The Supreme Court Prohibits Chapter 7 Debtors From Stripping Off Wholly Underwater Liens in Bankruptcy

By: Anthony J. Napolitano, CPA, Esq.

On June 1, 2015, the United States Supreme Court in *Bank of America, N.A. v. Caulkett*, 575 U.S. ____ (2015), unanimously held that a Chapter 7 debtor cannot strip off wholly "underwater" liens secured by the debtor's property. In *Caulkett*, the debtor's property was subject to two liens when the bankruptcy case was commenced. Since the obligation owed on the first lien exceeded the value of the property, the second lien was underwater and therefore had no value. The debtor sought to avoid the second lien, arguing that Section 506(d) of the Bankruptcy Code permitted a debtor in bankruptcy to void a junior lien when the obligation owed on the senior lien exceeded the value of the collateral. The bankruptcy court granted the motion, and both the district court and the Eleventh Circuit affirmed.

Section 506(d) provides, "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void . . . ." In order to avoid the bank's junior lien, the debtor relied on Section 506(a)(1), which provides that "[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." In other words, if the value of the creditor's interest in the collateral is zero, the claim cannot be a "secured claim" within the meaning of Section 506(a), and therefore eligible to be "stripped off" under Section 506(d).

Bank of America argued that the Supreme Court's earlier decision in *Dewsnup v. Timm*, 502 U.S. 410 (1992), which prohibited a Chapter 7 debtor from "stripping down" an undersecured junior lien to the value of the collateral, precluded the debtors from avoiding a wholly underwater lien. The Supreme Court agreed with the bank and acknowledged that *Dewsnup's* construction of the term "secured claim" resolves the question in this case. The holding in *Dewsnup* prevents the debtor from relying upon Section 506(d) to avoid the junior lien. Moreover, the Court declined to limit *Dewsnup* solely to partially undersecured liens noting that such a construction would lend itself to gamesmanship regarding the valuation of collateral.

While this case involved individual debtors with junior liens on residential property, the lower court's ruling had broader implications for the commercial lending industry. For that reason, this case generated a number of briefs filed by *amici curiae* ("friends of the court") urging the Supreme Court to reverse the Eleventh Circuit's decision that permitted the avoidance of the junior lien. For example, the joint brief of the American Bankers Association and the Loan Syndications and Trading Association noted that the commercial lending industry has relied on the protections afforded by *Dewsnup* for decades, and that an adverse ruling would be detrimental to the $40 billion in junior commercial loans presently outstanding. That brief noted that "[a] ruling that validated 'lien-stripping' in this context would cause marked and unanticipated disruption to a central sector of our Nation's still-fragile commercial and consumer lending markets."

Even though a debtor in bankruptcy can "strip down" undersecured liens and avoid wholly underwater liens in a Chapter 11 case, it was also noted that "Chapter 11 sanctions such a limitation only in the context of the highly structured process for plan confirmation, which provides numerous substantive and procedural protections for the lender." Permitting a debtor automatically to strip liens under Section 506(d), however, would deprive the junior lienholder of "the market tests [the Supreme Court] has found so central to the Chapter 11 process."

As a result, the Court's ruling is a victory for the secured lending industry as it precludes Chapter 7 debtors from "stripping off" wholly underwater liens simply because the collateral's present value is depressed. If debtors want to obtain a reduction of the amount of their secured claim and lien, they will need to pursue such relief through the more costly and time-consuming process of Chapter 13 (for individuals only) or Chapter 11 (for individuals and entities).

Anthony J. Napolitano is Senior Counsel in the Insolvency and Financial Solutions group in Los Angeles. He can be reached at 213.891.5109 or anapolitano@buchalter.com

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