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Despite various reports that the economic crisis may be improving, many property owners face the continuing problem of owing thousands if not hundreds of thousands of dollars more than their properties are currently worth. Many of these owners have chosen to allow their properties to go into foreclosure rather than continue to pay on loans that far exceed the value of the property. For many property owners, however, there may be an alternative to foreclosure. This month we provide a brief overview of the potential benefits of a Chapter 13 Bankruptcy proceeding when a real property owner owes more than the property is worth.

PROPERTY OWNERS MAY BE ABLE TO REDUCE THE DEBT OWED ON REAL PROPERTY THROUGH A CHAPTER 13 BANKRUPTCY PROCEEDING

While many economic reports note that foreclosures have been gradually decreasing, a significant number of real property owners struggle to make payments on loans that exceed the value of their properties. A Chapter 13 bankruptcy proceeding may offer relief to such property owners who are “under water.” In certain situations, Chapter 13 bankruptcy can eliminate a second or third lien against real property. In bankruptcy parlance, this is known as “lien-stripping.”

In order to qualify for this benefit, the property owner must be eligible for a discharge in bankruptcy under the provisions of Chapter 13 of the Bankruptcy Code (lien-stripping is also available in Chapter 11 bankruptcies, but that discussion exceeds the scope of this article). If a person has been discharged in a Chapter 7 bankruptcy within four years of filing the Chapter 13 petition, for example, then he or she is not eligible for discharge under Chapter 13. Additionally, if the property is the debtor’s personal residence (the “debtor” is the person who files for the bankruptcy), the lien cannot be stripped unless it is *completely* unsecured. This means that the homeowner must owe more on a senior lien than the property is worth.

To understand how this is applied, assume that a person’s home is worth \$200,000.00, and that the person owes \$236,000.00 to Wells Fargo Bank (the “first” mortgage). Assume also that this person obtained a second loan from Bank of America in the amount of \$75,000.00 that is secured by the property (the “second” mortgage). In this situation, the second mortgage is considered completely unsecured because the value of the home is not enough to pay the first mortgage if the property went into foreclosure. If the homeowner is otherwise eligible for discharge in bankruptcy, a Chapter 13 proceeding will allow him or her to “strip” the second mortgage. Thus, following completion of the Chapter 13 proceedings, this person will not have to pay back any part of the second mortgage.

If, on the other hand, the home is worth \$250,000.00, the second mortgage is not completely unsecured because there is a \$14,000.00 difference between the value of the home and the amount owed on the first mortgage. The second mortgage is therefore partially secured by that \$14,000.00 in value. In this situation, the homeowner cannot strip the second mortgage through a Chapter 13 bankruptcy.

In order to receive the benefit of a Chapter 13 lien-strip, a homeowner must observe certain other formalities required by the bankruptcy court. For example, a formal appraisal must be performed on the property, and the appraiser must verify the appraisal under penalty of perjury. The homeowner will have to prove the amount owed under the first mortgage, and must follow certain procedures designed to give proper notice of the intent to strip the lien. Finally, the homeowner must remain current on all payments required by the first mortgage after the Chapter 13 petition has been filed.

If the bankruptcy court approves the lien-strip, and the debtor completes all of the requirements of the Chapter 13 bankruptcy (which involves payments to the bankruptcy trustee for three or five years), then the second mortgage is “discharged.” This means that the debtor does not have to pay it back. Once the debtor obtains the discharge, then the second mortgage lender must re-convey title to the property back to the debtor. This re-conveyance will show that the property is free and clear of any lien by the second mortgage holder.

Chapter 13 bankruptcy is a powerful tool that can provide significant relief to homeowners who are struggling to pay multiple mortgages against their homes. Chapter 13 bankruptcy relief may also be available to owners of investment properties that are “under water.” As noted above, however, not all property owners will be able to obtain the lien-stripping benefits of a Chapter 13 bankruptcy. As with all legal issues, it is important to consult a qualified legal professional in order to understand all of the risks and benefits of filing for bankruptcy.

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