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"Strip, Strip Hooray!" - Supreme Court Settles Chapter 7 Lien-Stripping Debate

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Twenty-three years after initially visiting the issue, the United States Supreme Court has recently settled what some would call "the single most important unresolved issue in consumer bankruptcy"[1]—whether Chapter 7 permits a debtor to "strip off" a wholly unsecured junior lien. The issue is whether the Bankruptcy Code allows Chapter 7 debtors to obtain an order from the Bankruptcy Court removing a lien from their property when that property is worth less than the debt secured by senior liens. After the collapse in real estate prices, the ability to obtain such relief became a major issue as Chapter 7 debtors sought to have junior mortgages removed from their homes because the value of those homes had fallen below the amount owed on their first mortgages. In the absence of such relief, these junior liens would continue to exist on the debtors' homes even if such debtors received a bankruptcy discharge of their personal liability on the underlying debt. However, the Supreme Court recently handed a victory to mortgagees nationally by unanimously holding that Chapter 7 debtors cannot use the Bankruptcy Code to remove wholly unsecured junior liens; and that such liens will pass through bankruptcy unaffected.[2]

To illustrate, suppose that Debtor grants Creditor 1 a mortgage on his home to secure a $100,000 loan (the "Senior Lien"). Three years later, Debtor grants Creditor 2 an additional mortgage on his home to secure another loan for $25,000 (the "Junior Lien"). Debtor subsequently defaults on his obligations under both loans. Creditor 1 commences a foreclosure action when $95,000 is still owed on the first loan. Subsequently, Debtor files a petition for relief under Chapter 7 of the Bankruptcy Code, which temporarily stays the foreclosure proceedings. In the bankruptcy case, it is determined that the Debtor's mortgaged property has a fair market value of $80,000, meaning Creditor 1's claim will only be secured to the $80,000 value of the mortgaged premises (with the remaining $15,000 obligation being categorized as an unsecured claim) and Creditor 2's claim will be considered unsecured in its entirety. Does the Bankruptcy Code enable Debtor to void the unsecured portions of the Senior and Junior liens? The United States Supreme Court says no.

1 Appellant's Reply Brief in support of Petition for Certiorari at 1, *Bank of America, N.A., v. Caulkett,* No. 13-1421 (Oct. 21, 2014).
2 *Bank of America v. Caulkett N.A.; Bank of America v. Edelmiro Toledo-Cardona*, Nos. 13-1421 and 14-163, 2015 U.S. LEXIS 3579 (June 1, 2015).

A. The *Partially* Unsecured Senior Lien

In the 1992 decision of *Dewsnup v. Timm*, the United States Supreme Court addressed the situation of partially secured liens, like the Senior Lien in the above example. In *Dewsnup*, Timm extended a line of credit to the Dewsnups secured by a lien on two parcels of land. Upon defaulting on their note obligation, the Dewsnups filed for relief under Chapter 7 of the Bankruptcy Code, triggering the automatic stay protection of the Bankruptcy Code.

During the bankruptcy proceedings, relying on §§506(a) and 506(d) of the Bankruptcy Code, the Dewsnups argued—as a matter of statutory construction—that to the extent their mortgaged debt exceeded the court-determined fair market value of the collateral, the excess amount is unsecured and the lien should be "stripped down," resulting in a reduction in the amount of the secured claim. The Dewsnups were effectively asking the court to void the lien to the extent Timm's secured claim exceeded the court-determined value of the collateral.

The Supreme Court disagreed and held that Chapter 7 debtors are not permitted to "strip down" a lien that secures an amount greater than the market value of the collateral. Finding ambiguity in the statute, the Court reviewed policy considerations and the law in existence before the enactment of the Bankruptcy Code, and concluded that "the creditor's lien stays with the real property until the foreclosure."[3] Thus, in light of *Dewsnup*, it is settled law that in a Chapter 7 liquidation, a debtor is unable to "strip down" the unsecured Senior Lien held by Creditor 1 in the above example. However, *Dewsnup* did not directly answer the question of how the wholly unsecured Junior Lien held by Creditor 2 would be treated.

B. The *Wholly* Unsecured Junior Lien

Prior to the Supreme Court's decision, the appellate circuit courts were split with regard to the treatment of a wholly unsecured junior lien. The Eleventh Circuit Court of Appeals adopted a pro-mortgagor stance, concluding in a series of decisions that a Chapter 7 debtor can "strip off" such a lien. By contrast, the majority of circuit courts of appeal —including the Fourth, Sixth, and Seventh[4] — suggest that *Dewsnup* addresses both "stripping down" and "stripping off" of junior liens, which preserves the pre-Bankruptcy Code rule that "liens pass through bankruptcy unaffected."[5] This issue has not been addressed by the Second Circuit, though one Connecticut bankruptcy court appears to support *Dewsnup's* anti-stripping philosophy.[6] Amid judicial disharmony, a steady tension percolated. It was time for the United States Supreme Court to step in; and it did.

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3 *Dewsnup v. Timm,* 502 U.S. 410, 417 (1992)
4 *See, e.g., Ryan v. Homecomings Financial Network,* 253 F.3d 778, 782-783 (4th Cir. 2001); *In re Talbert, 344* F.3d 555,560-561 (6th Cir. 2003); *Palomar v. First Am. Bank,* 722 F.3d 992, 994-995 (7th Cir. 2013).
5 *Id.*
6 *See In re Poirer,* 214 B.R. 528, 529 (Bankr. D. Conn. 1997).

On June 1, 2015, Justice Clarence Thomas, writing for a unanimous Court, disagreed with—and reversed—the Eleventh Circuit's approach. While the opinion appeared to criticize the Court's approach to its decision in *Dewsnup,* it noted that the parties did not ask it to overturn that decision and, as a result,"[t]he reasoning of *Dewsnup* dictates that a debtor in a Chapter 7 bankruptcy proceeding may not void a junior mortgage lien . . .when the debt owed on a senior mortgage lien exceeds the current value of the collateral."[7]

It thus appears that mortgagees have won another battle against defaulting mortgagors. Nevertheless, while the Supreme Court's decision gives us some clarity, if the undercurrent of skepticism and criticism woven into Justice Thomas's opinion provides a glimpse into the future judicial landscape, the possibility remains that the victory may be short lived.

Questions or Assistance:

If you have any questions, please feel free to contact Eric Goldstein at egoldstein@goodwin.com or 860-251-5059 or Katie LaManna at klamanna@goodwin.com or 860-251-5603.

7 *Bank of America v. Caulkett; Bank of America v. Edelmiro Toledo-Cardona*, Nos. 13-1421 and 14-163, 2015 U.S. LEXIS 3579, at *7-12.

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