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# In Recent Ruling, SCOTUS Preserves Junior-Lien Lenders' Secured Claims

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**September 9, 2015** - On June 1, 2015, the U.S. Supreme Court issued its decision in *Bank of America v. Caulkett*.[1] The Court's unanimous opinion, which was written by Justice Thomas, established that junior mortgage lienholders maintain a "secured" claim against a bankrupt debtor even where the junior mortgage lien is completely underwater. Further, an underwater junior mortgage lien cannot be voided if the lien is an "allowed" claim within the meaning of the section 502(a) of the Bankruptcy Code. In the wake of the foreclosure crisis, the decision constitutes a significant victory for the many banks that issued second mortgages on homes owned by individuals who filed for bankruptcy at a time when the amount owed on their first mortgage exceeded the actual value of their homes.

For background, in *Bank of America v. Caulkett*, the respondents, two individuals, each owned homes with junior liens held by Bank of America.[2] The amount each respondent owed on his primary mortgage was greater than the respective value of each home.[3] Accordingly, Bank of America's junior lien was completely "underwater" in both instances.[4] Each respondent filed for bankruptcy and sought to void the junior lien held by Bank of America pursuant to Bankruptcy Code section 506(d), which voids liens that do not constitute "allowed secured claims" against a debtor.[5] The Bankruptcy Court permitted voiding of the liens.[6] Bank of America appealed, and both the District Court and the Eleventh Circuit affirmed the Bankruptcy Court's ruling.[7] The Supreme Court then decided the case on certiorari.

Both parties agreed that Bank of America's claim against the debtors was an "allowed" claim within the meaning of section 502. The major issue before the Court was whether Bank of America's underwater junior lien constituted a "secured claim" within the meaning of section 506(d), thus preventing Bank of America's claim from being voided.[8]

The respondents argued that the claim was unsecured, and therefore could be voided, relying on Bankruptcy Code section 506(a)(1) which states 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 the 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."[9] A plain reading of the text suggests that an underwater junior lien is unsecured and voidable.

Nevertheless, the Court relied on its previous decision in *Dewsnup v. Timm*[10] to find that an underwater junior lien is a secured claim. In *Dewsnup*, the Court held 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)."[11] The *Caulkett* Court, therefore, found that under *Dewnsup*, a secured claim is "a claim supported by a security interest in property, regardless of whether the value of the property would be sufficient to cover the claim."[12] Although the claim at issue in *Dewsnup* involved a partially underwater lien, the *Caulkett* Court held that the definition of "secured claim" includes claims involving liens that are wholly underwater—that is, where after taking into account the money owed on the first mortgage, the value of the junior lienholder's interest in the property would be zero. The Court found no reason to limit its holding in *Dewsnup* to claims backed by collateral with some value, noting that imposing this proposed limitation could lead to "arbitrary results" in light of the "constantly shifting value of real property."[13] Accordingly, the Court found that wholly underwater junior liens, such as those held by Bank of America were allowed secured claims that could not be voided under section 506(d).

B*ank of America v. Caulkett*'s implications for underwater junior lienholders is significant. By establishing that the issuer of a second mortgage can maintain a secured claim against a debtor that cannot be voided, *Caulkett* means that underwater junior lienholders may have a shot at recovery where they otherwise would not. However, the overall reach of *Caulkett* may be limited to the chapter 7 context. Lien allowance and avoidance in the chapter 11 context is determined by the application of other code sections including 111(b), 1123(b)(5) and the cram down provisions of the Bankruptcy Code. This, along with the fact that the Court did not discuss the broader application of its ruling, indicates that it is unlikely that *Caulkett* will have any impact on the treatment of underwater junior liens in the chapter 11 context.

**Footnotes**

[1] *Bank of America v. Caulkett*, 135 S.Ct. 1995 (2015).

[2] *Id.* at 1998.

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Id.* at 1998-99.

[10] *Dewsnup v. Timm*, 112 S.Ct. 773 (1992).

[11] *Id.* at 777.

[12] *Id.* at 1999.

[13] *Id.* at 2000-01.

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