §506(d)." *Id.* The practical effect of this ruling divorced the term secured from the value of the collateral. *Id.* Thus, as long as the claim is allowed and there is collateral, regardless of value, then the debt is secured and cannot be stripped. *Id.* As the Court noted, the *Dewsnup* definition seems to marginalize Section 506(d) to only situations where the claim is not allowed. *Id.*

The Debtors attempted to assert a number of grounds that would distinguish the present case from *Dewsnup*, all of which the Court rejected. Generally speaking, once the Court accepted that *Dewsnup* controlled this issue, they were unwilling to deviate from that definition. The Debtors attempted to assert that the term 'secured' should be restricted to claims that have some value.

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[1] This aspect of the decision was only lightly discussed. *Caulkett*, 135 S. Ct. at 1998. The Court noted that a claim was allowed if it was not objected to or the Bankruptcy Court allowed it. *Id.*

Caulkett, 135 S. Ct. at 2000. The court rejected this because it would create an artificial definition of the term 'secured' as defined within the Code. *Id.* Alternately, the Debtors argued that because the policy decisions that motivated the *Dewsnup* decision do not apply to wholly underwater liens, then the court should restrict the application of *Dewsnup*. *Id.* The Court disposed this argument in a manner similar to the first one, noting that these were insufficient grounds to create a new definition of the term 'secured'. *Id.* Finally, the debtors argued that *Dewsnup* was not meant to apply to all factual situations, and should not be applied here. *Id.* This argument was rejected as well. Based on the definition of 'secured' found in *Dewsnup*, it didn't matter whether a property was wholly or partially underwater. *Id.*

The Court found that junior mortgages could not be stripped in a Chapter 7 Bankruptcy, even when the property is wholly underwater. However, the Court failed to explicitly address Chapter 13 lien-stripping.[2] This is because the discussion was mostly limited to Section 506(d) and the *Dewsnup* decision, neither of which affects Chapter 13. The only time Chapter 13 Bankruptcy came up was obliquely during the discussion of *Nobelman v. American Sav. Bank*. The Court simply noted that *Nobelman* dealt with the interplay between 506(d) and 1322(b)(2). *Caulkett*, 135 S. Ct. at 2000. Section 1322(b)(2) is pertinent only to Chapter 13 Bankruptcy. This Section's interplay with Section 506(d) is what makes lien stripping in Chapter 13 Bankruptcy viable. The Court's noting of *Nobelman* implicitly validates the continued practice of Chapter 13 lien-stripping.

Beyond the continued viability of Chapter 13 lien-stripping, the Court did leave some hope for distressed debtors. The Court seemed to be heavily implying that it would be willing to overrule *Dewsnup* if the Debtors had asked. Justice Thomas notes that the "debtors do not ask us to overrule *Dewsnup*". *Caulkett*, 135 S. Ct. at 1999-2000. This statement was footnoted wherein Justice Thomas indicated his displeasure with the *Dewsnup* ruling. He states that "[f]rom its inception, *Dewsnup v. Timm*, has been the target of criticism." *Id.* at 2000 FN (internal citation omitted). Despite the bulk of this opinion being unanimous, Justices Breyer, Kennedy, and Sotomayor explicitly did not agree with this footnote. *Id.* at 1998. The general agreement with the footnote may indicate the Court's willingness to overrule *Dewsnup* under the right facts. On the other hand, Justice Ginsburg's comments at oral arguments may foreclose this line of reasoning. She stated "the law would be much more coherent if either *Dewsnup* applies to the totally underwater as well as partially underwater, or *Dewsnup* is overruled." Amy Howe, Argument analysis: Navigating between Scylla and Charybdis on underwater mortgages, SCOTUSblog (Mar. 24, 2015, 6:38 PM), http://www.scotusblog.com/2015/03/argument-analysis-navigating-between-scylla-and-charybdis-on-underwater-mortgages/. This may indicate that rather than undermining *Dewsnup*, the *Caulkett* decision could serve to strengthen it.

The big question is what does this mean for debtors practically? Unfortunately, the answer is not much. The 9th circuit had already determined that lien-stripping in a Chapter 7 Bankruptcy was not viable. *See In re Laskin*, 222 B.R. 872, 875 (B.A.P. 9th Cir. 1998)(applying *Dewsnup*). Thus, *Caulkett* will not change the practice that was already occurring within Nevada. The Court's implicit validation of Chapter 13 lien stripping is a positive sign, as is the bread-crumb trail to potentially overturn *Dewsnup*. Hypothetically, if *Dewsnup* was to be overturned, the Court has

[2] Notably, Chapter 13 lien-stripping was addressed extensively in Amicus Briefs. The Court failing to address this issue seems to indicate Chapter 13 lien-stripping is still viable.

indicated that the Code may allow Chapter 7 lien-stripping. However, until that time, there does not appear to be any new benefit to distressed debtors.