How Bankruptcy Can Help With Foreclosure

by Attorney Stephen R. Elias

Learn how bankruptcy can avoid or stall the foreclosure of your home.

If you are facing foreclosure and cannot work out a deal or other alternative with the lender, bankruptcy may help.

If you get behind on your mortgage payments, a lender may take steps to foreclose -- that is, enforce the terms of the loan by selling the house at a public auction and taking payment of your loan out of the auction.

This won't happen overnight. The foreclosure process typically starts after you fall behind on your payments for at least two months, and often three or four. That gives you time to try some alternate measures, such as loan forbearance, a short sale, or a deed in lieu of foreclosure.

But if you've already tried and failed with these measures, now is a good time to consider bankruptcy as a possibility for avoiding or stalling foreclosure. Here are some ways that filing for bankruptcy can help you.

The Automatic Stay: Delaying Foreclosure

When you file either a Chapter 13 or Chapter 7 bankruptcy, the court automatically issues an order (called the Order for Relief) that includes a wonderful thing known as the "automatic stay." The automatic stay directs your creditors to cease their collection activities immediately, no excuses. If your home is scheduled for a foreclosure sale, the sale will be legally postponed while the bankruptcy is pending—typically for three to four months. However, there are two exceptions to this general rule:

Motion to lift the stay. If the lender obtains the bankruptcy court's permission to proceed with the sale (by filing a "motion to lift the stay"), you may not get the full three to four months. But even then, the bankruptcy will typically postpone the sale by at least two months, or even more if the lender is slow in pursuing the motion to lift the automatic stay.

Foreclosure notice already filed. Unfortunately, bankruptcy's automatic stay won't stop the clock on the advance notice that most states require before a foreclosure sale can be held (or a motion to lift the stay can be filed). For example, before selling a home in California , a lender has to give the owner at least three months' notice. If you receive a three-month notice of default, and then file for bankruptcy after two months have passed, the three-month period would elapse after you'd been in bankruptcy for only one month. At that time the lender could file a motion to lift the stay and ask the court for permission to schedule the foreclosure sale.

How Chapter 13 Bankruptcy Can Help

Many people will do whatever they can to stay in their home for the indefinite future. If that describes you, and you're behind on your mortgage payments with no feasible way to get current, the only way to keep your home is to file a Chapter 13 bankruptcy.

How Chapter 13 works. Chapter 13 bankruptcy lets you pay off the "arrearage" (late, unpaid payments) over the length of a repayment plan you propose—five years in some cases. But you'll need enough income to at least meet your current mortgage payment at the same time you're paying off the arrearage. Assuming you make all the required payments up to the end of the repayment plan, you'll avoid foreclosure and keep your home.

2nd and 3rd mortgage payments. Chapter 13 may also help you eliminate the payments on your second or third mortgage. That's because, if your first mortgage is secured by the entire value of your home (which is possible if the home has dropped in value), you may no longer have any equity with which to secure the later mortgages. That allows the Chapter 13 court to "strip off" the second and third mortgages and recategorize them as unsecured debt – which, under Chapter 13, takes last priority and often does not have to be paid back at all.

Canceling debt. Chapter 7 bankruptcy will also cancel all the debt that is secured by your home, including the mortgage, as well as any second mortgages and home equity loans.

Canceling tax liability for certain property loans. Thanks to a new law, you no longer face tax liability for losses your mortgage or home-improvement lender incurs as a result of your default, whether you file for bankruptcy or not. This new law applies to the 2007 tax year and the following two years. (See New Tax Break for People Who Default on Their Mortgage.)

However, the new tax law doesn't shield you from tax liability for losses the lender incurs after the foreclosure sale if:

- the loan is not a mortgage or was not used for home improvements (such as a home equity loan used to pay for a car or vacation), or
- the mortgage or home equity loan is secured by property other than your principal residence (for example, a vacation home or rental property).

This is where Chapter 7 bankruptcy helps. It will exempt you from tax liability on losses the lender incurs if you default on these other loans.

Chapter 7 Cannot Cancel the Foreclosure

With all this debt being cancelled, you may be wondering why the foreclosure on your home won't be cancelled too. The trouble is, when you bought your home you probably signed two documents (at least) — a promissory note to repay the mortgage loan, and a security agreement that could be recorded as a lien to enforce performance on the promissory note.

Chapter 7 bankruptcy gets rid of your personal liability under the promissory note, but it doesn't remove the lien. That's the way Chapter 7 works. It gets rid of debt but not liens – you'll still probably have to give up the house under the lien since that's what provided collateral for the loan.

Chapter 7 Bankruptcy May Not Be Right For You

Not everyone can or should use Chapter 7 bankruptcy. Here's why:

You could lose property you want to keep. Chapter 7 might cause you to lose property you don't want to give up. As an example, if your wedding ring is particularly valuable, it may exceed the dollar amount of jewelry you're allowed to keep in a bankruptcy (under something called the "jewelry exemption"). In that case, the bankruptcy trustee could order you to turn the ring over to be sold for the benefit of your creditors.

You may not be eligible. Even if Chapter 7 bankruptcy would work for you, you may not be eligible. Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, you are not eligible if your average gross income for the six-month period preceding the bankruptcy filing exceeds the state median income for the same size household. Nor are you eligible if your current income provides enough excess over your living expenses to fund a reasonable Chapter 13 repayment plan.

Bankruptcy's Effect on Your Credit Score

Both bankruptcy and foreclosure will damage your credit score. However, sometimes bankruptcy is the preferable option when trying to rebuild credit. Here's why:

A foreclosure will damage your credit score for many years, will not get rid of your other debt, and is particularly harmful if you are house shopping.

In contrast, discharging your debts in bankruptcy will harm your credit score, but can help you rebuild your score quicker than after a foreclosure. This is because bankruptcy will leave you solvent and debt-free – and therefore able to start rebuilding good credit sooner.

Keep in mind that the current mortgage meltdown and credit crunch (which are prevalent at the time this article is being written) may change the way bankruptcy and foreclosure affect credit ratings.

If All Else Fails: Relief From Debt and Tax Liability

If you're certain you won't be able to propose a Chapter 13 repayment plan that a bankruptcy judge will approve, and Chapter 7 will provide only a temporary delay from the foreclosure sale, then what's the point of either?

If you have to lose your home -- a bitter result to be sure, but sometimes unavoidable -- you can at least view bankruptcy as the best way to get out from under your mortgage debt and tax liability. Bankruptcy also offers a way to save some money, which will help you find new shelter and weather the psychological and economic shocks that lie ahead.