The Supreme Court Extends *Dewsnup* to Protect Mortgage Liens that are Wholly Under Water—At Least in Chapter 7

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On June 1, 2015, the Supreme Court, in two cases consolidated for decision, *Bank of America, N.A. v. Caulkett* and *Bank of America, N.A. v. Toledo-Cardona,*[1] extended its prior ruling in *Dewsnup*[2] by holding that a lien of a mortgage cannot be voided by a bankruptcy court ("stripped off"[3]) in a chapter 7 case even if it is wholly under water. As discussed in the fifth edition of *Krasnowiecki on Real Property Law and Practice*, chapter 12, at pages 767–772, the court in *Dewsnup* dealt with a first mortgage that was only partly under water, the issue being whether the debtor may have the part of the lien that exceeds the judicially established value of his or her interest in the property declared void. The court appeared to reason that a mortgage that is still partially secured is an "allowed claim" under section 502 and that such a claim is not subject to being stricken under subsection 506(d) because that subsection declares as "void" only claims that are not "allowed secured claims."[4] As pointed out in section 12-4.1 of the book, this reasoning seems to ignore the fact that subsection (a) of the very same section 506, tells us that *"[a]n allowed claim* … secured by a lien on property … is *an unsecured claim* to the extent that the value of [the] creditors' interest … is less than the amount of such allowed claim."[5] Giving the words their obvious meaning, subsection 506(a) tells us that the part of the secured claim that is determined, by a judicial valuation, to be in excess of the value of the collateral ceases to be an "allowed *secured* claim" and becomes an allowed *unsecured* one. When subsection (d) of the same section then tells us that *"[t]o the extent* that a lien secures a claim … that is *not an allowed secured claim"*[6] it is void, it is very difficult to conclude that the unsecured portion of the lien cannot be stricken, but that is what the court in *Dewsnup* concluded.

In *Bank of America v. Caulkett*, the Supreme Court appears to recognize that the above plain language of subsections 506(a) and (d) ought to be followed as a matter of statutory construction, at least in the case where the mortgage lien is wholly under water, but goes on to say "we decline to do so here based on policy arguments."[7] The policy argument that the

1. *Bank of America, N.A. v. Caulkett,* 135 S. Ct. 1995 (2015). The court granted certiorari in these cases after the fifth edition of the book was in print (*Krasnowiecki on Real Property Law and Practice,* Fifth Edition, © PBI Press 2015). This supplement pertains to the discussion in sections 12-4.1 and 12-4.2 of the book.
2. *Dewsnup v. Timm,* 502 U.S. 410 (1992).
3. "Strip off" appears to be used to describe the situation where the entire lien is declared void; "strip down" is used when a portion of the lien is declared void.
4. 11 U.S.C. §§ 502, 506(d).
5. Id. § 506(a), emphasis added.
6. Id. § 506(d), emphasis added.
7. *Bank of America, N.A. v. Caulkett,* footnote 1, above, op. at 6.

court puts forward is that if it were to permit a wholly underwater mortgage to be stricken under subsection 506(d), this would lead to the absurd result that when, for example, a property is valued at $1 above its first mortgage indebtedness, the second mortgage lien would be preserved, but when it is valued at $1 less, the second mortgage lien would be stricken. That is a good policy argument for not allowing a wholly underwater mortgage lien to be stricken, but it is persuasive only if the court's decision in *Dewsnup* is assumed to be correct. Why didn't the obvious meaning of subsections 506(a) and (d) persuade the court to a different result in *Dewsnup?* The answer the court gives to this question in *Caulkett* is that in *Dewsnup* it resolved an ambiguity in the language:

> Rather than apply the statutory definition of "secured claim" in §506(a), the Court reasoned that the term "secured" in §506(d) contained an ambiguity *because the self-interested parties before it disagreed over the term's meaning. Id.*, at 416, 420. Relying on policy considerations and its understanding of pre-Code practice, the Court concluded 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.*, at 415; see *id.*, at 417–420. It therefore held that the debtor could not strip down the creditors' lien to the value of the property under §506(d) "because [the creditors'] claim [wa]s secured by a lien and ha[d] been fully allowed pursuant to §502." *Id.*, at 417. In other words, *Dewsnup* defined the term "secured claim" in §506(d) to mean a claim supported by a security interest in property, *regardless of whether the value of that property would be sufficient to cover the claim.*[8]

In section 12-4.1, chapter 12, of the book, the author argues that the court's reasoning in *Dewsnup,* though difficult to follow, may reflect a concern that a drop in the value of a property may be short-lived, especially in a bankruptcy context, and that a lender should not be deprived of the right to retain its full lien against the property to capture the hoped-for increase in its value, even if that hope is not shared by the market and thus not reflected in the valuation of the property. The author notes that this same concern appears to have led Congress to give the lender who is caught in a chapter 11 case and whose loan has become undersecured the right to elect to be fully secured under subsection 1111(b).[9] The election allows the lender to protect the hoped-for increase in the value of the collateral, at least during the pendency of the plan, preventing the debtor from proposing a plan that would pay off the secured portion of the lender's claim in cash at confirmation and leave the debtor free to sell the property at a gain. The election under subsection 1111(b), coupled with the fact that the lender is given the right to credit bid if the debtor proposes to auction the property off under the plan, protects the lender's right to a hoped-for increase in the value of the property—at least over the period of the plan. It is important to note, however, that the protection of a subsection 1111(b) election is offered only to a lender whose collateral value has not eroded so far as to render the security interest in the property "of inconsequential value."[10]

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8. Id. at 4, emphasis added.
9. 11 U.S.C. § 1111(b).
10. Id. § 1111(b)(1)(B)(i).

The fact that subsection 1111(b)(1)(B)(i) denies the election to the lender whose mortgage is wholly under water and the fact that *Dewsnup* involved a mortgage that was only partially under water led many bankruptcy courts to conclude that *Dewsnup* does not prevent a wholly underwater mortgage from being stripped off a property. Surely, the courts concluded, such mortgages could not be classified as an "allowed secured claim," so that the language of subsection 506(d)—that a lien that is not an allowed secured claim is void—could be given full effect. This was particularly true in chapter 13 cases, where subsection 1322(b)(2) expressly gives the bankruptcy courts the power to modify the terms of secured debt except if the mortgage is "secured only by a security interest in real property that is the debtor's principal residence."[11] Subject to the principal residence exception, which the Supreme Court, in *Nobelman*,[12] extended to home mortgages that are partially under water, bankruptcy courts have generally been willing, in a chapter 13 case, to void the lien of mortgages that are wholly under water, whether they be on a principal residence or on other real property—typically second mortgages or lines of credit secured by the property. Some have even been willing to void the unsecured portion of mortgages that are partially under water if they are not on a principal residence of the debtor on the theory that *Dewsnup* does not apply to chapter 13 cases. These cases are discussed at some length at pages 772–779 of the book.

It is unclear whether the court in *Caulkett* intends its decision to apply to chapter 13 cases. The debtors argued that because the court in *Nobelman* emphasized that a mortgage that is partly under water on a primary residence is still "secured" by that residence, so that it cannot be modified under subsection 1322(b)(2), by implication, one that is wholly under water is no longer a "secured claim" under subsection 506(d). The court rejected that argument as follows:

> *Nobelman* said nothing about the meaning of the term "secured claim" in §506(d). Instead, it addressed the interaction between the meaning of the term "secured claim" in §506(a) and an entirely separate provision, §1322(b)(2). See 508 U.S., at 327–332.[13]

Whether this enigmatic statement means that the practice of stripping off a wholly unsecured mortgage lien in a chapter 13 proceeding is now threatened is not clear. Subsection 1322(b)(2) of the Bankruptcy Code certainly gives the courts the power to approve a plan that modifies both secured and unsecured debt (subject to the principal residence exception). But, as noted in section 12-4.1 of the book, pages 775–778, subsection 1325(a)(5)(B)(i) of the Bankruptcy Code requires that the lien of an "allowed secured claim" remain attached to the property unaltered until the payments under the plan are completed and the debtor is discharged. If "allowed secured claim" must now be read, as *Caulkett* seems to require, as "a claim allowed under section 502 that has a state-law-recognized security interest in real property, regardless of its valuation," then the practice of striking liens during the pendency of a chapter 13 plan may have to end.

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11. Id. § 1322(b)(2).
12. *Nobelman v. American Sav's Bank*, 508 U.S. 324 (1993). *Nobelman* is discussed in chapter 12, section 12-4.1, of the book, pages 772–774.
13. *Bank of America, N.A. v. Caulkett*, footnote 1, above, op. at 6.