

COPING WITH UPSIDE DOWN REAL ESTATE DURING AN ECONOMIC DOWNTURN

The Essential Guide for Homeowners Facing Foreclosure



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INTRODUCTION



My name is Steve Beede and I'm an attorney in Sacramento, California. I am the President of BPE Law Group, Inc. which focuses on business, property, and estates. I have been practicing law for over fifteen years and a couple of years ago, I recognized a need to help educate Realtors on how to deal with homeowners who are upside down in their mortgage. From that sprang an entire course for Realtors on the subject which eventually morphed into a course for homeowners themselves.

Over the past twelve to eighteen months, we've gone through a huge dislocation in our economy. Millions of people have been foreclosed by lenders because they had loans they could not afford. The good news, though, is that there are strategies that can be

utilized to deal with these dislocations.

This book will focus on coping with upside down real estate during an economic downturn. My objective in writing this book is to give you knowledge and information to help you understand how we arrived at this place in our economy and to give you the tools you need to deal with an upside down loan. This book is geared toward property owners who are dealing with upside down mortgage loans as well as real estate professionals, including real estate brokers and loan officers, whose clients might have upside down loans.

Stephen J. Beede

CHAPTER ONE

A BRIEF HISTORY

What we are going through is not new or unprecedented.

Historically, dislocations in the marketplace happen in cycles of seven to eight, maybe ten years at the outside. There is a natural ebb and flow to any economy founded on the principles of supply and demand. When demand is low, the supply starts off low and prices stay relatively flat. Over time, as demand increases, supply will also increase. Increases in demand are a natural motivation for developers to create more supply by building more houses and depending upon the availability of money, supply will increase until demand is met. As supply is chasing demand, prices will rise. Sometimes, however, supply will out-pace demand, resulting in an oversupply, which, naturally, causes a fall off and reduced prices. The market eventually stabilizes and the cycle starts again.

What we are currently experiencing is something unique in our

history. The cycle that we're experiencing now began in 1991, after the last major downturn in the marketplace. In November, 2006, it hit a very abrupt stoppage. This is significant because this cycle lasted about sixteen to seventeen years. Arguably, it will take a similar, though not necessarily equivalent, amount of time to correct.

One of the reasons that we are experiencing the current economic crisis is due to the fact the financial industry changed the way it did business. Traditionally, if a person wanted to purchase a property, he would go seek a loan from a bank and the bank would lend the money and the borrower would repay the loan over time. However, if the banks waited for each borrower to repay their loans, the banks would only be able to make a finite number of loans. So, what lenders have done is charge some fees on the front end of the loan and charge some fees for managing the loan which they eventually sell on the secondary market to entities such as Fannie Mae and Freddie Mac. The existence of the secondary mortgage

market fuels money back into the lending system for new loans to be made. Year after year, this system worked relatively well because the underlying presumption was that the properties securing these loans were worthwhile.

In the late 1990's, however, the financial market was deregulated and there was an assumption that our financial institutions would police themselves and do what was in their own best interests as well as what was in the best interests of their customers. Unfortunately, the reality is that no one was watching the store; the financial institutions did not police themselves. They were more concerned with selling loans than with the value of the properties securing those loans. As a result of this shift in focus, a home parcelization system was created which allowed loans to be broken up into little components and sold to companies like Goldman Sachs, Bear Stearns, and others. These companies, many of which are no longer in business now, put default insurance on their little pieces of these

loans and expected to be protected in the event a borrower defaulted. Well, unfortunately, because the same loans were leveraged again and again and again, sometimes as many as forty times, when there was a default, there was nothing for these companies to collect because the properties were not worth as much as the loans which they secured.

What made it work was the introduction of adjustable rate mortgages. Many lenders knew from what took place in the 1980's how dangerous these types of loans were, but that did not stop them. Adjustable rate mortgages made it possible for people, who would have been otherwise unable to do so, to obtain mortgage loans. People could qualify with next to no income. They could literally obtain financing by putting just about anything on the loan application and the lenders really weren't verifying the information in the loan application. And as a result of this, the demand for loans increased which, in turn, created an environment for other creative financing

vehicles like stated income, low doc and no doc lows.¹

The lenders weren't verifying the loan applications because they knew the loans could be sold on the secondary market; companies in the secondary mortgage market were literally chomping at the bit to get a piece of as many loans as possible. Eventually, in 2006, those original teaser interest rates started adjusting up. When those interest rates began bumping up, the borrowers could no longer afford to make their mortgage payments. Thus, began the first round of foreclosures. Once the foreclosures started, there was a snowball effect and those companies in the secondary market had a real problem as they began to realize that the properties which secured these loans weren't worth the debt on them.

As a result, we are presently in a situation where between the leverage on the loans and the insurance securing the loans, there's \$300,000,000,000 of theoretical real estate investments out in the

¹ Low doc and no doc loans required little to no documentation from the borrower in support of the financial information they provided in their loan application.

marketplace. Unfortunately, the underlying real estate securing those investments in worth only about \$3,000,000,000. All of this created the perfect storm for an economic correction which is what we are currently experiencing.

CHAPTER TWO

UNDERSTANDING YOUR OPTIONS

The objective of this book is to give you some idea of how to cope with upside down mortgages and to get beyond your current financial situation with as little damage as possible. There are two main issues which I'll address as they relate to upside down loans and those are: 1) negotiated remedies and 2) forced remedies.

Negotiated Remedies

There are four negotiated remedies upon which I'll focus. These are:

- Do Nothing
- Buy Time
- Sell the Property
- Give the Property Back to the Lender

Do Nothing: The first negotiated remedy is to do nothing and for some people doing nothing is an adequate strategy. Remember, we

are at the end of a very long cycle. Most economists believe that by the summer of 2010 or the beginning of 2011, the real estate market will begin to improve and we'll begin seeing demand increasing which will result in an increase in supply and an increase in prices.

However, as things stand now, in November of 2008, the supply of homes reaching demand is enormously large. In other words, supply is out-pacing demand; as a result, housing prices remain down. The fact that there are so many real estate owned (REO) properties currently on the market is keeping real estate prices down because the lenders have placed them on the market at fire sale prices.² The primary reason that lenders place these properties on the market at such low prices is that they want to sell them as quickly as possible; they don't want to have these properties on their books at tax time because they'll have to show them as assets. Nevertheless, until these real estate owned properties are off the market and the until this current correction period ends, prices will remain low and the

² Properties which have been foreclosed by banks are said to be "real estate owned".

downward pressure on the marketplace will continue.

Fortunately, it appears that the number of REO properties coming on the market is starting to slow down and these properties are actually selling faster than they are coming on the market. This is a signal that the market will begin picking up in the near future.

Because prices are so low, it's a tremendous time to buy real estate and investors are well of aware of this. They are aggressively scooping up properties. Fewer properties are being purchased by buyers who want to live in them because obtaining financing is so difficult. This trend will probably continue for at least another twelve months. The economists anticipate another bump of adjustable rate loans in the spring of 2009 which will trigger the last round of foreclosures unless the federal government intervenes. It's conceivable that the new administration may actually do something to halt the anticipated bump of adjustable rate loans. However, based upon the current data, the number of REO properties will increase

slightly in 2009 with absorption back into the market being completed by the end of 2009 or the beginning of 2010.

Because it appears that the market will begin turning within the next 12 months or so, some people will choose to do nothing and wait it out. This is a good strategy for people with fixed rate loans or for those who are able to modify their loans.

Buying Time: Unfortunately, waiting it out is not a viable strategy for most people who are upside down. For those who don't have the luxury of doing nothing, buying time may be an adequate strategy. Buying time involves contacting the lender and trying to work out some kind of a change in the payment structure or term of the loan which will enable the borrower to continue making his loan payments. In other words, you are attempting to negotiate a modification of your loan.

You might be wondering why a lender would even consider a loan modification. Lenders are not in the business of owning property;

they are in the business of making loans and collecting payments.

Lenders don't want to foreclose, but do so because of their economic interests.

Because lenders don't want to foreclose, they will work with a borrower to modify the loan terms whenever possible. However, the lenders have very little flexibility because they are really only managing the loans for the investors who actually loaned the money in anticipation of getting a certain amount of return.

Refinancing is also a means of buying time. However, because so many borrowers owe more than what their property is worth, refinancing is usually not an option. For those who can't refinance, loan modification may be possible. The most typical loan modification involves changing the interest rate from an adjustable rate to a fixed rate or reducing the interest rate. Right now, there are a lot of people who have interest rates that are 8.5%, 9.5%, or even 10% or more and are indexed up as adjustable rates. These rates may increase

every six months by a point or more which has resulted in payment increases of \$500 per month or more for many borrowers.

The prevailing fixed interest rate is between 6% and 7%. So, if a lender will reduce the interest rate to a fixed rate level, many people will be able to afford their mortgage payments and keep their homes.

Another common loan modification involves changing the term of the loan. For people who have loans with balloon payments, changing the loan term may be a viable option.³

Many people are in default because they obtained interest only loans and negative amortization loans which resulted in their loan balances increasing rather than decreasing over time. That fact, coupled with decreasing market rates has caused these borrowers to be upside down and to owe more on their loans than they originally borrowed. For borrowers in this situation, a modification which allows the delinquent payments to be tacked on to the principal

³ Balloon loans require the payment of a lump sum, usually substantial, at the end of the loan term. People obtain balloon loans in order to keep their monthly payments down. Most people anticipate refinancing at the end of the loan term, but because of the current market, refinancing has become impossible for many borrowers.

balance may be the solution.

In 2008, Senate Bill 1137 was passed by the California legislature. Senate Bill 1137 requires lenders to make three attempts to contact a borrower to discuss loan modification. These three attempts must be made on different days and at different times of day. The goal of the legislation is to force lenders, who previously may have never bothered to contact borrowers to discuss loan modification, to proactively work with borrowers to create a modification plan. The legislation imposes a thirty day waiting period after the last attempt to contact the borrower is made before the lender can commence foreclosure proceedings.

The FDIC, which is now government controlled, as well as many large lenders like Bank of America, which has taken over Countrywide, JP Morgan Chase, and IndyMac are creating their own loan modification programs to help their customers. Additionally, there are many private companies that offer foreclosure prevention

assistance and advertise themselves as being able to assist borrowers in modifying their loans. Some of these companies are very good and can be very affective in helping borrowers save their homes from foreclosure. Others, on the other hand, are straight out scams and specialize in bilking already financially strapped consumers out of more money, but never provide the promised services. So, do your due diligence before you hire a foreclosure assistance prevention company to assist you.⁴

Doing nothing and buying time may not work for some people. For some, the debt on the property may be so high that reducing the interest rate to a flat 5%, 6%, or 7% won't help them. As a way around this and to make modification possible for the people that fall into this category, the federal government, in October, 2008, launched the Hope for Homeowners program. Pursuant to this program, if a lender is willing to reduce the principal owed on the loan to the current

⁴ The Department of Housing and Urban Development, the Attorney General in your state, and the Better Business Bureau are good places to start if you are trying to find out whether the foreclosure prevention assistance company you are considering is legitimate.

market value of the property and reduce the interest rate to flat level at market rates, then the federal government will insure or guarantee the loan. In other words, if the lender will agree to write off the over-encumbrance and lock in a fixed interest rate, the federal government will insure that the lender won't lose anything beyond the amount they write off. This program is voluntary and unfortunately, lender participation has been very, very low. However, there may be new measures that come up next year which enhance the program in order to increase participation by lenders.

Selling the Property: The next type of negotiated remedy is selling the property. When a person sells property, one of two conditions generally exist. The first is that the property has equity. This means there is some ownership value in the property beyond the amount of the loans on it. In other words, the property is worth more than the outstanding balance of any loans against it. The second condition is that the property has no equity; the homeowner owes

more on the loan than the home is worth. Very rarely will you encounter a situation where the loan balance and the property value are exactly equal.

California has a statute called the Home Equity Sales Act. This law comes into play in any real estate transaction where a property with equity is being sold and the seller is in default on the loan. The Home Equity Sales Act protects sellers in this situation from improper contracting and contains a number of provisions that require the seller to attest that he is making an informed decision. It's imperative that you consult with an experienced real estate attorney if you're involved in a transaction that falls under the provisions of the Home Equity Sales Act because it's not uncommon to run afoul of this law.

For most people facing foreclosure, however, the property has no equity. Many of the properties which are currently in foreclosure or have been recently foreclosed were purchased during the run up from 2000 to 2006. Much of the pricing during that period was based upon

speculation that the market would go up forever and that the properties could always be sold for a profit. This presumption that the market would go up indefinitely was not grounded in historical trends, but rather was based wholly on speculation. Unfortunately, that speculation was horribly wrong and we're paying the price for it now.

So, for many people facing foreclosure who are upside down in their mortgage, a short sale is a viable option. In a nutshell, a short sale is an agreement between the borrower and the lender whereby the lender agrees to accept less as a payoff of the loan than what is actually owed on it. Unless the lender agrees to a short sale, an upside down borrower would be unable to sell the property because he would be incapable of conveying clear title to the purchaser as long as the lender's security interest in the property remained in effect.

To put it simply, suppose the seller owes \$500,000 on the property. A buyer makes an offer to purchase of \$400,000. In order for the buyer and seller to consummate the transaction, that \$100,000

difference must go away. So, the seller, in a short sale situation, is essentially asking the lender to take the hit and absorb or write off that \$100,000.

The thing that you must understand about short sales is that they are completely voluntary. Lenders are under no obligation, whatsoever, to accept less than what they are owed on a mortgage. Now, this doesn't mean that they won't, but *most lenders really don't want to take the hit; they want the borrower, who legally owes the money, to take the hit.* And that's where affective negotiating becomes critical.

Statistically, most short sale negotiations are unsuccessful.⁵ I would venture to guess that the primary reason for the low success rate is that most Realtors really don't know enough about foreclosure law and mortgage law, specifically, and real estate law, in general, to successfully negotiate short sales.

When a borrower begins the short sale negotiation with the

⁵ In California, the short sale success rate is between 4% and 12%.

lender, the first thing the lender will expect is for the borrower to prove that he can't afford to pay the loan or take the hit when the property is sold. If the borrower is able to demonstrate is inability to pay, it will make the negotiations easier; it will increase the likelihood that the lender will agree to the short sale because the lender knows it will never get anything from you anyway.

So, the first thing the lender will expect to receive from a borrower requesting a short sale is a hardship letter. In the hardship letter, the borrower must specify exactly what the hardship is and why he can't make his mortgage payments. Generally speaking, acceptable hardships include loss of a job, death of a spouse, and serious illness.

In addition to the hardship letter, the borrower must also provide the lender with a sworn statement of income and expenses and assets and liabilities. The lender may also want to see the tax returns for the past few years to ascertain whether the financial information

provided by the borrower is consistent with what's contained in the tax returns. The lender may also look at the tax returns to determine whether the borrower's changed financial status or reduced income has been consistent.

The lender's goal in reviewing the borrower's financial information is to determine whether the borrower has any assets, such as bank accounts, real estate, or other property, which can be liquidated in order to payoff the loan. Even though the lender cannot force a borrower to sell property to payoff the loan, the lender can use the existence of other assets as leverage to try to force the debtor to absorb at least a portion of the short fall in a short sale situation. Remember, if the lender doesn't agree to the short sale, it won't happen.

So, if the lender doesn't believe that the borrower has a legitimate hardship which will prevent him from paying the loan and absorbing the short fall, the lender may not agree to the short. In

many situations, however, the lender will agree to the short sale only to inform the borrower at the close of escrow, that it wants the borrower to sign a promissory note for the amount of the short fall.

So, in our example, the lender would ask the borrower to sign a promissory note in the amount of \$100,000. In the lender's eyes, this is an absolutely reasonable request. After all, they held up their end of the original deal by lending the money. So, it's only fair that the borrower holds up his end by repaying all of the money he borrowed.

In recent months, lenders have been agreeing to release their security interest on property, but haven't been releasing the debt. By releasing the security interest, lenders are helping facilitate the sale of the property by allowing the title to be cleared. By refusing to release the debt, they are maintaining their right to collect the debt from the borrower without the necessity of a new promissory note. Essentially, they are positioning themselves to sue the borrower at some point in the future if the payoff of the loan is short.

Because short sales are voluntary, the borrower doesn't have to agree to sign a promissory note. Nor does he have to agree to the lender's proposal to release it's security interest, but not it's debt. So, should a borrower agree to sign a promissory note in the amount of the short fall? Should a borrower agree to a release of the lender's security interest, if his obligation on the debt won't be released simultaneously? In other words, what can a borrower do to induce the lender to cooperate, rather than insisting on including one-sided provisions and conditions in the short sale agreement which truly burden the borrower?

To know how to respond to these types of demands from the lender, a borrower must examine two critical items. The first is what avenues can the lender actually pursue against the borrower. In other words, a borrower must know whether, if he doesn't pay the mortgage and the short sale doesn't work, the lender can get a judgment against him and take everything he has. Even in cases where the account

has been turned over to a collection agency that's threatening to take everything the borrower owns, he must know exactly what remedies his lender can actually pursue to collect the debt.

California foreclosure law holds the answer to what exactly a lender can do in trying to collect a debt from a borrower. Three very important rules form the foundation of California foreclosure law.⁶ The first of these rules is the “**security first rule**”. The security first rule says that if a lender makes a loan to a borrower and as a part of the process, the borrower signs a promissory note and signs a deed of trust, which the lender subsequently has recorded, a lien against the property is created. The deed of trust makes the property the security or collateral for the loan evidenced by the promissory note. So, if the borrower defaults on the loan payments, the lender can foreclose and take the property.

If a borrower defaults on a secured loan, the security first rule

⁶ If you live in a state other than California, you should contact an experienced real estate attorney to ascertain the law of your state. The rules vary from state to state and many states have rules very similar to the California rules. However, some state's foreclosure laws are quite different from California law. And there is no national or federal foreclosure law.

requires the lender to take the security for the loan first. But first before what? Pursuant to the security first rule, the lender must take the property first before it can pursue a judgment against the borrower if the value of the property or security is less than what is owed on the loan.

The next rule is the “**single action rule**”. Pursuant to the single action rule, a lender can only get one shot at a borrower to collect a debt. The lender can't pursue multiple collection remedies against the borrower; it can't sue the borrower multiple times, trying to collect the debt in a piecemeal manner.

The last rule is the “**acquisition loan rule**”. Under the acquisition loan rule, if the borrower obtained the loan to purchase the property and the property is a one to four unit residential property which the borrower occupied as his primary residence, the lender can never collect beyond the security. In other words, if the sale of the property in our example results in a \$100,000 short fall, the lender can

never come after the borrower to collect it; the lender is barred from getting a deficiency judgment.⁷

So, let's take a look at how these three rules come into play in a short sale negotiation. In our example, the short fall is \$100,000. If the lender agrees to the short sale, but, in exchange, requires the borrower to sign a \$100,000 short fall, the first thing that I'd do if he were my client is review the loan documents to determine whether the loans on the property are acquisition loans. If the loans are acquisition loans, then the lender can never get a judgment against the borrower for the deficiency. Under these circumstances, there is no reason for the borrower to agree to sign a promissory note for the \$100,000 short fall. The acquisition loan rule gives a borrower leverage and in some cases, the lender will waive that provision and agree to the short sale. On the other hand, some lenders will use the fact that a short sale won't affect the borrower's credit in the same way

⁷ Under certain circumstances, if a lender forecloses and subsequently sells the property at a loss, it can go to court to get a judgment against the borrower for the short fall. That judgment is known as a deficiency judgment.

a foreclosure will to push back; in which case, the borrower might offer to pay 10% of the short fall or maybe a little more to get the lender to agree to the short sale. The important thing to remember is that short sales are voluntary; so, it's all about leveraging your strongest negotiation points to induce the lender to agree to the short sale.

Give the Property Back: The final type of negotiated remedy is to give the property back. However, it's not as simple as it sounds. Lots of people talk about sending the lender “jingle mail”, literally mailing the keys to the property to the lender and walking away under the mistaken notion that that's the end of it.⁸ For the lender, though, things are far from over because the reality is that the lender doesn't have to take the property back. This doesn't mean that a lender won't take it back; it simply means that the lender must agree to take it back.

When a lender agrees to take a property back, the borrower will

⁸ The keys simply evidence possession of the property. Returning the keys to the lender does not relieve a borrower of his legal obligation under the terms of the promissory note and security deed.

sign what is commonly called a “*deed in lieu of foreclosure*”. The number of liens on a property will affect whether a lender will agree to take it back. If a property has a first and a second mortgage on it, chances are the first lienholder will not agree to take it back. In this scenario, if the first lender were to agree to take the property back, once it recorded the deed in lieu of foreclosure, it would be junior in time to the second mortgage holder. So, the first lender would rather foreclosure than lose it's first lien position. However, if there is no second, then the lender might consider taking a deed in lieu of foreclosure which would be a very beneficial thing for the borrower. A well crafted deed in lieu agreement will include a provision that relieves the borrower of any further obligation to the lender. However, due to the high number of upside down loans, most lenders are not even considering requests for deeds in lieu of foreclosure. Nevertheless, it doesn't hurt to ask and if your lender will consider taking a deed in lieu of foreclosure, be sure to get an experienced

attorney to negotiate for you and guide you through the process.

CHAPTER THREE

UNDERSTANDING YOUR OPTIONS *Forced Remedies*

There are two types of forced remedies, foreclosure and bankruptcy.

Foreclosure: In California, there are two types of foreclosure, judicial and non-judicial. For the most part, these two types of foreclosure are used nationwide, although some states may only employ one or the other. In those states that utilize only one form of foreclosure, that form is most commonly judicial.

In California, non-judicial foreclosures are often referred to as trustee's sales, also known as the fast track program. It's called fast track because of how quickly the process progresses. Here's a quick summary of how it works. Once the borrower has defaulted on the loan and the lender has been unsuccessful in collecting the mortgage delinquency from the borrower, it will file or record a Notice of Default

in the county where the property is located. The Notice of Default is a legal document that puts the world on notice that the property may be coming up for foreclosure as a result of the borrower's failure to make his mortgage payments. The Notice of Default will also be published in the newspaper, posted on the property, and mailed to anyone with an interest in the property, such as junior lienholders. The recordation of the Notice of Default starts a ninety day clock. That ninety days is the period of time during which the borrower can cure the default. If at the end of that ninety day period, the borrower hasn't cured the default, the lender will record the Notice of Sale and that sets up a twenty-one day period during which the borrower can cure the default. If at the end of that twenty-one day period, the borrower hasn't cured the default, the lender will sell the property to the highest bidder at a foreclosure sale.⁹ The foreclosure sale typically takes place on the courthouse steps or some other public place designated by statute.

⁹ In today's market, at a non-judicial foreclosure sale, the lender will usually open the bidding with the amount they are owed. Since most properties are over-encumbered, the lender, in most instances, will be the highest bidder. The lender then becomes the owner of the property and the property is said to be "real estate owned" (REO). Most lenders place REO's on the market almost immediately.

The entire non-judicial foreclosure or trustee's sale process takes about 111 days. California law prohibits a lender who avails itself of this fast track process from seeking a deficiency judgment against the borrower if it sells the property at a loss. So, in our example, if the borrower owes \$500,000, but the lender only gets \$400,000 at the trustee's sale, the lender cannot go after the borrower for the \$100,000 short fall.

The single action rule also comes into play when a lender chooses to use the fast track process. Under California law, the trustee's sale, the non-judicial foreclosure, counts as an action; it's a collection action against the borrower. So, the single action rule precludes a lender from foreclosing at a trustee's sale to take advantage of the speed of the process from then going to court seeking a judgment for the short fall.

If a lender simply doesn't want to let the borrower off the hook for short fall, then it will have to go the judicial foreclosure route. A

judicial foreclosure, as its name implies, is a lawsuit filed in the superior court of the county in which the property is located. The basis for the lawsuit is the breach by the borrower of his contract with the lender. In a nutshell, it is a breach of contract lawsuit filed by the lender against the borrower after the borrower defaults on the loan.

If the court finds in favor of the lender, the judge will order the sheriff of the county to sell the property at what's called a sheriff's sale. The notification process is very similar to that of a trustee's sales.¹⁰ So, once the property is sold at the sheriff's sale, the judge will hold a hearing where the lender must produce evidence of the fair market value of the property as of the date the lender got the property back. If the value of the property is less than the amount owed on it, then the judge will issue a judgment against the borrower. This is called a deficiency judgment. Once the lender gets a deficiency judgment, with very few exceptions, it can collect on it from all the

¹⁰ Both trustee's sales and sheriff's sales require that certain statutory notice provisions be followed. Aside from putting all interested parties on notice that the property is subject to foreclosure, the purpose of the notice requirements is to create a market; the more people that come to the sale, the more likely the price will be bid up at the auction. This naturally increases the chance that the lender will get more for the property at the foreclosure sale.

borrower's assets, wherever located, for the most part. This leaves the lender in a very powerful position and the debtor in a very vulnerable position.

So, the question is: why would a lender ever choose the trustee's sale over a judicial foreclosure? The short answer is time.

Remember, from notice of default to sale, a non-judicial foreclosure takes about 111 days. In California, the reality is that it takes somewhere between a year and a year and a half from the time a lawsuit is filed before the parties actually get before a judge. If the lender successfully obtains a deficiency judgment, California law provides a one year right of redemption. This means that the borrower has one year to repay the debt and any interest and costs to the lender in order to regain title to the property.

So, the reality of the situation for a lender who goes the judicial foreclosure route is that it could be two and half years before it can sell the property. For most lenders it is much more practical to take

the fast track, 111 days from notice of default to sale, and forgo the right to seek a deficiency judgment. About 99.9% of the time, a lender will choose non-judicial foreclosure over judicial foreclosure because judicial foreclosure takes too long and costs too much. Moreover, if the lender has already received bad press, like Countrywide, it could find itself embroiled in a much bigger mess that could drag out and change the results of the case significantly.

If a borrower has a non-acquisition loan, maybe as a result of a refinance or because he bought the property as an investment property rather than as a personal residence, the lender would not be barred by the acquisition loan rule from seeking a deficiency judgment against him. So, in negotiating a short sale under these circumstances, the leverage point for the borrower is time. Does the lender really want to wait two and half years before it can sell the property? In most instances, the answer to that question is no. Lenders simply don't want to wait that long; therefore, they're going to

move forward with a trustee's sale rather than a judicial foreclosure.

If a borrower has a first and second loan, however, things get complicated. The borrower may have gotten an 80/10/10 when purchasing the property.¹¹ Or, the borrower may have refinanced and obtained a second mortgage or home equity line of credit. Suffice it to say that if the borrower has more than one loan on the property, it makes negotiating a short sale very tricky. In order for the short sale to happen, all the lenders that have a security interest in the property must agree to the short sale. For example, there's a \$400,000 first mortgage and a \$100,000 second mortgage on a property. If a buyer wants to purchase the property for \$400,000, the first mortgage holder will more than willing to agree to a short sale because it's going to get paid in full. Will the second mortgage holder do the short sale? Not necessarily because it will lose everything. For practical purposes and to avoid having to foreclose, the first mortgage holder may allow

¹¹ These types of loan were very popular a few years ago. The borrower would get an 80% first loan from one lender, a 10% second from the same or a different lender, and put down 10% to finance the purchase of the property.

some money to go to the second mortgage holder, but this junior lender will still be taking a hit if they go along. So, you must determine what options the junior lender has when negotiating.

This brings us to the issue of “sold out junior lienholders”. In our example, the first mortgage holder is the priority lienholder because its mortgage was recorded first. The second mortgage holder is a junior lienholder because its mortgage was recorded after the first mortgage. And so on it would go, if there were additional mortgages on the property.

If the first mortgage holder forecloses, it wipes out all security interests that are junior to it. Whoever is the highest bidder at the foreclosure sale takes the property free and clear of all liens. If the second mortgage in our example is an acquisition loan, and the first lender forecloses, that \$100,000 second gets wiped out and the second mortgage holder has no recourse.

On the other hand, if the second mortgage is not acquisition

debt, the scenario changes. If the first lender forecloses and the second mortgage is non-acquisition debt, the foreclosure only wipes out the second lender's security interest; but, it doesn't wipe out the debt. This is significant because under this set of circumstances, the second is considered a sold out junior lienholder. A sold out junior lienholder can go into court and get a judgment. Because there is no longer any security for the second mortgage after the first mortgage holder forecloses, the delay of a judicial foreclosure no longer exists. The second mortgage holder can bring a lawsuit for breach of contract against the borrower and easily obtain a judgment to collect on the sold out junior loan.

When a borrower is dealing with a sold out junior lienholder, it's critical to understand whether the acquisition loan rule applies. If it doesn't, in the context of a short sale negotiation, the borrower must be aware of exactly what the junior lienholder could get if it went to court. If the second mortgage is a \$100,000, non-acquisition loan, the

maximum the second lender could get if it went to court is \$100,000 plus attorney's fees and costs. Remember, though that the process could still take a year to a year and a half. A borrower should never agree to give the lender, up front with zero costs, everything it could possibly get if it went through the cumbersome and time-consuming legal process. Again, this is a leverage point. The best negotiating strategy may be to offer to sign a promissory note for a smaller amount such as 10% of the amount owed in an effort to get the second lender to agree to the short sale. For a junior lender, getting something may be better than spending time and money chasing a court judgment that may be uncollectable anyway.

So, to summarize, the critical analysis we undertake with our clients is to first review the loans to ascertain what recourse each lender has. Then, we build a strategy that might enable the borrower, in the case of a foreclosure or short sale, to avoid the debt or a judgment.

The benefit to a borrower in doing a short sale is that it allows him to avoid a foreclosure, but there's also some risks. The process of proving he has a financial hardship requires that the borrower disclose his assets to the lender in order to get the lender in order to get the lender to even consider a short sale. If the borrower has \$1,000,000 in a bank account or trust fund or other substantial assets, he might not want to risk disclosing that information to the lender because the lender will expect him to tap into those funds to pay the debt. Again, from the lender's perspective, if you can afford to take the hit, the lender will demand that you do so *even if the lender has no recourse against you!*

On the other hand, if the borrower doesn't have these kinds of issues, the decision to go for a short sale will be much easier. Of course, the borrower has already suffered credit damage as a result of the default, but a short sale won't affect the borrower's credit in the same way as a foreclosure.

Another important consideration of the lender not being paid in full is the tax consequences, commonly called “debt forgiveness”. Under our tax laws, if you owe someone a debt and then do not have to pay it back, the IRS considers that savings as money in your pocket and you get taxed on it as income even if you never really had the money. For example, if the lender foreclosed and was barred by the single action rule from pursuing a judgment against the borrower for the short fall, that short fall was deemed forgiven debt and, thus, treated as taxable income. The same applies to any debt forgiveness whether it be from a short sale, a deed in lieu, or any creditor that gets less than they are owed in a foreclosure.

Understandably, the tax consequences of a short sale have been huge concern for people already facing a loss of their home and destruction of their credit. In December, 2007, however, Federal government provided some help, at least to owner-occupants. The Debt Relief Act of 2007 provides that any debt on a personal

residence forgiven in 2007, 2008, 2009 will not be treated as taxable income.¹² So, in our previous example, the \$100,000 of forgiven debt would not be treated as income as long as it was debt on the borrower's personal residence.

In September, 2008, California adopted the Debt Forgiveness Act which is very similar to the federal Debt Relief Act. The California law applies to debt forgiven in 2007 and 2008 and will probably be extended to debt forgiven in 2009.

Neither the federal nor the California debt forgiveness statutes apply to rental or investment properties or business properties. Therefore, if a borrower owns these types of properties, any forgiven debt is taxable. So, it's important for a borrower to work out a strategy with his accountant for dealing with the tax consequences if he successfully negotiates a short sale with his lender involving a property that was not his personal residence. Keep in mind, though that if the borrower purchased a property for \$500,000 and it is now

¹² In September, 2008, the federal government extended the Debt Relief Act to 2012.

only worth \$400,000 the borrower may be able to claim a “capital loss”. That \$100,000 in loss of capital value may be used to offset the taxes he may owe as a result of the forgiven debt on rental properties and non-acquisition loan deals.

For a borrower facing foreclosure, timing is critical. Lots of my clients are concerned with how quickly the foreclosure process will proceed; they're concerned with whether they'll be kicked out of their home tomorrow. Well, the reality is that's not how it works. The following table illustrates how a foreclosure proceeds from the first missed payment to the actual foreclosure sale.

Month	Borrower's Action	Consequences/ Lender's Response
December, 2008 (Month One)	1st Missed Payment	Phone Call from Lender
January, 2009 (Month Two)	2nd Missed Payment	Letter from Lender
February, 2009 (Month Three)	3rd Missed Payment	Letters/Calls from Loss Mitigation Department
March, 2009 through May, 2009 (Months Four - Six)	4th - 6th Missed Payment	Lender Records Notice of Default and 90 Day Notice of Default Period Begins
June, 2009 (Month Seven)	7th Missed Payment	Lender Records Notice of Sale and 21 Day Notice of Sale Period Begins

End of Month Seven	N/A	Lender Sells Property at Foreclosure Sale
After Foreclosure Sale (End of Month Seven/Beginning of Month Eight)	Borrower Continues to Occupy Property	Lender Gives Borrower 3-day Notice¹³

When a borrower first realizes he's not going to be able to make his mortgage payment, when he contacts the lender, if his loan is current, generally, he will speak with a customer service representative. So, if our borrower wants approval to do a short sale or loan modification, the lender's answer will be no. Unfortunately, customer service representatives have no decision making authority and this, in part, accounts for the initial refusal to agree to a short sale or loan modification. The other reason for the lender's refusal to do a short sale or loan modification for a borrower who's current is the fact that a percentage of people are going to continue making their payments and will never default because they feel morally obligated to pay their debts.

¹³ If a tenant occupies the property, under California law, the lender is required to give the tenant 60 days notice before the tenant can be evicted.

On the other hand, if a borrower has missed several payments, he will begin receiving communications from the loss mitigation department. Keep in mind that the loss mitigation department has the authority to decide whether to agree to a short sale or loan modification. Unfortunately, to get to the loss mitigation department, the borrower has to have missed a few payments. In other words, the price of speaking with the loss mitigation department is the destruction of the borrower's credit.

So, in most instances, it will be seven, eight, nine, maybe even ten months before the foreclosure happens and the borrower will be required to vacate the property. I recently heard of an instance where the borrower had not made a payment for eighteen months and had yet to receive a notice of default. Suffice it to say, though, that the trustee's sale or fast track process will be significantly shorter than the judicial foreclosure process.

For the borrower facing foreclosure who also has a lot of credit

card debt or other personal debts such as medical bills, taxes, or student loans, understanding how long the foreclosure process takes is essential in deciding how to manage those debts. If it costs \$5000 per month to live in the property and it will take eight months for the foreclosure to happen, that's \$40,000 that can be used by the borrower to payoff or pay down his other debts.

Bankruptcy: The other forced remedy is bankruptcy. It's important to understand that bankruptcy is really a function of your overall financial health. Despite the scare tactics being promoted on the web, the foreclosure of one or more properties, should not put you in bankruptcy. Bankruptcy is the ultimate damage to a person's credit and is designed to give people a fresh start. Bankruptcy is a viable and reasonable option for anyone who is so far in debt - *with court judgments pending or entered against them* – that they simply cannot dig themselves out. Bankruptcy is designed to give people a “fresh start” by clearing away the debt. Of course, doing so is also the

ultimate damage to a person's credit.

The bankruptcy laws changed a few years ago and made it necessary for debtors to pass a threshold test called the “means” test in order to file a Chapter 7 bankruptcy.¹⁴ If a debtor doesn't satisfy the means test, the new bankruptcy laws require him to file a Chapter 13 also known as a wage earner plan.¹⁵

The critical thing to remember about bankruptcy is that once a debtor files a petition, whether Chapter 7 or Chapter 13, the automatic stay becomes affective. The automatic stay gives a debtor protection from any adverse actions by his creditors. In other words, once the automatic stay goes into affect, creditors are prevented from making any collection efforts against a debtor including phone calls, letters, garnishments, foreclosure, and repossession. Additionally, if a creditor's lawsuit against a debtor is pending when the debtor files bankruptcy, the automatic stay prevents the creditor from moving

¹⁴ A Chapter 7 bankruptcy is a debt liquidation that wipes out most unsecured debts including credit card debt, medical bills, and some taxes. Family support obligations and student loans are not dischargeable in bankruptcy.

¹⁵ Chapter 13 is a debt consolidation plan which allows a debtor to restructure his debt and pay it over a three to five year period.

forward with the case.

In order to proceed with any collection efforts action against a debtor who has filed bankruptcy, a creditor must get permission from the court. To get this permission, the creditor must file a Motion for Relief from Stay. In many instances, the court will grant the motion and once granted, the creditor can take all legal remedies against the debtor to collect the debt.

When I meet with a client who is upside down in his mortgages, has several junior loans, and these loans are non-acquisition debts, I know with a fairly high level of certainty that these lenders will seek a deficiency judgment against the borrower. Add to this the fact that the client has a lot of credit card debt and it's becomes clear that the client is a really good candidate for bankruptcy.

CHAPTER FOUR

HANDLING THE PROPERTY DURING FORECLOSURE

For those facing foreclosure, how the property should be handled is of great concern. From rent collection, to insurance, to taxes, it's important to know what your rights and obligations are in order to protect yourself and avoid any additional liability.

One of the most common concerns many of my clients have is how they should deal with their tenants. If a borrower has a tenant living in a property, whether the borrower is current on his mortgage payments or in default, the tenant has a contractual obligation to pay the rent. Often, once a tenant becomes aware of the pending foreclosure, he may decide not to pay the rent, at which point the landlord can have the tenant evicted. However, the court generally will not award the landlord a money judgment for the unpaid rent because the landlord has failed to live up to his obligation to pay the

mortgage. This is a lose-lose situation because the tenant gets evicted and the landlord doesn't get a judgment. It's far better if the landlord can work out some other arrangement with the tenant.

Additionally, if a borrower has a tenant, the lender has a right to collect the rent from the tenant if the borrower has defaulted on the loan. In California, the typical security agreement (“Deed of Trust”) includes an additional provision called an “Assignment of Rents”. This provision gives the lender the power to simply notify the tenant of the default and instruct the tenant to send his rental payments to the lender. If the tenant fails to remit the rental payments to the lender, the lender has recourse against the tenant; the lender can sue the tenant. This happens rarely, but the lender has an absolute right under the Assignment of Rents to collect the rent from the tenant after a borrower's default.

Another issue that comes up is whether the borrower in default should pay the property taxes. If the borrower doesn't pay the

property taxes, the lender will probably do so and will have an additional claim against the borrower.

Once there is a default, the borrower is still obligated to maintain the property. Many communities have covenants, conditions and restrictions, called "CC&Rs" and well as local ordinances which require the lawn be mowed and the property otherwise maintained in good condition. Many communities have homeowner's associations which require the payment of dues. Depending upon the law in the state where the property is located, the homeowner's association can place a lien on the property. If there is a tenant in the property, it's especially important for the borrower to pay the homeowner's association dues so that the tenant will continue to receive the benefits which they're contractually obligated to receive. Additionally, it's important for the borrower to pay the utility bills as long as he occupies the property.

It's essential that homeowner's insurance on the property be

maintained even after a default. If the homeowner fails to maintain homeowner's insurance and the property is destroyed, the lender has no security for its loan and can sue the borrower directly for a money judgment. Thus, even if the lender initially had no recourse other than taking the property, if the property to be destroyed without insurance, the lender would now have recourse against the borrower.

CHAPTER FIVE

ACTION STEPS

All of the information in this book is useless without some practical action steps to guide you. If you are facing foreclosure, please seriously consider the information in this book and the following steps.

- Don't panic. Nothing adverse is going to happen immediately. You have several months to create a strategy and make a decision.
- Get some good advice. You should consult with experienced bankruptcy and real estate counsel. You should also seek tax advice from an accountant or tax attorney. It's also important to get some good advice from a Realtor who is well versed in short sales.
- Look to the future. The fact that you've had a foreclosure or short sale doesn't shut you out of the marketplace. For most

people who experience a foreclosure or a short sale, lack of or insufficient income is not the problem. The problem is too much debt. So, if you manage your debt properly and get your credit score up, it's possible to buy a home in as little as two years after a foreclosure, short sale, or even bankruptcy.

- Be aware of the latest developments in the law. With the new administration coming into office, there will probably be a lot of new policies going into affect to spur and improve the economy which may include taking care of homeowners who are upside down in their loans. You can subscribe to the [BPE Real Estate News](#) to stay informed of the last developments in real estate and business news.

AFTERWORD

If you wish to retain my law firm, BPE Law Group, Inc. please visit <http://www.bpelaw.com> or call (916) 966-2260.¹⁶ Through the BPE consultation program, you can get a one hour consultation for \$200.00. During the consultation, we will go over your financial situation; we'll examine your loans to determine whether they are acquisition loans and what recourse your lenders may have. Then, we'll develop a strategy for you to use to avoid having your lenders go to court to obtain judgments against you.

If you are facing foreclosure or are upside down in your mortgage, it's important that you be proactive. Whether you contact my law firm or another law firm really doesn't matter. I simply encourage you get some help sooner rather than later.

Lastly, remember that this economic downturn is the product of a large number of short-sighted banking changes combined with an

¹⁶ We will meet with you in person, over the phone, or via e-mail or fax. Our goal is to accommodate our clients.

aggressive loan marketing program by lenders that took the money and made loans that they knew would become unaffordable when interest rates changed. While we can't fully treat borrowers as victims (they did take on more than they could realistically afford), the process was stacked against the borrower from the start. So, although this experience will cause loss, and hurt, and even reluctance to ever buy again, understand that this wasn't solely a personal failure of the borrower. Real estate will remain the soundest and most effective investment that we will make in our lives and, while it may take you a few years to restore your credit, you should learn from this experience and get back into ownership as soon as possible.