Dewsnup III: Bank of America v. Caulkett

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By Ashley Warshell and Alvin C. Harrell

I. Introduction

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II. The Bankruptcy Code

The United States Bankruptcy Code (the Bankruptcy Code or the Code) provides for the bifurcation of claims at 11 U.S.C. section 506(a)(1), which states:

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the estate’s interest in such property... and is an unsecured claim to the extent that the value of such creditor’s interest or the amount so subject to setoff is less than the amount of such allowed claim...

Therefore, if there is an allowed claim that is secured by a lien, and the claim exceeds the appraised value of the property subject to the lien, the claim is split into two separate claims (secured and unsecured), and these claims are subject to different treatment in the bankruptcy case. Further, section 506(d) provides:

To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless –

1. such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or

2. such claim is not an allowed secured claim due to the failure of any entity to file a proof of such claim under section 501 of this title.

Subject to the stated exceptions, this subsection allows a debtor to wholly avoid a lien secured by a claim that has been disallowed under section 502, i.e., a claim that has not been deemed an “allowed secured claim” in the bankruptcy case. Note that the effects of section 506(d) lien avoidance extend beyond rejection of the creditor’s assertion of a claim in the bankruptcy case, in effect terminating the creditor’s substantive state law property rights, and making section 506(d) an exception to the general policy of the Bankruptcy Code in leaving property rights intact. Thus, the scope and definition of the term “allowed secured claim” in this context are significant and give rise to potentially far-reaching results for debtors and secured creditors.

III. Dewsnup and Nobleman

A. Dewsnup

In 1992, in the Supreme Court decided Dewsnup v. Timm, addressing the question of how broadly the definition of “allowed secured claim” should be read in the context of section 506(d). In Dewsnup, the debtor in a Chapter 7 case argued that the portion of the mortgage lien in excess of the appraised value of the real property was void under section 506(d) because it was not an “allowed secured claim” under section 506(a). In other words, the debtor viewed section 506(a) as bifurcating the secured creditor’s claim and lien for purposes of section 506(d), resulting in a fully-secured lien and an unsecured lien, the unsecured lien being subject to avoidance in bankruptcy under section 506(d). Critics of this view noted that section 506(a) bifurcates claims, not liens, and that the purpose of section 506(d) is entirely separate from the disallowance of claims for purposes of section 506(d).

The United States Supreme Court disagreed with the debtor, finding that the plain language of the Bankruptcy Code was ambiguous and rejecting the debtor’s argument based on the following criticisms: (1) The practical effect would be to give the debtor a potential windfall at the expense of the undersecured creditor, modifying the mortgage-mortgagee bargain and state property rights with no apparent intent or justification; and (2) the debtor’s interpretation would be inconsistent with the long-standing policy of allowing liens that secure an allowed claim to pass through bankruptcy unaffected.

The second criticism appeared to weigh heavily on this decision, as the Court discussed pre-Code bankruptcy law and the need for “a clean slate.” Thus, as explained in Dewsnup, avoidance of liens under section 506(d) is limited to those liens that secure claims disallowed by the bankruptcy court pursuant to Bankruptcy Code section 502 (11 U.S.C. section 502).

Inherent to the Court’s analysis in Dewsnup is the long-standing Bankruptcy Code structure providing that the treatment of allowed claims in bankruptcy relates primarily to the priority and right of payment from distributions to unsecured creditors. Under the Bankruptcy Code, an “allowed claim” is a claim against the bankruptcy estate that is allowed under Bankruptcy Code section 502. Section 502 disallows claims that are deemed defective for various stated reasons. Thus, the purpose of section 506(d) is to void liens that secure claims that have been disallowed for one or the reasons stated in section 502. As the Court stated in Caulkett: “Dewsnup construed the term ‘secured claim’ in [section] 506(d) to include any claim ‘secured by a lien...and fully allowed pursuant to [section] 502.”

B. Nobleman

In Nobleman v. American Sav. Bank, the Court addressed a similar issue in the context of a Chapter 13 bankruptcy case, where the debtor’s home mortgage lien was partially underwater. Nobleman involved application of a Chapter 13 Bankruptcy Code provision, at 11 U.S.C. section 1322(b)(2), which provides that a Chapter 13 plan may “modify the rights
of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence..."13 The debtors argued that this "anti-modification" language (protecting home mortgage liens from modification) applied only after the lien had been modified under section 506(a). The debtors cited the "rule of the last antecedent," arguing that the section 1322(b)(2) protection for residential mortgage liens only applied to "secured claims" as defined in section 506(a).14 As noted above, section 506(a)(1) bifurcates partially secured claims into secured and unsecured parts; so the effect of the debtor's interpretation would be to limit the section 1322(b)(2) protection of residential mortgage liens to the part of the lien representing the appraised value of the mortgaged property. This would allow the underwater part of the lien to be avoided.

Once again, the United States Supreme Court disagreed with the debtor's interpretation, this time focusing on the word "rights" in section 1322(b)(2), as defined by state property law.15 The Nobleman opinion quotes Butner v. United States16 multiple times, emphasizing the language in Butner explaining that "property interests [i.e., property "rights"] are created and defined by state law."17 With this in mind, the Nobleman Court noted that the section 1322(b)(2) protection of residential mortgage liens extends not to "secured claims" as the term is used in section 506(a), but rather to the "rights of holders of secured claims."18 Thus, the purpose of the anti-modification language in section 1322(b)(2) is to protect the state law lien rights of mortgagees. The interpretation adopted in Nobleman, like that in Dewsnup, prevented a reduction of the debtor's home mortgage lien to the value of the property. Fundamental to the Court's analysis in Nobleman is, again (as in Dewsnup), a recognition that section 506(a) is limited to the bifurcation of bankruptcy claims, not liens, and that (pursuant to Butner and Long v. Ballard and the plain meaning of the Bankruptcy Code) liens flow through bankruptcy and are not affected by the treatment or calculation of claims, e.g., in section 506(a), except in cases where there are specifically delineated statutory exceptions such as section 506(d). After Dewsnup and the clear line of authority dating from Long v. Ballard, it might seem this should be clear. When the Supreme Court, in effect, said it again in Nobleman, there could surely be no remaining doubt. However, the question of whether the Nobleman and Dewsnup decisions extended to cases where there are wholly unsecured home mortgage liens remained a subject of debate.19

IV. Bank of America v. Caulkett

In Caulkett,20 the Court addressed two debtors' attempts to modify their wholly underwater second mortgage liens using Bankruptcy Code section 506(d). In an opinion written by Justice Thomas,21 the Court first considered the plain language of section 506(a), recognizing the debtors' argument that a "straightforward" reading of the language does not provide Bank of America's claim, secured by a wholly underwater mortgage, the same protection as a fully secured claim, which is entitled to full payment in bankruptcy.22 However that is not the issue, and a focus on this issue ignores the relevant distinctions (e.g., between "claims" and "liens") in the statutory language, long recognized by the Court as significant, as noted above. The Court proceeded to deconstruct each of the debtors' arguments in turn. First, the Court dismissed arguments based on the "hedging" language in Dewsnup (which suggested the case could be limited to its facts), reiterating that the Dewsnup construction of the term "secured claim" in section 506(d) was not dependent on any distinction between partially and wholly underwater mortgages.23 Nor could it be redefined as a partially secured claim, as this would lead to inconsistencies with section 506(a).24 The language of section 506(a) clearly bifurcates only allowed claims, not liens (and these are carefully defined terms in the Bankruptcy Code, treated separately and differently throughout the Code). Nor is there any concept of a partially secured lien in section 506(d); as noted above, section 506(d) voids entirely a lien that secures a disallowed claim.

In other words, Dewsnup defined the term "secured claim" in [section] 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. Under this definition, [section] 506(d)'s function is reduced to "voiding a lien whenever a claim secured by the lien itself has not been allowed."25

The Court further noted the awkwardness of the debtor's proposed approach under which a single dollar difference between claims could affect the validity of the mortgagee's entire lien, resulting in arbitrary line-drawing.26 Finding none of the debtors' arguments to be compelling, the Court concluded that Dewsnup's construction of "secured

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15. Id. at 328.
17. Id. at 328. 55, as quoted in Nobleman, 508 U.S. at 329. See also supra note 9.
20. Caulkett, 557 U.S. ___ (slip op. at 1).
21. Id. at 6-7.
22. Id. at 6-7.
claim" controlled, preventing the underwater second mortgage liens from being voided under section 506(d). 30

V. What About the Nobelman Issue?

Although the Dewsnup/Caulkett issue surely has reached a final resolution in the United States Supreme Court, the Court did not comment directly on the interaction of this holding with Nobelman in the context of wholly underwater residential mortgage liens in Chapter 13 bankruptcies. Currently, the United States Courts of Appeal for the Second, Third, Fifth, Sixth, Eighth, Ninth, and Eleventh Circuits have found that entirely underwater home mortgage liens are not protected under section 1322(b)(2), making this the majority view. 31 Although, unlike Caulkett, the issues in Nobelman and these other cases additionally involve section 1322(b)(2) of the Bankruptcy Code, 32 all of these cases share roots in the attempt to bifurcate liens under section 506(a)(1) and (d), and the resulting effect on state property rights. It remains to be seen whether these common roots will be enough to overcome the majority view and extend Nobelman beyond partially underwater mortgage liens.

Nonetheless, the Supreme Court's unequivocal and consistent articulation of the limited roles of section 506(a) and (d) in the modification of liens is clearly inconsistent with the analytical basis for modifying underwater mortgage liens in the Chapter 13 cases. The latter cases depend on section 506 as the basis for modifying underwater liens under section 1322(b)(2), yet there is no basis anywhere in the Supreme Court opinions (or their interpretation of the Bankruptcy Code) for voiding underwater home mortgage liens in Chapter 13 cases on the basis of section 506. Since that section is the foundational basis for most of the statutory interpretations allowing underwater liens to be avoided, 33 there does not appear to be any room left for justification of these cases other than the language of section 1322(b)(2) itself, and this interpretation of section 1322(b)(2) was seemingly rejected in Nobelman. 34 Thus, Dewsnup, Nobelman, and now Caulkett appear to invite, or even mandate, that the treatment of wholly-underwater mortgage liens in Chapter 13 cases be revisited and carefully reconsidered.

VI. In re Woolsey: Dewsnup 2 1/2?

In In re Woolsey, 35 the United States Court of Appeals for the Tenth Circuit delved into the relation between Dewsnup and Bankruptcy Code section 506(d) in the context of a Chapter 13 plan that proposed to void a wholly underwater second mortgage lien. Woolsey involved the usual scenario of debtors' seeking to void an underwater home mortgage lien in a Chapter 13 case. In this instance, the lien was held by Citibank. The latter successfully objected to confirmation of the Chapter 13 plan in the bankruptcy court, and the district court affirmed, leading to the appeal.

The Tenth Circuit stated the question succinctly and confronted it directly: "May Chapter 13 debtors like the Woolseys void a state law lien secured by no remaining value in the collateral?" 36 The court then noted that "the path to answering that question would seem to begin and end with the language of 11 U.S.C. [section] 506(d),", 37 thereby immediately recognizing the relevance of Dewsnup. 38 Following the clear mandate of Dewsnup, in Woolsey the Tenth Circuit noted that section 506(d) provides for avoidance of liens that do not secure an allowed secured claim, and that "Citibank's secured claim, is an "allowed" one." 39

The next question was whether Citibank's underwater mortgage constituted a secured claim. The Woolsey court noted that Bankruptcy Code section 506(a) requires a secured claim to be supported by economic value (thereby preventing a wholly underwater lien from creating a secured claim for purposes of the bankruptcy priority and distribution process). But the court noted that this is not the issue in a case like Woolsey. As the Tenth Circuit recognized, Dewsnup unequivocally rejected the argument that section 506(a) defines a "secured claim" for the additional purposes of lien avoidance under section 506(d). In Dewsnup (and essentially, one can add, again in Caulkett), the Supreme Court held that the "term "allowed secured claim" [in section 506(d)] means a claim "allowed" under [section] 39.
502 and "secured" by a lien enforceable under state law." Therefore, "value in the collateral has no bearing on the lien-avoiding language of [section] 506(d); any lien secured under state law must be respected and protected from removal."\(^{41}\)

The Tenth Circuit then revisited the arguments to the contrary, as rejected in Dewsnup and now, again, in Caulkett, essentially that the definition of "secured claim" in section 506(a) should control the application of section 506(d) for lien avoidance purposes. The court noted that this view is supported by the fact that sections 506(a) and 506(d), though having separate purposes, were inartfully placed in the same Bankruptcy Code section, "a mere three subsections" apart.\(^{42}\) The Tenth Circuit viewed this as a "topsy-turvy result," though in your authors' view it is just another example of sloppy drafting that invited creative arguments based on a historically incongruous and obviously unintended interpretation (as recognized, multiple times now, by the Supreme Court).

At this point it might seem that we could all agree with the Supreme Court that the result is at best a statutory ambiguity, or perhaps an anomaly, based on the fact that two essentially unrelated subsections (506(a) and (d)) appear "but a mere three subsections" apart in the statute.\(^{24}\) On the other hand, surely this is not at all that shocking, or the first time that something like this has happened. So the Woolsley court's seeming indignation at the prospect of unrelated provisions appearing in the same Bankruptcy Code section seems misplaced, as does its conclusion that in Dewsnup the Supreme Court "felt at liberty to ignore these problems."\(^{45}\)

Surely the Woolsley court was mistaken if it intended to suggest that the somewhat odd and apparently casual juxtaposition of sections 506(a) and (d) was sufficient to inferentially wipe out over a hundred years of consistent and foundational precedent without even a hint of Congressional intent, and that this created a legal issue in Dewsnup only because "the litigants...happened to disagree over the statute's meaning..."\(^{46}\)

These rather flippant comments seem to unduly demean the very real (and important) legal issues at risk in these cases. Still, the Woolsley court appropriately recognized the gist of the Supreme Court's holding in Dewsnup, concluding that: "in light of the ambiguity so generated, the [Supreme] Court felt free to strike out to interpret [section] 506(d) on its own, unchained by [section] 506(a)'s plain language."\(^{47}\) With section 506(a) thus unchained, the Woolsley court noted, and without any other indication that Congress intended to overturn long-standing precedent, Dewsnup mandates that section 506(d) be limited to the avoidance of liens that secure claims disallowed under section 502.\(^{48}\) So the Woolsley court is to be commended, despite its disagreements over the Dewsnup rationale, for recognizing the impact of the Supreme Court's holding in Dewsnup on the state of the law.\(^{49}\)

As noted above at Part III, that is apparently more than can be said of some other courts and commentators. The Woolsley court wisely avoided some of the convenient analytical traps that others have eagerly embraced. The Woolsley court argued, for example, that section 506(d) should have a different meaning in Chapter 13 cases (as compared to the Dewsnup Chapter 7 rationale) because of section 1322(b)(2). As is obvious, the Woolsley court noted that lien avoidance has a different role in Chapter 13 cases, because it is expressly authorized at section 1322.\(^{50}\)

Thus, the direct issue in Dewsnup (the relation between sections 506(a) and (d)) is not precisely the one presented in Chapter 13 cases (which also involve the relation between sections 506 and 1322(b)(2)).\(^{51}\)

Still, and even though "every federal court of appeals to consider the question has already refused to extend Dewsnup's definition of the term 'secured claim' to other statutory provisions using that term in Chapter 13, where the focus is on reorganization rather than liquidation[,]"\(^{52}\) the argument advanced by the debtor in Woolsley would require the court to conclude that the fundamental meaning of section 506 (as mandated in Dewsnup) is different in Chapter 13 cases.\(^{53}\) The court therefore rejected the debtors' argument that the term "secured claim" in section 506(d) "should be read to require proof of value before a lien is protected from removal" in Chapter 13 cases in accord with [section] 506(a).\(^{54}\)

\(^{40}\) Id. at 1275–76. The Woolsley court expressed additional reservations about the rationale of Dewsnup, essentially arguing for the one-hundred-plus years of foundational precedent in regard to the relation between federal bankruptcy and state property law consistently relied on by the Supreme Court as a fundamental aspect of American federalism - should be cast aside because "the Court itself has repeatedly instructed that pre-enactment practices is irrelevant only to the interpretation of an ambiguous text" and holds no sway when the statutory language is clear. Id. at 1274 (quoting Broadfoot v. Gurney, 938 F.2d 1565, 1573 (2d Cir. 1991)). Apparently the Woolsley court would prefer to overturn a fundamental principle of federalism on the basis of apparent drafting sloppiness that happened to place unsecured gains in the same Bankruptcy Code section, with the slightest suggestion of Congressional intent to change the law.

The Woolsley court also asserted that Dewsnup is anomalous because "Chapter 7 is irreducibly different from Chapter 13 in many situations." Woolsley, 696 F.3d at 1271 (citations omitted). But this is disingenuous. These "situations" are expressly stated exceptions to the foundational principle that liens flow through Chapter 7 cases, based on clearly articulated Congressional intent and expressed in unmistakable statutory language, elements that are blatantly missing in the Woolsley scenario.

\(^{49}\) Id. at 1274. See also supra note 38.

\(^{50}\) Id. at 1273. This is part of the basic structure of the Bankruptcy Code - intended as an inducement for debtors to make partial payments to creditors by filing under Chapter 13.

\(^{51}\) Woolsley, 696 F.3d at 1275–76.

\(^{52}\) Id. at 1275 [citations omitted]. See also supra Part III.

\(^{53}\) Woolsley, 696 F.3d at 1273. The court noted that the other Chapter 13 cases in question relied on the language of § 1322(b)(2) rather than § 506(d). Woolsley, 696 F.3d at 1278. See also supra notes 35–36.

\(^{54}\) Woolsley, 696 F.3d at 1276.
The Woolsey court also briefly considered the role and impact of section 1322(b)(2), as the source of the Chapter 13 avoidance power.35 The court interpreted Nobelmao as leaving open an alternative theory that wholly-underwater mortgage liens may be outside the scope of section 1322(b)(2)'s anti-modification clause.36 Nonetheless, while the Woolsey court seemed willing to consider another line of reasoning, in supplemental briefing the Woolseys "emphatically announced that '[t]here is no [Bankruptcy] Code provision other than 11 U.S.C. [section] 506(d) that declares void a wholly underwater lien."'37 This precluded consideration of any other argument in Woolsey. While your authors agree with that conclusion,38 it may require yet another Supreme Court decision to make that point clear to all.

VII. Conclusion

It is extraordinary that such a fundamental and long-standing principle as the relation between bankruptcy and state property law should be continuously questioned on the bases asserted in these cases, despite multiple Supreme Court decisions to the contrary. It will be interesting to see whether Dewsnap, Nobelmao, and Conkellet have now sufficiently clarified these issues, or how many times more the Court will have to say, i.e., we really meant it.

35. Id. at 1279.
36. Id., noting that "tax courts have already read Nobelmao this way...".
37. Id. But see supra notes 31 - 33.
38. See supra note 37.

The Federalist Society...

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but you get the basic point. Today we frequently provide government support by helping households leverage as opposed to helping households save and build the resources internally to be able to manage major life expenditures and life events.

Paul S. Atkins: Amen with that, and it is tax policy, of course, but then there is also the really invidious zero interest rate policy that the Federal Reserve now is doing, which is decimating savers and pensioners and I think is setting us up for huge problems once the tide recedes and you see on the beach all the trash that's left there, when people are ripped off by too-good-to-be-true types of things that they are being sold because they don't earn money off of their banking and savings accounts.

But we're getting the signal that we need to wrap up. So, thank you all for coming.

CFPB Investigating a Lead...

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service [other than unknowingly or incidentally transmitting or processing undifferentiated financial data]." The petition noted that the definition includes an exception for providers of a "support service of a type provided to businesses generally or a similar ministerial service."39 The company argued in the petition that it does not provide any "material service" to covered persons nor does it provide services that fall within the specific examples contained in the statutory "service provider" definition. It asserted that lead generation services instead fall within the exception for services "provided to businesses generally." According to the petition, lead generation services are no different than advertising agency services, public relations services, marketing consultants and strategists and any other of the numerous support services which are now economically woven into the fabric of the American business model. They have nothing to do with core financial services functions.

II. CFPB Denies Lead Generation Company’s Petition to Modify or Set Aside CID

On August 6, 2015 the CFPB denied the petition of the company and its employee to modify or set aside the CID. In its decision denying the petition, the CFPB stated that, as an initial matter, the petitioners waived these arguments by not raising them with the CFPB’s enforcement counsel during the meet-and-confer process. The CFPB also ruled that the objection failed on its merits because it was "essentially a substantive defense to claims the CFPB has yet to assert." The CFPB stated that "such fact-based arguments about whether an entity is subject to or complied with a law’s substantive provisions are not defenses to the enforcement of a CFPB regulation.” According to the CFPB, its position was supported by case law involving the Federal Trade

4. See CFPB, Decision and Order on Petition by Selling Source, LLC and Tim Madden to Modify or Set Aside Civil Infractions: (Continued from previous column)