

PUBLICATION

The Supremes Tell the Eleventh Circuit: No Lien Stripping

June 05, 2015

On June 1, 2015, the United States Supreme Court issued a unanimous ruling resolving a split amongst circuit courts in which the 11th circuit was the singular minority, addressing the permissibility of "lien-stripping" in chapter 7 bankruptcy cases. In *Bank of America, N.A. v. Caulkett*, U.S. Supreme Court, Case No. 13-1421 (2015) the Supreme Court reversed the 11th Circuit, holding that the majority of circuit courts were correct in concluding that a chapter 7 debtor cannot avoid junior liens on real property under 11 U.S.C. § 506(d).

Previously, in the en banc decision *In re McNeal*, 735 F.3d 1263 (11th Cir. 2012), the 11th circuit court found that the Supreme Court in *Dewsnup v. Timm*, 502 U.S. 410 (1992) implicitly rendered wholly unsecured junior liens on residential real property in chapter 7 cases void upon discharge. As a result, at least in the 11th Circuit, if the junior lienholder was wholly "underwater", the lien was voided. The ramification of this decision was significant, as it allowed for chapter 7 debtors to extinguish payment for and liability of a secured debt by avoiding a lien on their property without regard to the stability of surrounding property values or future ability to repay the debt.

In finding that chapter 7 "lien-stripping" was an incorrect interpretation of the Court's definition of the term "secured claim" in § 506(d) as explained in *Dewsnup*, the Court reversed *McNeal*, and confirmed the pre *McNeal* prevailing law. The *Caulkett* Appellees argued that the language of 11 U.S.C § 506(a)(1), providing that "[a]n allowed claim . . . is a secured claim to the extent of the value of such creditor's interest in . . . property," makes the secured claims of wholly underwater junior lienholders zero, and instead an unsecured claim. The Supreme Court rejected the Appellee's argument, finding that the issue had been previously addressed, as "under *Dewsnup*, a 'secured claim' is a claim supported by a security interest in property, regardless of whether the value of that property would be sufficient to cover the claim." Additionally, the Court clarified that a junior lienholder's claim, absent objection, are both "allowed" and "secured" under § 506(d) and cannot be avoided. Further, the Court found Appellee's arguments to be "an insufficient justification for giving the term 'secured claim' a different definition depending on the value of the collateral," which would "leave an odd statutory framework in its place."

The practical effect of this decision may not be exponentially widespread, as only the 11th circuit had previously allowed for lien stripping in chapter 7 cases. However, the decision should stabilize the secondary mortgage market and eliminate voidability risks that arose after the *McNeal* decision and hopefully make it cheaper for consumers to obtain junior mortgages. While the reversion may allow junior lienholders to complicate foreclosure sales by using their leverage to negotiate some type of recovery, this news is positive for junior lienholders and no surprise to superior creditors. With foreclosure rates at an all-time low since 2006, it is unlikely that the occurrence of problematic junior lienholders during the pendency of a foreclosure case will be universal. After all, these junior lienholders still had the ability to contest the valuation of a property subject to a chapter 7 lien strip request, and lenders are aware of property markets and valuation trends which would influence the need to litigate the validity of their loan both in bankruptcy and foreclosure matters. If a junior lienholder undoubtedly holds a wholly unsecured claim, than the decision in *Caulkett* may be of no consequence, as the lien previously would be subject to avoidance under the bankruptcy code, it still remains subject to elimination in foreclosure. Furthermore, it is more likely that consumers wishing to retain property will

strive to complete a chapter 13 plan in which a junior lien can be stripped, after the completion of stipulated monthly payments, increasing recovery for junior lienholders.