Can a Second Mortgage Lender Foreclose On My Home?

I recently met with a client who was debating filing for Arizona chapter 7 bankruptcy protection. This client owned his family home, but had two mortgages against its value. He wanted to reaffirm the primary mortgage rather than include it in the bankruptcy proceedings as he wanted to retain the family home. He did not want to reaffirm the second mortgage. His question to me was whether or not the lender of a second mortgage could initiate a foreclosure proceeding if monthly payments weren't made, even if the primary mortgage was not in arrears.

I hate to be the bearer of bad news, but any lien holder can initiate foreclose proceeding on a property regardless of whether or not the first mortgage is in good standing with its lender. Both primary and secondary mortgages, as well as any additional liens against the property, are loans secured against the value of the home. The difference between them is simply the order in which the lenders are paid in the event of sale or foreclosure. The loan provided by the first mortgage lender will be repaid in full before the loan provided by the second lender is repaid.

While either lender can initiate foreclosure proceedings, the likelihood of them doing so differs somewhat. If you default on your primary mortgage, it is almost given that the lender will eventually initiate foreclosure proceedings. When your mortgage is in arrears, it is in the lender's best interest to sell the property in order to recoup loan principle. A second mortgage lender is only paid after the primary mortgage debt has been repaid which means that, after the first mortgage is paid, there must still be money remaining from the sale of the home to make it worthwhile for a second lender to pursue foreclosure.

With the nose-dive that home prices have taken as of late, this is often not the case. For example, let’s pretend you currently own a home that has been appraised for $200,000. If you have a primary mortgage in the amount of $250,000 and a second mortgage in the amount of $50,000, your second mortgage lender is unlikely to initiate foreclosure proceedings as the entire sale price ($200,000) would be returned to the primary mortgage lender.

However, if your primary mortgage had a principle balance of $100,000, they may initiate foreclosure. I should note that one caveat to this is in the case of piggy-backing loans, when a single lender financed both the primary and secondary mortgages.

It is usually about this time in my explanation that my client starts to wonder. “I didn’t reaffirm my second mortgage, aren’t I personally off the hook? And even more, you just said that since my home is underwater, so the second mortgage lender won’t pursue foreclosure.” Here is what I tell them.

By not reaffirming your second mortgage, you are no longer personally liable on the promissory note associated with the security agreement. However, your property remains encumbered by the mortgage debt. What this means is that you cannot be sued personally for the principle value of the second mortgage if the home is foreclosed upon or sold for a loss. The lender will not bring civil charges against you for breach of contract and you will not receive late night phone calls from collections agencies. You as an individual have no obligations to that debt.

It does not, however, remove the lender's lien against your home. If you do make payments, you still pay down that loan; however, such a positive payment record is not reflected in your credit report and thus not beneficial in rebuilding your credit(remember, you are no longer personally liable for that debt).

Another complicating factor I should through in here is how the 2005 changes to the Bankruptcy code effected reaffirmation agreements. Prior to these changes, an individual could keep the asset in question without signing a reaffirmation agreement. As long as they were current on their payments, the item remained in their possession. This was beneficial because, it at any time down the road they needed to surrender the asset, they did so without liability for any deficiency.

Under the 2005 Reform act: a reaffirmation agreement is binding only if it is entered into before the discharge is filed, the debtor receives the numerous disclosures required from the creditor, except credit unions (§524(k), the Debtor does not rescind the agreement and the court approves the reaffirmation agreement - that may include having a hearing (§524(c)). The court will only approve the reaffirmation agreement if it believes that the debtor is capable of fulfilling their end of the contract.

I bet you wondering where I am going with this. Many creditors have taken the stance that these added provisions require the debtor to sign a reaffirmation agreement if they want to retain possession of the asset. This restores personal liability in the case of default. But, §524(c) states that an obligation must be "enforceable under applicable non-bankruptcy law, whether or not discharge of such debt is waived".

So if a debtor remains in good standing with regards to this asset, but simply refuses to sign a reaffirmation agreement, then perhaps there is no default "enforceable under applicable non-bankruptcy law." Regardless, it is my experience that the courts are very hesitant to approve a reaffirmation agreement unless they are certain that the debtor both desires to restore personal liability and can afford the monthly payments.

What are your options in this scenario? One option is working with your lender to create a compromise that is acceptable for both parties. If your second mortgage is wholly unsecured by falling home prices, the lender stands to lose more by initiating foreclosure than coming to a compromise that allows you to keep your second mortgage current. I do not recommend defaulting on your second mortgage because,

even though you are not personally liable for the debt, the lien on your property will remain. Home prices will eventually rebound and that second mortgage lender will still be there.

Another option to consider prior to filing is whether or not you would be better qualified for a chapter 13 Bankruptcy. Chapter 13 bankruptcy involves a 3-5 year creditor repayment plan, but allows the debtor to retain valuable non-exempt items. Furthermore, with chapter 13 filing you have the ability to "cram down" or "strip down" a second mortgage that is wholly unsecured due to insufficient equity in the property. This removes its secured status and reclassifys is as in unsecured debt.

Finally, you may also consider giving up the property entirely and entering both loans into the bankruptcy filing. Bankruptcy will remove your personal liability from both loans, in the case of a deficiency sale. Thus you would no longer be liable for the remaining balance on either mortgage and, because you have turned over the property, and the problem of liens against the property would be moot. While your bankruptcy is pending you can remain in your home, even though you are not making payments, which may allow you time to secure new lodgings.

These situations are complicated and, because they often involve a family's largest asset (or debt as the case may be), I strongly recommend that you speak to a licensed bankruptcy lawyer in order to find the solution that's best for you.