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United States Supreme Court Ruling Favors Lenders On Second Lien “Lien Stripping” Issue

On June 1, 2015, the United States Supreme Court issued a ruling in *Bank of America, N.A. vs. Caulkett*¹, an important ruling in protecting the lien rights of second lienholders. In this case, the debtors sought to eliminate the second liens on their homes. If the court accepted their arguments, they could retain their homes by simply paying the first lienholders and could relegate the second lienholders to an unsecured claim in their separate Chapter 7 proceedings, where the lienholder would likely recover little or nothing. To strip the second lien, the debtors sought to invoke 506 of the Bankruptcy Code, which provides, “To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void.” 11 U. S. C. §506(d). If successful, the debtors could have reaffirmed the first lienholders’ debts and retained their homes. Significantly, the second lien debts would not have to be reaffirmed and could have been discharged as mere unsecured claims in the bankruptcy.

In each case, the Bankruptcy Court accepted the debtors’ arguments and granted their motions to strip the second lien. Both the District Court and the Eleventh Circuit affirmed. The theory of the lower courts’ decisions was that, if the first lienholder was permitted to foreclose on its collateral, the second lienholder would not receive a recovery except on account of its unsecured claim so the courts’ decisions put the second lienholder in the same financial position as it would be in if the first lienholder foreclosed.

The United States Supreme Court, in an opinion written by Justice Clarence Thomas, ruled that the “lien stripping” was not permissible under a prior decision of the United States Supreme Court. In that case, *Dewsnip v. Timm*, the Court concluded that an allowed claim “secured by a lien with recourse to the underlying collateral . . . does not come within the scope of §506(d).” *Dewsnip v. Timm*, 502 U.S. 410, 415 (1992). Based on this decision, the Supreme Court determined that the lower courts reading of Section 506(d) of the Bankruptcy Code was not correct and that a debtor could NOT eliminate the secured status of a second lienholder’s claim and have it disallowed solely because the value of the collateral did not exceed the amount of the first lienholder’s claim.

¹ The case was decided together with No. 14–163, *Bank of America, N. A. v. Toledo- Cardona*, also on certiorari to the same court.

As a result of the decision, a debtor in bankruptcy will be required to address all liens against the property if it wishes to retain the home, which should provide greater certainty to lenders making subordinate financing.

If you wish to read the full decision, you can find it at this link:

http://www.supremecourt.gov/opinions/14pdf/13-1421_p8k0.pdf

Please contact any of our lawyers if we can assist you.

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