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SCOTUS: Second Mortgages NOT Voidable In Chapter 7 Proceedings (Caulkett Decision)

Article By:

Commercial Litigation Practice Group - Stark & Stark

On Monday, June 1, 2015, the Supreme Court of the United States published its opinion in the matter of ***Bank of America v. Caulkett***. The issue determined was whether or not, in a bankruptcy liquidation (Chapter 7 proceeding), the debtor can void a second mortgage when the property (typically the home) is worth less than the first mortgage. The Court ruled they cannot.

For years, individual Chapter 7 debtors have routinely stripped down their second mortgages completely under the theory that since there was no equity in the collateral (usually a debtor's home), then it was unsecured and hence dischargeable as an unsecured debt. This left second mortgagees without any collateral post-discharge. The Court's decision this week has changed all of this.

The Justices relied directly on a 1992 decision (*Dewsnup v. Timm*). A unanimous Court followed *Dewsnup*, in which the Court had ruled that when the amount of a mortgage lien is greater than the market value of the property at issue, the Bankruptcy Code does not allow courts to reduce the lien's value to the property's market value.

Justice Thomas's opinion for the Court opines that Section 506(d) of the Bankruptcy Code allows a debtor to void a lien on his property when it "secures a claim against the debtor that is not an allowed secured claim." All agreed that Bank of America's claims were allowed. The real issue was whether the claims were secured. Recall the value of the lender's interest on its second mortgages on the properties was zero.

In *Dewsnup*, the Court was dealing with what is known as a "partially underwater" mortgage. In that case, the debtor owed $120,000, but sought to reduce that debt to $39,000, which was the current value of the collateral. There, the Court ruled that she could not do so because the creditors' claim was secured by a lien and was therefore "secured" for purposes of Section 506(d).

In *Caulkett*, the homeowners were completely "underwater." In other words, the debtor's house was worth $98,000 when he filed for Chapter 7 bankruptcy, but he owed $183,000 on his first mortgage and $47,000 on his second. The Edelmiro Toledo-Cardona's residence, also part of the appeal, was worth just under $78,000 when he filed for bankruptcy, yet he owed $135,000 on his first mortgage and $32,000 on his second. The Court ruled Monday that the same reasoning applies to mortgages

that are “completely underwater.” The Court concluded that a valuation of one dollar more or one dollar less than the first mortgage balance could create a conceptually horrendous result. “Given the constantly shifting value of real property,” the Court concluded, “this reading could lead to arbitrary results.”

What this means to second mortgage consumer lenders on residential real estate is that there could well be more Chapter 13 filings, since a debtor can still strip down a second mortgage in that proceeding under 1322 (b)(2) if the second mortgage is wholly unsecured. There will likely be less Chapter 7 filings, since the second mortgage will remain intact after the debtor’s discharge. And, if the debtor files a Chapter 7, the debtor may stop paying on all of his mortgages, since he cannot readily eliminate the second mortgage lien. On the other hand, the debtor may try to simply pay the first mortgagee and hope the second mortgagee will not foreclose, thinking it is unlikely that the second mortgagee will be tempted to pay off a first mortgage with a large balance simply to realize its smaller equity balance.

This decision also means that the second mortgage holder now has a say at any “short sale” or attempted refinance, and depending on the market trends, the second mortgage lender may now take a closer look at the circumstances. If the market values in the neighborhood are trending upwards, the first mortgage is current and the taxes are being paid, then a second mortgage foreclosure may be well worth considering or at least an objection to any Chapter 7 debtors’ strip down application. This is an economic decision and a new option that should be weighed.

It may take a while before the debtors’ bar fully digests the opinion, and there may still be attempts in the near future by debtors at “stripping down” second mortgage liens in Chapter 7 liquidation proceedings. This means lenders should be ever vigilant for these applications and weigh them against the economics of the collateral. However, after Monday’s opinion, with the proper objection to the debtor’s motion, the “strip down” in Chapter 7 liquidations should be impossible. On the other hand, the decision does not put equity back into the property or get the lender paid; it only allows additional options for the vigilant lender willing to consider the new opportunity.

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