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“Lien Stripping” in Chapter 13 Bankruptcy

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Many homeowners are “upside-down” on their home mortgages, and are looking for a way out. In some areas of California, homeowners have seen home values drop 50% or more, and are deciding whether to “strategically default”, that is, to walk away from their home. Although a strategic default may be the best option in some cases, in other cases the homeowner may want to consider a Chapter 13 bankruptcy, which provides a mechanism to “strip” junior liens.

Following is an example of how lien stripping works:

Current fair market value of residence:
\$500,000.

First mortgage/trust deed: \$500,000.

Second mortgage/trust deed: \$200,000.

Section 506 of the Bankruptcy Code provides that a lien is a secured claim only to the extent there is value in the asset to which the lien attaches. To the extent that claims exceed the value of the collateral, that portion of the claim is unsecured.

Thus, section 506 confers on the Court the power to redefine debts as either “secured” or “unsecured.” Upon a proper showing, the Court will allow the lien to be stripped from the property. Once the lien is stripped, the debt can be “discharged,” – eliminated – by completing the bankruptcy.

In the above example, the home owner’s debt to the junior lender will be discharged and the lien (mortgage/trust deed) “stripped.” When the home owner thereafter sells the property, the owner need only pay the first position loan, even if the

property has appreciated since the close of the home owner’s bankruptcy case.

Whether a lien(s) can be “stripped” from a parcel of real property requires an individualized analysis of a debtor’s entire financial situation. Furthermore, filing for bankruptcy – even where the debtor is statutorily eligible to do so – may not be the best decision in all cases. In any event, debtors should obtain the assistance of an attorney before deciding whether to file for bankruptcy, walk away from a property, or take other action.

Earle Law Offices provides trial and appellate litigation, as well as non-litigation, legal services in the areas of bankruptcy, business law, constitutional and civil rights law, family law, real estate law, tax law, and trusts and estates.

* Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Supreme Court, the United States Court of Appeals for the Fourth and Ninth Circuits, federal trial courts in the Northern District of California, and the United States Tax Court. He has served as a Judge Pro Tempore for the Santa Clara Superior Court, and is also a licensed Real Estate Broker.

Mr. Earle received his law degree from the Santa Clara University School of Law, where he served as an Editor of the school’s Law Review, and where he received awards for academic excellence. He received his undergraduate degree, with honors, in business administration from the University of La Verne.

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