Using Bankruptcy Law to Set Aside a Second Mortgage

May 19, 2011 - It used to be that federal bankruptcy law allowed a judge to modify your mortgage. That all changed several years ago when Congress modified the law. Now, bankruptcy judges have no power to make modifications to a first mortgage on your primary residence. But there is a little known portion of the law that continues to allow judges to completely eliminate any second mortgage on your home. Having that knowledge could be the difference between losing your home in a foreclosure and being able to hold onto it over the long haul.

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Once a homeowner receives notice that their home is being foreclosed on, the foreclosure can be temporarily halted by declaring bankruptcy. Under the current law however, that will only stop the foreclosure for a month or two. Although bankruptcy judges have the power to modify the payments on credit card bills, auto loans, and even investment property, congress stripped them of the right to modify a first mortgage on the home you live in.

But a second mortgage is a different story. And there are millions of homeowners across the country whose homes are worth less than they paid for them and who have second mortgages that they can no longer afford.

The way that the law works is fairly straight forward. If you have a second mortgage on your home, but no equity in your home to cover that mortgage, a bankruptcy judge can declare your second mortgage to be unsecured debt. For example, let's say you purchased your home for $400,000 in 2005 and it is now worth only $250,000. When you made your purchase, you put $12,000 down on the house, you got a first mortgage of $300,000 and a second mortgage for $88,000.

In this example, there is absolutely no equity left in your home to cover the $88,000 you owe on your second mortgage. In a bankruptcy proceeding, you can petition to judge to declare that mortgage unsecured debt.

When this happens, you will likely be placed on a repayment plan for your other debts that will last for several years. During that time, the judge will place the second mortgage on hold and no payments are likely to be due on it during your repayment plan period. At the end of the repayment plan, the entire second mortgage will likely be set aside.

This strategy has not been used frequently in bankruptcy proceedings but it is gaining in popularity. And while lenders are not happy about it, there is not much chance that Congress will change the law anytime soon. Consumers need to be aware that this strategy can be used to save their homes. At the same time, the strategy won't work for everyone and the ramifications of declaring bankruptcy can be very serious. Anyone considering taking this route needs to discuss the strategy with a bankruptcy attorney.

byJim Malmberg
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