

Second Mortgage Lien Strip in Non-Dischargeable Chapter 13 Bankruptcy? “Yes We Can”

New decision out of Colorado Bankruptcy Court (Judge Sid Brooks) says that you can strip a second mortgage in a Chapter 13 Bankruptcy that is not eligible for discharge. *In re Waterman, 10-35794-SBB*

Why does this decision matter? In general, a chapter 13 bankruptcy allows a debtor to remove (strip) the second mortgage from their home if the value of the home is worth less than what is owed on the first mortgage. This situation is called having a *wholly unsecured mortgage claim*. Despite this benefit in chapter 13 bankruptcies, it often makes better sense for the debtor to file chapter 7 bankruptcy as opposed to entering a 36-60 month payment plan that is a chapter 13 bankruptcy. Once the chapter 7 is discharged, some enterprising attorneys would file a subsequent chapter 13 bankruptcy to strip the 2nd mortgage (because chapter 7 has no mechanism to strip the 2nd mortgage). However, since the subsequent chapter 13 bankruptcy is filed within 4 years of the previous chapter 7, the chapter 13 bankruptcy is not eligible for discharge. Within the industry, this strategy is known as a *chapter 20* bankruptcy (chapter 7 + chapter 13).

As a result, courts are all over the place on whether such an option was permissible. Judge Tallman ruled—no—in the case of *In re Mendoza, 2010 WL 736834* (Bankr.D.Colo. 2010). Whereas cases out of Northern California and Oregon ruled—yes; e.g. *In re Tran, 431 B.R. 230* (Bankr. N.D.Cal. 2010). This new case, *In re Waterman*, by no means settles the issue; this issue will ultimately need to be decided on appeal. But it does provide a breath of hope to the idea that a non-dischargeable chapter 13 bankruptcy filed in good faith can strip a second mortgage.

Waterman is an interesting decision as it tries to integrate the reasoning of the cases that are against lien strip and those that are

for it. Judge Brooks focuses his reasoning on the issue of *good faith*. *Waterman* holds that the bankruptcy code does not structurally forbid a 2nd mortgage lien strip in chapter 13 bankruptcy; but still reasons that the debtor must file the chapter 13 in good faith; meaning that stripping the 2nd mortgage cannot be the sole reason for the chapter 13 bankruptcy. In this case, poor Mr. Waterman's situation did not improve after his chapter 7 discharge; the economy is still tough (he is a mortgage broker) and he got divorced. He filed his chapter 13 bankruptcy to stop the pending foreclosure of his house. The key, then, is that the subsequent chapter 13 bankruptcy must have some other purpose than simply stripping the second mortgage.

Unfortunately, until we get an appellate court ruling, whether you can strip your second mortgage in a non-dischargeable chapter 13 bankruptcy will very much depend on which bankruptcy judge you are assigned. Nevertheless, if a debtor is eligible for a chapter 7 bankruptcy, I still prefer the chapter 7 discharge and settle second mortgage strategy. If the second mortgage is wholly unsecured, many debtors have had success approaching their second mortgage lender/servicer after the chapter 7 discharge and offering them 5-15% of the balance owed as a settlement to remove the 2nd mortgage lien.

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