

*The law is rapidly changing in this area.
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Options for Defaulting Property Owners:
The Legal and Tax Consequences

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Entering the third year of the depressed real estate market, we continue to see homes, apartments and commercial properties become “distressed properties”, either because the value of the property is less than the secured debt, or because the owner can no longer make the payments. Property owners are looking for ways to get out from under the debt that only a few years ago seemed manageable, when they assumed that real estate prices would continue to rise indefinitely.

The purpose of this outline, and the presentation intended to go with it, is to carefully consider the options available to the property owner whose equity has declined or evaporated altogether and/or who cannot continue making the loan payments according to the terms of the loan documents. This outline should not be construed as legal advice or a representation of fact or law by the attorneys who prepared it. Specific legal advice and consultation with an attorney and a certified public accountant is necessary to apply the real estate law and tax law to your particular situation.

What Are the Options? The options for dealing with rising payments and/or declining value, and the legal and tax consequences to a property owner of selecting or allowing one of those options to occur, are discussed below. The possible responses by the owner include the following, roughly in order of the extent of possible adverse consequences associated with that choice:

- 1) “Stay the course” – continue making payments on all loans, as agreed
- 2) Renegotiate some or all loan terms (a loan modification, or “loan mod”)
- 3) Attempt a “Short Sale” of the property
- 4) Give the lender a “Deed in Lieu” of foreclosure
- 5) Stop making payments and allow a foreclosure on one or more of the loans
- 6) File for bankruptcy law protection.

1) Stay the Course: The owner should always consider fully whether it makes sense to just continue with owning the property and loan arrangements that he or she already has. In some cases, it may look more appealing after consideration of the negative consequences of some of the other options. By “staying the course,” we mean:

- a) Continue payments to the lender (or all lenders, if there are multiple loans)
- b) Maintain or even improve your credit rating
- c) Continue living in your present neighborhood and home, assuming you like it
- d) Hope for an eventual improvement to the market that will restore or even increase your former equity in the property
 - i) Acknowledging, of course, that we have no way of knowing if or when the real estate market will appreciate substantially.

2) Renegotiate the loan terms: a Loan Modification, or “Loan Mod”

- a) Lenders may renegotiate loan terms on either a short-term or permanent basis, to:
 - i) Add past-due payments to the principal balance
 - ii) Defer part of or all payments for a specific period of time
 - iii) Extend the maturity date of the loan
 - (1) From 15 to 30 years, for example, or
 - (2) From 30 to 40 years.
 - iv) Reduce the interest rate
 - v) Maintain the current rate instead of enforcing the planned increase in a variable rate ARM
 - vi) Forgive or forbear on a portion of the principal balance owing.
- b) The final agreement needs to be in writing. “A contract in writing may be modified by a contract in writing.” Civil Code §1698.
- c) The modification does not alter the priority of the deed of trust securing the debt, unless the lender advances additional funds in excess of the original amount secured, without the consent of the junior lienholder. Sain v. Silvestre (1978) 78 CA3d461.
- d) Forbearance Agreement: The renegotiated terms may be included in a forbearance agreement to: Temporarily suspend the foreclosure process; Possibly extend the date of sale; Retain the delinquent status of the loan unchanged; Possibly temporarily suspend payments; Forgive late fees or some or all of the interest or debt.
 - i) **New Program for Unemployed Borrowers**: Effective July 1, 2010, a new program change to the Making Home Affordable Program is the “Home Affordable Unemployment Program”.
 - ii) This program allows for suspension or reduction of an unemployed borrower’s mortgage payment for up to a three month period of time (can be six months for some borrowers). Qualification for this program is the same as the Making Home Affordable Loan Modification requirements (i.e., primary residence, first loan of less than \$729,750, etc.).
 - iii) The program also requires that the borrower make the forbearance request before the loan is seriously delinquent (less than 3 payments behind) and require the borrower to document that unemployment benefits will be received during the forbearance period.
 - iv) Monthly payments of 31% of gross monthly income during the unemployment/forbearance plan period may be required depending upon investor and servicer restrictions.
 - v) At the end of the forbearance period, the borrower must be considered for a HAMP loan modification (unemployment compensation cannot be considered as income for qualification of a loan modification).
- e) The lender may want to consider renegotiating as set forth below due to laws passed, participation in a modification program, fear of being criticized in the media and for the same reasons they really do not want to foreclose: they would prefer to have a homeowner’s loan become a performing loan rather than remain a non-performing loan, or worse, become a

foreclosed property they own (called an “REO”, for Real Estate Owned). This is really dependent though on whether the investor on the loan will lose less money by offering a loan modification as compared to letting the home go to foreclosure. When there is equity in a home or if a borrower does not make enough money, it can be more profitable to let the home go to foreclosure than to offer the borrower a modification that is affordable for them.

- i) **2008 California Law:** The lender is required to assess the borrower’s financial situation for qualification for a loan modification or other loan workout solution, under California legislation enacted on July 8, 2008. At the time of passage, the Legislature noted that 57% of borrowers that were late did not know that their lender might offer alternatives to foreclosure.
 - (1) It is the intent of the Legislature that the lenders “offer the borrower a loan modification or workout plan if such a modification or plan is consistent with its contractual or other authority.” Civil Code §2923.6(b)
 - (2) The legislature found that under typical pooling and servicing agreements that servicers acts in the best interests of all parties if the “Anticipated recovery under the loan modification or workout plan exceeds the anticipated recovery through foreclosure on a net present value basis.” Civil Code §2923.6(a)(2)
- ii) **Making Home Affordable Program of 2009:** This plan unveiled by President Obama on February 18, 2009, with guidelines of the program released March 4, 2009 contains provisions to assist homeowners to modify the loan.

The details of the program for first lien modification are:

- (1) Monthly mortgage payments would be reduced by the lender so payments don’t exceed 31% of the borrower’s monthly gross income. This results in a 31% front end debt to income ratio that includes mortgage principal, interest, property taxes, insurance and homeowner association dues. The lower payment amount is reached by first reducing the interest rate on the loan to a floor of 2%, then extending the term of the loan to up to 40 years, then forbearing (not forgiving) on principal (which results in a balloon payment on sale, refinance or end of term). The reduced interest rate is in place for five years, then increases by 1% per year to Freddie Mac Survey rate in effect at the time the modification is entered into.
- (2) Homeowners do not have to be delinquent to participate but the home must be their primary residence with a first loan of no more than \$729,750 (for one unit) and they must show financial hardship or likelihood of imminent default (like a payment reset). If a borrower’s back end debt (such as second lien payments, credit card debt and auto loans) to income ratio exceeds 55% of monthly gross income, then the borrower must attend HUD certified credit counseling.
- (3) The plan creates incentives for servicers, lenders and homeowners to enter into the modifications. Servicers would receive fees of \$1000 for every eligible modification and lenders would receive an incentive payment of \$1500 for modifications on loans that are current but at risk of imminent default. Principal will also be reduced by \$1000 a year for five years if the homeowner stays current on the loan.
- (4) Lenders receiving funds under the financial stability plan must modify loans under these guidelines if the Net Present Value Test is met. Participating lenders must screen borrowers and offer the modification if they meet the eligibility requirements absent fraud or prohibition in the servicing agreement. A list of lenders that have signed contracts to participate in the Program with the Treasury Department can be found at: www.makinghomeaffordable.gov under the section to contact your servicer.

- (5) Recent enhancements to the program now require that income documentation be verified before a trial period plan is offered. The program also prohibits referral to foreclosure until a borrower is evaluated and found ineligible for HAMP.
- (6) Consideration of Principal Write-down: All servicers are also now required to consider an alternative modification with principal write-down where HAMP eligible borrowers owe more than 115% of the current value of their home. The analysis occurs with an alternate net present value test that compares the NPV results with and without principal write-down. If the NPV results are higher with the write-down, the servicer can use the alternative result and reduce principal. The program can also allow for principal forgiveness in equal steps over a three year period so long as the borrower remains current on the payments.

The details of the program for second lien modification are (2MP):

- (1) The second lien modification program is designed to facilitate automatic modification of a second lien when a first lien is modified under the program
 - (2) For amortizing loans paying principal and interest, the interest rate will be reduced to 1% for five years. Then the interest rate will step up to the current interest rate on the first lien modification subject to the interest rate cap on the first lien.
 - (3) For interest only loans, the interest rate will be reduced to 2% for five years. Then the interest rate will step up to the current interest rate on the first lien modification subject to the interest rate cap on the first lien.
 - (4) Lenders must also forbear on principal in the same proportion as the first lien modification and have the option to extinguish principal under an extinguishment schedule of up to twelve cents per dollar of unpaid principal balance extinguished.
 - (5) Servicers receive incentive payments of \$500 for second lien modification and success payments of \$250 per year for three years as long as the first loan remains current.
 - (6) Borrowers receive success payments of \$250 per year for five years to pay down the principal balance on the first mortgage.
- f) A big issue in negotiating a modification can revolve around who actually owns the loan. If the loan is held by a private individual, trust or mortgage backed security or a company other than the servicer, then the terms of a modification are restricted by a servicing and pooling agreement between the owner of the loan and the servicer. These agreements often restrict whether a modification will be allowed and the owner of the loan may not be participating in the Making Home Affordable Program even when the servicer is participating.
 - g) The evidence suggests that owners that are still current may not receive a warm reception to a request to re-negotiate terms. This has shifted some with the Making Home Affordable Program where you don't have to be delinquent to participate, but some lenders still won't consider a modification unless the borrower is delinquent, due to investor requirements.
 - h) Tax consequences of a loan workout:
 - i) If the workout arrangement involves a cancellation or forgiveness of part of the principle amount of the debt, and regardless of whether the debt is recourse or non-recourse, there can be tax consequences under IRC § 61(a)(12), which equates cancellation of debt (COD) income with other ordinary income, and which may or may not be excluded under the rules discussed below on page 18, Tax Consequences of a Foreclosure.
 - i) Advance Fees: Effective October 11, 2009, new legislation made it unlawful to charge any fee in connection with a loan modification or loan forbearance until the person has fully

- performed each and every service the person contracted to perform or represented he or she would perform.
- i) This provision supersedes the usual limitations on receipt of advance fees if a DRE-approved form is used.
 - ii) It applies to everyone: licensees and attorneys alike.
 - (1) Note that only attorneys and real estate licensees are authorized to represent a borrower in connection with a real estate-secured loan anyway, under other provisions of law.
 - iii) This provision remains in effect only until January 1, 2013.
- j) Lack of Success: Statistics as of December, 2010 indicate that only about Eighteen Percent (18%) of all HAMP eligible loans have received permanent loan modifications (521,630 permanent modifications out of 2.8 million estimated HAMP eligible loans). California has received 123,629 of those permanent modifications issued.
- 3) **Short Sale: Basic features:** In another solution for the owner that cannot continue to carry the property, the owner lists or otherwise markets the property, and if the offer by the buyer is less than the amount necessary to pay all costs of sale and liens, the proceeds available to the owner will be “short” of the amount necessary to cover all costs.
- a) In that situation, there are essentially three possible ways the transaction can go:
 - i) The deal cannot close if one or more of the secured lenders demands full payment.
 - ii) The seller pays sufficient additional money into escrow to pay the shortfall and expedite the closing.
 - iii) One or more lien holders agree to accept a “short sale”; i.e., to reduce the amount of their demand to the net amount of cash proceeds available, in order to facilitate a closing. This is the desired outcome of the short sale; the owner receives nothing, but cooperates because he or she *expects* to be relieved of further obligations to all secured lenders.
 - (1) Relief from all further liability may not occur; see below under Termination of Liability.
 - (2) Some lenders allow an “incentive” payment to the Seller, as:
 - (a) An incentive for the Seller to pursue the short sale instead of allowing a foreclosure;
 - (b) An incentive to try for the highest selling price possible under the circumstances;
 - (c) A further incentive not to “trash” the home on the way out.
 - (3) On the other hand, an increasing number of lenders seem to be asking for promissory notes, payment of an additional amount of cash, or waiver of the seller’s protections from further liability. See Termination of Liability, below.
 - b) Advantages and Disadvantages:
 - i) The primary advantages to the owner include the opportunity to stop making high mortgage payments without too much damage to the credit rating. As with several of the options, the owner will usually not take away any cash on closing, but may be relieved of the obligations to the lenders, if that can be negotiated.
 - (1) Note that *all* lenders will have to reconvey their deeds of trust in order for the buyer to acquire clear title to the property, subject only to the lien of the new lender (s). A short sale negotiated with the senior lien holder does not automatically affect in any way the junior lien holders.
 - (2) A judgment lien or mechanics lien would have to be released, too, either by payment of the full amount due, or by negotiation of a lesser payoff.

- ii) The disadvantages of a short sale include:
 - (1) Uncertainty regarding future liability for the short-fall, especially if the loan or loans were non-recourse in the beginning, and the sale is not within the HAFA program or not protected by the new CCP§580e discussed below.
 - (a) The approval letter from the lender may well contain language saying that the seller is not relieved from liability for any deficiency, even though the seller may not have been liable for the deficiency following a foreclosure.
 - (2) Greater exposure to a fraud claim by a lender, if the information provided to the lender in a “hardship” package is different than the information provided in the original loan application or fraud action related to the information submitted for approval of a short sale.
 - (3) The “hassle factor”: greater time commitment in listing the property, allowing it to be shown, continued obligation to keep up the maintenance on the property.
- c) Termination of Liability. One might assume that on the closing of a short sale with the consent of the lender to accept a “short” payoff and the reconveyance of the deed of trust by that lender, that the owner would have no concern about further liability to the lender. But while some lenders will write comforting letters confirming that the borrower has no further liability, others want to accept the benefits of the short sale, but also state that “we may obtain a deficiency judgment against you”, or “we are not waiving our right to pursue you for the shortage”. A demand for a cash payment or a promissory note for some or all of the shortfall may be received from one or more of the secured lenders. However, there is currently some uncertainty as to whether a lender is within its rights to make such a demand for additional payment, whether a seller’s agreement to pay the shortfall in the future would be enforceable, and whether the seller’s remains liable for the shortfall if the lender puts in a demand for payment of all available proceeds but otherwise says nothing regarding the future liability of the seller.
 - i) We are unaware of any case law specifically answering these questions. However, in a case involving a short payoff of a secured debt (Brooks v. Fidelity (1938) 26 CA2 114), the court said:

“Weighing all of the conditions then existing – the depressed market for real property, the value of ready cash, the scarcity of bidders at foreclosure sales due to financial conditions which then existed in the general business depression, defendants [the bank] may have preferred an agreement for the payment of \$10,000 in cash, rather than to take over real property on foreclosure.”
 - ii) New Legislation, SB 931 passed, enacted as CCP§ 580e: This new law, effective January 1, 2011, provides that a borrower cannot be liable for the deficiency when a first lender accepts in writing to receive the proceeds of a short sale on a 1-4 unit residential dwelling. The written acceptance by the first lender obligates them to accept the proceeds of the short sale as full payment. This applies only to first loans – not second loans, HELOCs or lines of credit. A first lender can still pursue the borrower for fraud or waste claims if these are discovered after the short sale.
 - (1) Legislation (CA Civil Code §2943(d)(3)) is in effect until January 1, 2014, that seems to provide for the right of the second lender to pursue the seller after a short sale: “... any sums that were due and for any reason not included in the [beneficiary’s] statement or amended statement shall continue to be recoverable by the beneficiary as an unsecured obligation of the obligor [seller] pursuant to the terms of the note and existing provisions of law”.

- (2) The issuance of a 1099 C for “cancellation of debt” income would seem to be evidence that the debt was in fact cancelled, even if the 1099 C says the debt was recourse and not non-recourse. It’s not clear whether the lender can still sue for a deficiency if it has issued a 1099C.
- iii) Of course, there can be no actual “deficiency judgment” because, by definition, a deficiency judgment can only be obtained following a judicial foreclosure, and there can be no foreclosure after the deed of trust has been reconveyed, as would be the case in a short sale.
- iv) An agreement containing mutual releases, signed by both parties, is the ideal way to obtain protection from further liability.
- v) If a release cannot be obtained, the seller may have to rely on contract principles to establish one of the following contract-law grounds:
 - (1) The lenders have waived any further rights by accepting the terms of the sale and the proceeds on closing.
 - (2) The lenders have confirmed the cancellation of the debt or debts by issuing one or more 1099 Cs.
 - (3) The short sale documentation (the contract, any addenda, escrow instructions, etc., taken as a whole) creates a modification under Civil Code §1698.
 - (a) “Modification of Contract in Writing
 - (i) (a) A contract in writing may be modified by a contract in writing.
 - (ii) (b) A contract in writing may be modified by an oral agreement to the extent that the oral agreement is executed by the parties.
 - (iii)(c) Unless the contract otherwise expressly provides, a contract in writing may be modified by an oral agreement supported by new consideration. The statute of frauds (Section 1624) is required to be satisfied if the contract as modified is within its provisions.”
 - (4) The parties have reached an accord and satisfaction under Civil Code § 1521
 - (a) “Accord Defined. An accord is an agreement to accept, in extinction of an obligation, something different from or less than that to which the person agreeing to accept is entitled.” Civil Code § 1521
 - (b) Generally, performance by payment by the debtor of the new consideration (the “satisfaction”) is required.
 - (c) The debtor should make it clear that the payment is intended as full satisfaction of the debt.
 - (5) The parties have reached a novation under Civil Code §1530
 - (a) “Novation Defined. Novation is the substitution of a new obligation for an existing one.” Civil Code §1530. See Davies Mach. Co. v Pine Mountain Club, Inc. (1974) 39 CA3d 18, 24.
- vi) The provisions of Code of Civil Procedure §726 prevent the lenders from pursuing any further claims after accepting the terms of the short sale. This is the “sanction” effect of §726.
- vii) Our best general advice is to have the seller’s attorney negotiate for a clear, written release of seller of any further obligation to the lender(s).
- viii) Short sale fraud is becoming more of an issue. The Department of Real Estate has released alerts related to “short sale flipping” fraud where a “straw buyer” and double escrow is in place to immediately sell the short sale to another party for a higher amount.

- d) Listing Agreements. The listing as well as the purchase contract must contain appropriate conditions to protect the seller in the event consent to the terms of closing is not received from all lien holders. A seller cannot be assured of delivering clear title unless all liens can be satisfied or waived by the lienholder.
 - i) Sellers should request that language similar to that used in the former (and now removed) CAR Form SSL be added to the listing agreement, saying that the seller is not obligated to pay the commission if the lender(s) are not willing to release the seller from further liability.
 - ii) This assumes the standard California approach wherein the seller accepts the offer subject to the condition that all lenders of record agree to accept the amount of the net proceeds of sale in satisfaction of any and all claims they may have against the seller. See CAR article, “MLS Short Sales and REO Issues”, dated June 17, 2008.
 - (1) Note that in some areas of the country sellers do not accept any of the offers received, but merely pass on all offers to the lender, and the lender selects the best offer.
- e) Purchase Contracts. Likewise, sellers and agents will often want to add a CAR Form SSA to the purchase agreement, to assure that seller’s obligation to convey title to the buyer is conditioned on the agreement of the lender or lenders to accept the proceeds of sale in full satisfaction of the debt or debts. This can be waived later, if the seller decides to pay some nominal amount or sign a promissory note. The purchase contract might also contain language that until the short sale is approved by the lenders,
 - i) the buyer is not expected to conduct his or her inspections,
 - ii) to release any contingencies.
 - iii) And the time periods for inspections, corrective work, obtaining loan approval, etc., will begin to run only on notification of the consent of the existing lender to the short sale terms. See CAR’s recommended language.
- f) Taxation: The tax consequences on closing of a short sale may be more onerous than the consequences of a foreclosure or deed in lieu of foreclosure, according to CAR, if the debt being cancelled would have been non-recourse, because the short sale may give rise to cancellation of debt income even if the loan were non-recourse. However, this position may not be correct. See the explanation of the tax consequences of a foreclosure, below.
- g) Lender willingness to accept less than the full amount due seems to be increasing, possibly with the rationale that receiving a slightly discounted amount now is better than proceeding with a foreclosure and taking the chance of receiving a different amount at foreclosure sale
 - i) The offer by an independent third party (and possibly a BPO or an appraisal ordered either by the new lender or the existing lender) may give some comfort that the price offered represents a selling price that is reasonable in the current market
 - (1) An offer by a related party will be a tougher sale. Most banks ask for a representation and warranty that the buyer is not a person the owner has a personal or business relationship with.
 - ii) Reportedly, lenders have been accepting short sale proposals at a promising rate
 - (1) Note that if the proceeds of sale are more than the amount of a first lien, then the first lien will be paid in full and the sale is not “short” as to it, but may be “short” as to the holder of the second, junior lien
 - (2) If the proceeds are insufficient to pay even the first lien, then negotiations will take place with both lenders
 - (a) The first will be asked to discount the amount of the debt to the available proceeds; and

- (b) The second (and lower priority) lender(s) will be asked to reconvey with a small payment, usually between \$3,000 and \$6,000. A junior lien holder in this position will rationally be comparing receiving little if it reconveys to what it might receive if it proceeded with its own foreclosure, or what it might receive if the holder of the first foreclosed and it considered a suit as a sold out junior.
- h) Experienced Real Estate Broker and Lawyer Participation: Both can be helpful.
 - i) Some brokers have determined that special or additional fees are desired for negotiating short sales.
 - (1) An additional commission to the listing office is possible, if the listing office is to do all the negotiations for the seller, or to a licensed third party, for facilitating the approval of the short sale.
 - (2) Additional fees to the listing office:
 - (a) Some agents may seek up-front fees, non-refundable even if the transaction does not close, to offset the additional time required, but any advance fee is problematic due to the limitations on licensees imposed by the “advance fee” rules in Bus. & Prof. Code §§10026, 10085, and 10146; DRE Regs. §§2970 & 2972; and the foreclosure consultant rules in Civil Code §2945.1.
 - (b) Additional prohibitions on advance fees were enacted October 11, 2009, (Civil Code §2944.7), and these could also be determined to apply to negotiations to reduce the principal amount of the loan as a “loan modification”, within the meaning of that code section.
 - (3) Fee to a lawyer for negotiating with the principal and subordinate lenders could be a good investment
 - ii) Brokers report that lenders are often making requests for brokers to reduce their commissions on sale when the lender is asked to approve a short sale.
 - (1) A listing broker that agrees to accept a reduced commission is still liable to pay the MLS-published commission, unless the listing includes disclosures:
 - (a) That the sale and gross commission are subject to lender approval.
 - (b) How the reduction will affect the selling office (i.e., “any reduction in the total commission payable is to be split 50-50 between the listing office and selling office...”).
 - (2) Note that commissions are protected somewhat for pre-approved short sales in the HAFA program. See j), below.
- i) Affect on Credit Rating: Though it is impossible to give a precise or quantitative answer to how it affects the rating or credit score, a short sale is reported to be adverse but not as bad as a foreclosure or a bankruptcy. It is generally reported as account paid in full for less than full balance. Fannie Mae and Freddie Mac released regulations that allow for a borrower to obtain a new home loan 2 years after a short sale.
- j) Extension of Making Home Affordable Program to Short Sales (Home Affordable Foreclosure Alternatives Program – HAFA): Effective April 5, 2010, the participating servicers in the Making Home Affordable Program will institute new streamlined procedures for short sales. The Making Home Affordable Incentives will be extended to approval of short sales as an alternative to foreclosure. The intent is to streamline the short sale process and provide incentives to borrowers and services to pursue this option if a loan modification was not possible or if the borrower failed to make payments on a trial modification. Incentive payments of up to \$2000 are available to servicers and \$3000 to borrowers to assist with

relocation costs. Junior lien holders will be paid by the servicer, up to 6% of the purchase price or \$6,000 (whichever is less) for the junior lien holder to release their claims.

i) This program is only open to sellers that have loans that are HAMP (Home Affordable Modification Program) eligible with HAMP participating servicers (i.e., first loan amount is less than \$729,750, primary residence, financial hardship, etc.). Every eligible borrower is required to be considered for HAFA before the loan can be referred to foreclosure or a foreclosure sale is conducted.

ii) The program allows for a pre-approval process for a short sale where the lender sets the amount they will accept before the home is listed. The homeowner is given at least 120 days and up to one year to sell the home. Real Estate commissions of up to 6% are allowed by the lender. The lender is not allowed to pursue the borrower for the deficiency, collect a cash contribution or require a promissory note. The borrower may be required to make affordable monthly mortgage payments at 31% of their gross monthly income to the lender while the house is on the market to be sold.

iii) The procedure for short sale pre-approval begins after the borrower is denied for a Making Home Affordable Loan Modification. The same financial information is used and the lender determines what amount they are willing to accept in a sale. This results in a Short Sale Agreement between the lender and borrower (the listing Broker is also required to sign the agreement to acknowledge receipt and the terms). Once an offer is received it must be submitted to the lender within 3 business days and the lender has 10 business days to approve or disapprove the offer.

k) An alternate method of obtaining a HAFA short sale approval can occur if there was no application for loan modification or short sale agreement entered into with the lender. Once an offer is received on the home, it is submitted with the form "Alternative Request for Approval of Short Sale" (Alternative RASS) and the borrower is considered for the program.

4) Deed in Lieu of Foreclosure:

a) Basic transaction: The owner transfers title by deed to the secured creditor in full satisfaction of the debt.

b) Features of the transaction:

i) A transfer of title to the lender in exchange for a release of further liability is negotiated

ii) The owner delivers the signed, acknowledged deed to the lender

iii) The lender must consent to accepting the deed; it cannot be forced to accept the deed

(1) The best plan is to have the lender also sign the deed itself

(2) The borrower may try to record the deed without the lender's consent, but secured creditor may record a notice of non-acceptance of a deed in lieu of foreclosure recorded without the lender's consent. CC §1058.5.

(3) The lender receives title subject to all of other liens currently on the property, both senior to or junior to the lender's own lien. This makes it essential for the lender accepting a deed in lieu to get a title report or possibly title insurance, and the allocation of the cost of these will have to be negotiated.

c) A written settlement agreement with a release is recommended to confirm that the transfer of the property is in full and complete satisfaction of the debt, and the lender has no further claim against the owner.

d) Extension of the Making Home Affordable Program to Deeds-In- Lieu (Home Affordable Foreclosure Alternatives Program – HAFA): Effective April 5, 2010, the Treasury

Department also extended the MHA Program to allow for a deed-in-lieu of foreclosure to occur as a foreclosure alternative if the property does not sell in a short sale under the foreclosure alternatives program (HAFA). The borrower would receive \$3000 to assist with relocation costs under this program. As an alternative, some investors will allow a deed in lieu of foreclosure to occur without a prior attempt to short sale the property, but this is at the investor's discretion. Similar to the short sale program, junior liens can receive payments of 6% or \$6000 (whichever is less), to release their liens. Both senior and junior liens must agree to release the borrower from all deficiency claims with the deed in lieu of foreclosure.

- 5) Foreclosure:** If payments are not being made, eventually the lender will usually commence a foreclosure (unless the lien is a junior lien and the senior lien or liens are in excess of the value of the property), and the procedures employed and the consequences to the borrower depend on the type of foreclosure selected by the lender. Brief Outline of Procedures in a Non-judicial Foreclosure
- a) Notice to Owner from the lender
 - b) Lender meeting with Owner to negotiate a modification
 - c) Notice of Default with declaration that lender has contacted borrower
 - d) Three month waiting period, (or three months plus 90 days, if the lender does not have a qualified loan mod program)
 - e) Notice of Sale
 - i) With declaration that lender has contacted borrower (if the lender already filed the Notice of Default prior to enactment of the new law)
 - ii) Newly enacted California Civil Code §2924.8 requires posting of the property with a notice to the tenants stating that they will be given a 60 day notice after the foreclosure (but see change below), unless certain exceptions apply.
 - iii) This was superseded by new federal law allowing for 90 day notice in most cases
 - (1) Twenty day period following Notice of Sale
 - (2) Trustee's Sale conducted and deed recorded
 - (3) Time for reinstatement: Any time up to five days before the sale
 - (4) No deficiency judgment is permitted following a non-judicial foreclosure. CCP §580d.
 - f) Pre-foreclosure requirements: Under legislation enacted July 8, 2008, a lender must, prior to commencing a foreclosure, contact the borrower in person or by telephone to assess the borrower's financial situation and explore options to avoid foreclosure. Civil Code §2935.5
 - i) The lender must mail notice first, then follow up telephonically
 - ii) The lender must advise the borrower of
 - (1) his or right to a meeting; and
 - (2) a toll-free number for a HUD-certified housing counseling agency.
 - iii) The Notice of Default cannot be filed until 30 days after the contact with the borrower, or if the borrower cannot be located, 30 days after the lender has met the due diligence requirement
 - iv) The contact requirements don't apply if:
 - (1) The borrower has surrendered the property. "Surrender", in this context, means
 - (a) Sending a letter confirming surrender of possession
 - (b) Delivery of the keys
 - (c) The borrower has filed for protection under the bankruptcy laws; or

- (d) The borrower has contracted with a company whose primary business is to advise homeowners on how to extend the foreclosure process and avoid their contractual obligations to mortgagees or beneficiaries. Civil Code §2923.5(h).
- v) These prior notice provisions apply only until January 1, 2013.
- g) California law enacted February 20, 2009 requires an extension to the foreclosure process of ninety days on principal residences where the deed of trust was recorded between January 1, 2003 and January 1, 2008, unless the lender has a qualified loan modification program. This law is in effect until January 1, 2011 (Civil Code §2923.52(d)).
- h) Advantages of a Non-judicial foreclosure
 - i) Although foreclosure is in most cases the lender's only remedy, it is the lender's option to decide *how* to foreclose. The advantages for the lender in a non-judicial foreclosure are numerous, and as a result, most foreclosures will be non-judicial foreclosures under the power of sale in the deed of trust. The advantages to the lender include:
 - (1) Avoiding a court proceeding;
 - (2) Not encouraging the borrower to consult an attorney;
 - (3) Less time and less expense for costs and legal fees;
 - (4) No post-sale redemption by the borrower;
 - (a) The right of redemption in a non-judicial foreclosure ends with the right of reinstatement: 5 days before the date scheduled for sale
 - (5) Possible higher price at the private foreclosure sale;
 - (6) Immediately marketable title (due to the absence of a right of the borrower to redeem the property after the sale);
 - (7) The lender may sell the collateral piecemeal for multiple properties held as security; and
 - (8) A longer statute of limitations period: a non-judicial foreclosure under a deed of trust is not affected by expiration of the relevant statute of limitations on the note (generally 4 years on most notes (CCP §337) or 6 years for a negotiable note). Flack v Boland (1938) 11 C2d 103, 77 P2d 1090; Sipe v McKenna (1948) 88 CA2d 1001.

6) Judicial Foreclosure:

- a) Advantages to the lender:
 - i) Possible availability of a deficiency judgment following the judicial foreclosure sale, if not otherwise barred. See below re rules for determining if a deficiency judgment may be obtained.
 - ii) Expedite application for appointment of a receiver to recover rents during the foreclosure proceeding
 - iii) Provides a forum for resolution of disputes between the borrower and lender
- b) Disadvantages to the lender
 - i) Greater cost in attorneys' fees
 - ii) Longer time to get to sale
 - iii) Unavailability of title insurance on the Sheriff's Deed due to borrower's statutory right of redemption
 - iv) Short time period within which to seek a deficiency judgment: three months after the sheriff's sale. Paykar Constr. v Bedrosian (1999) 71 CA4th 803
 - (1) Possible loss of all remedies if borrower proves there was no default

- (2) The running of the statute of limitations on the underlying note provides a defense in a judicial foreclosure. Flack v Boland (1938) 11 C2d 103, 77 P2d 1090.
- c) **Right of Redemption**
- i) Judicial sale creates in the judgment debtor and its successor-in-interest a new right of redemption (commonly referred to as statutory or post-sale redemption) whenever the right to a deficiency judgment is not waived or prohibited. CCP §§726(e), 729.010-729.090
- (1) If the lender waives any right to a deficiency, there is no further right of redemption
- (2) If the sales proceeds are sufficient to cover the debt, interest, and costs, the redemption period is three months from the date of sale. CCP §729.030(a).
- (3) If the proceeds are insufficient, the redemption period is one year. CCP §729.030(b).
- d) **Anti-deficiency legislation: Is it recourse or non-recourse?**
- i) “Recourse” means that the lender has the right to (first) sell the collateral at auction and (next) go after the borrower for any “deficiency” (i.e., the difference between the proceeds received at the foreclosure sale and the amount of the debt, including all accrued but unpaid interest, late charges, attorneys’ fees, etc.) In many states notes are recourse or non-recourse merely by being labeled as such. In California, the labels are generally not used, and, unless the Note clearly states it is “Non-recourse”, it is initially considered to be “recourse”, by default, and the question of “recourse or non-recourse” is really answered by our “anti-deficiency legislation”, which protects many borrowers against a deficiency judgment, in certain enumerated situations. If the law does not allow the lender to obtain a deficiency judgment, the loan is said to be “non-recourse”.
- (1) Generally, the recourse/non-recourse determination, important for tax purposes as well as liability purposes, is made once, at the time the loan transaction is entered into. Brown v. Jensen (1953) 41 C2d 193,197.
- (a) See Rev. Rul. 90-16 for the same result for tax purposes.
- (2) The stated purpose of the anti-deficiency legislation (as to non-judicial foreclosures) and the redemption periods (following judicial foreclosures) is to discourage under-bidding by the foreclosing lender that could lead to a higher deficiency judgment. Roseleaf Corp. v Chierighino (1963) 59 C2d 35, 27 CR 873.
- e) **Non-recourse loans:** Under the provisions of our statutes (the anti-deficiency legislation) a deficiency judgment is never allowed in the following circumstances:
- i) As to a seller-financed note and deed of trust on any property. CCP §580b
- ii) As to a purchase money deed of trust on one to four units if the owner intends to occupy at least one unit as residence. CCP § 580b
- (1) An amendment to §580b in SB 1178 was *expected* to be enacted in the summer of 2010 to extend non-recourse status to loans modified or that refinance the amount of a purchase-money loan. However, the bill was vetoed by the Governor in September, 2010. Currently, there remains considerable doubt as to whether a re-financed loan will be recourse or non-recourse.
- (2) After a non-judicial foreclosure. “No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property or an estate for years therein hereafter executed in any case in which the real property or estate for years therein has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust.” CCP § 580d.

- (3) After a short sale as to which the holder of the first lien consents in writing, no deficiency judgment can be had. New (as of January 1, 2011) CCP §580e. The second, however, is unaffected and may or may not be able to pursue the borrower for the shortfall.
- f) Two (or more) loans on the property can further complicate the exposure of the owner, regardless of whether the second or other junior loan is a traditional term loan or a home equity line of credit.
- i) Foreclosure by the senior lien holder:
- (1) Once the foreclosure is concluded, all of the junior liens are rendered worthless, and that lien holder(s) is/are referred to as “sold-out junior lien holders”, or “sold-out juniors” for short. Though the security (deed of trust) for the note has been wiped out, the sold out junior still holds the note and is theoretically owed the money
 - (2) A sold-out junior is relegated by CCP §729.080(e) to the position of an unsecured creditor and can sue on the underlying debt, if the note were recourse in the beginning. On the other hand, if the junior debt were non-recourse from the start (such as with an owner-occupied residence, or a seller financed property) the junior has no further remedy.
 - (a) To determine if the sold out junior can sue the borrower, we have to look back to rules in §580(b) re purchase money loans on owner-occupied residential property. If the borrower is protected from a deficiency judgment generally, then the borrower is also protected from a suit on the note by a sold out junior. Brown v. Jensen (1953) 41 C2d 193. See rules above.
 - (b) Note that a junior lienholder can also sue for a deficiency (if not precluded by §580b) even if the junior lienholder is itself the buyer at the foreclosure sale conducted by the senior lienholder.
 - (i) The fair value antideficiency statute (CCP §580a) requires a junior who purchases the security at the senior sale to give credit for the fair value of the property in any subsequent action to enforce the now sold-out junior debt. See Walter E. Heller W., Inc. v Bloxham (1985) 176 CA3d 266.
 - (ii) There is a short three-month statute of limitations (CCP §§337, 580a) to any debt enforcement action by the purchasing junior creditor. Citrus State Bank v McKendrick (1989) 215 CA3d 941.
 1. But the three-month statute of §580a does not apply to a sold out junior lienholder that did not purchase, who has three years to sue. Roseleaf Corp. v. Chierighino (1963) 59 C3d 35, at p 39.
 - (3) If the first and the second are held by the same lender, a foreclosure on the first loan will prevent the lender from suing on the second, as a sold out junior lienholder. Simon v. Superior Court (1992) 4 CA4th 63.
 - (a) This rule has been severely criticized, and many questions remain unanswered. For example, if the senior lienholder also provides a HELOC (home equity line of credit) secured by a second, but otherwise are not linked, it’s not clear if the loans are considered “merged”.
- ii) Foreclosure by a junior lien holder
- (1) Traditionally, before property values plummeted, junior lien holders would have a viable remedy by conducting their own foreclosure proceeding. The belief that they would have such a remedy was undoubtedly part of the motivation for making the loan in the first place. Now, when values can often be lower than the balance due to the 1st

alone, the holder of the 2d has little incentive to commence a foreclosure, since the 2d would be acquiring the property “subject to” the lien of the 1st.

- (2) Note also that a property owner normally would prefer to have the 2d non-judicially foreclose instead of the 1st, so that the 2d does not become a sold out junior. But the 2d may choose not to foreclose, if there’s no equity, for the reasons cited above.
 - (a) A judicial foreclosure by the 2d could still result in a deficiency judgment, however, assuming it wasn’t otherwise barred by §580b.
 - (b) Or if the 1st were also in default, the 2d could wait for the 1st to foreclose, and then pursue the borrower as a “sold out junior”

iii) Tax Consequences of a Foreclosure:

- (1) Section 61(a)(12) of the Internal Revenue Code has long provided that if a person borrows money and the debt is later cancelled or forgiven, so that the borrower does not have to pay back the loan, that the borrower has received the equivalent of ordinary income and will have to pay income taxes on the forgiven debt. This is called “cancellation of debt” income, or simply “COD” income. In real estate transactions, the exact calculation of the character and amount of the gain or loss from a foreclosure, a deed in lieu of foreclosure, or a short sale depends on whether the debt forgiven was, in the first place,

- (2) recourse, or
- (3) non-recourse

(a) Note: as stated above, a debt that is initially recourse but becomes non-recourse later because the lender chooses to proceed with a non-judicial foreclosure, will probably be treated by the IRS as a recourse debt for purposes of calculating the tax consequences of the foreclosure. See Rev. Rul. 90-16.

- iv) Recourse Debt. For recourse debt, a two step process is used, first determining the amount of capital gain or loss on the transaction, and then calculating the amount of cancellation of indebtedness ordinary income (sometimes called “cancellation of debt” income, or “COD income”.)

- (1) Capital gain or loss is determined by:

- (a) Fair market value (“FMV”) of the property,
- (b) Less adjusted basis in the property
- (c) Equals capital gain or loss.

- (2) COD ordinary income. In addition to the capital gain or loss calculation, it is necessary to calculate the cancellation of debt ordinary income, if any. COD income is determined by:

- (a) Amount of the debt
- (b) Less the proceeds of the foreclosure sale (or value of the property, if the lender acquires the property in the foreclosure sale)
- (c) Equals COD income
 - (i) COD income is essentially the amount of the debt that *didn’t* get paid off.

- (3) Exclusions from Ordinary Income: COD income can also be excluded for various reasons, meaning that although COD has been created, the homeowner/debtor will not be taxed on it. The list of circumstances (detailed in IRC §108 and IRS Pub. 908) includes:

- (a) Bankruptcy

1. when the owner has actually filed for protection from creditors under the federal Bankruptcy Act

2. Applies even where the debt is cancelled in a foreclosure (permitted by the court in granting “relief from the automatic stay”) rather than directly in the bankruptcy discharge
 - (b) Insolvency, defined as the amount of the owner’s debt in excess of the FMV of all assets, before the discharge of the debt. §108(d)(3)
 - (c) Qualified personal residence debt, under IRC §163(h) (3) (b). The debt must be incurred before January 1, 2013 IRC §108(a), 108(f) (1). This was enacted in the federal Mortgage Forgiveness Debt Relief Act of 2007 (December 15, 2007) and extended from the original 2010 date by the Emergency Economic Stabilization Act of 2008 (October 3, 2008). California has now conformed to this law, though the maximum amount that can be forgiven is significantly limited, under SB 1055, enacted October, 2008.
 - (d) Qualified real property business indebtedness.
 1. Note: it not clear if simply owning rental property is sufficient to claim this exclusion on the basis that the owner is in the business of renting real property
 - (e) Qualified farm debt
 - (f) Qualified student loan debt
 - (g) Basis Reduction: Generally, the basis of property (either the property securing the debt or other property) must be decreased by the amount of COD income excluded, thereby increasing the amount of potential capital gain calculated as to that property. The rules are set forth in IRC §1017 and Regs. §1017-1.
 - (h) Multiple Exclusions. If the total debt cancelled exceeds the amount allowed to be excluded then the maximum personal residence debt is excluded and then another exclusion (such as for insolvency) can still be used for the balance, if the appropriate tests are met.
- v) Non-Recourse Debt. For non-recourse debt, there is no COD ordinary income, but the capital gain portion may be higher than that calculated for a recourse debt. The gain is calculated as:
 - (1) The total outstanding debt or the fair market value of the property, whichever is greater
 - (2) Less the adjusted basis of the property
 - (3) Equals the capital gain
 - (a) Again, the gain may be excluded if the property has been the owner’s personal residence under IRC § 121, which excludes:
 - (i) Up to \$500,000 in gain for a married couple, or
 - (ii) Up to \$250,000 in gain for an single filer, if
 - (iii)The taxpayer lived in the home for at least two years out of the last five years.
 - (b) However, because any gain reported in a non-recourse transaction does not result in COD income, the exclusions for COD income based on bankruptcy, insolvency, and personal residence indebtedness do not apply.
- vi) See generally CAR’s “Taxation of Foreclosures and Short Sales” dated October 9, 2008.
 - (1) NOTE: The CAR Q & A may not be correct on one point.
 - (2) The CAR Q & A entitled “Taxation of Foreclosures and Short Sales” dated October 9, 2008, implies that the tax treatment of a short sale where the debt is non-recourse is treated worse than it would be in a foreclosure. The examples in the Q & A indicate that the borrower will have COD income in addition to capital gain or loss, even

though it is well recognized that a foreclosure on non-recourse debt does not result in COD income.

- (3) The US Supreme Court held that the amount of the debt remaining unpaid following a short sale was included as part of the amount realized in the calculation of the gain or loss, as described above, and therefore increased the amount of capital gain, but did not result in any COD ordinary income. Commissioner v. Tufts (1983) 461 U.S. 300.
- (4) The IRS has consistently ruled accordingly. Rev. Ruling 91-31.

g) Strategic Mortgage Default: The Consequences of a “Buy and Bail”, or simply “Bail”.

i) A Strategic Mortgage Default is a conscious decision to default on a mortgage based on a rational decision, not because the borrower is unable to make the payments. An insightful article in the New York Times (January 11, 2010) points out lenders and government agencies have strongly criticized walking away from mortgage debt.

(1) President Obama encourages the “responsible course”.

(2) Former Secretary of the Treasury Henry Paulson refers to it as “not honoring your obligation”.

(3) FHA is also opposed to the “Buy and bail” transaction. See letter of September 19, 2008, to mortgage lenders advising them to be on the lookout for what they describe as this “unscrupulous activity”.

(a) “Buy and Bail” is the name given to a strategy in which the troubled homeowner buys a new home at today’s depressed prices, while his credit rating is still good, and then abandons the former house with the mortgage in excess of the value, allowing the former house to go into foreclosure.

But the article goes on to say that it’s less of a moral issue than an economic decision, and that’s the way the major banks themselves address it as to their own investments:

(b) Morgan Stanley recently made a conscious decision to stop making payments on five San Francisco office buildings it owned, after their value plunged. Was that immoral?

ii) The Pros of considering this approach:

(1) If the loan was non-recourse, the borrower is certain that no deficiency judgment can result from a foreclosure, whereas in a short sale, the potential for further liability exists.

(2) If misrepresentations were made in the original loan application, the borrower may be faced with an increased possibility of being sued for fraud if he or she applies for a short sale approval.

(3) If the homeowner hasn’t yet stopped payments on the old house, the credit rating may still be favorable when the new loan application is submitted

(4) The foreclosure on the old house only gets reported after the purchase of the new house

(5) In some areas, the mortgage payment and amount of the mortgage debt could both be cut in half, depending on the specifics of the two transactions, such as the decline in market values, for a home that may be comparable in size and condition.

(6) If the house was owner-occupied, and the old mortgage was “qualified personal residence indebtedness”, the cancellation of debt income may be excluded under the rules above.

iii) The Cons

- (1) The foreclosure will be a significant adverse impact on the credit rating
- (2) The tax consequences of the cancellation of debt could be problematic, if none of the exclusions discussed above apply.
- (3) Reportedly, some lenders qualifying buyers for new loans are concerned enough about the problem to ask for warranties and representations from borrowers, to the effect that they don't own other property they intend to "bail" on.
 - (a) A provision in a note or other contract that says a default on another obligation to a third party is also a default under the present note, even if the present note is paid current, is called a "cross-default clause". These clauses have historically been present in larger credit transactions, or transactions involving multiple documents and multiple obligations, such as an extensive line of credit for an operating company.
- (4) A default may lead to a review of the initial loan application, and if any fraud or misrepresentation is discovered, further legal action is possible.
 - (a) To date, few lawsuits by lenders against borrowers that exaggerated their qualifications have been reported.
 - (b) A Wall Street Journal article of January 30, 2010, reports that purchasers of mortgage debts Fannie Mae and Freddie Mac have commenced requiring lenders to buy back defaulted debt where the loan was obtained through misrepresentation, and presumably the lenders would be more inclined to pursue the borrowers if the losses and other circumstances justify it.
- (5) Fannie Mae announced in July, 2010, that "those that strategically default on their home despite having the capacity to pay and those that don't complete a workout alternative in good faith will be ineligible for a new Fannie Mae-backed loan for seven years from the date of foreclosure.

7) Bankruptcy:

a) Basics:

- i) Under current law, a Chapter 7 or Chapter 13 bankruptcy will delay the process of a foreclosure, but in many cases will not dramatically change the eventual outcome.
- ii) The filing of any bankruptcy will put into effect an "automatic stay" that prevents any foreclosure (either judicial or non-judicial) from proceeding. No action to collect the debt or enforce the security is allowed; anything pending is put "on hold"
- iii) The lender's hands are not permanently tied, however. During the course of the proceeding, the lender can petition the court for relief from the automatic stay in order to proceed with the foreclosure, and relief can be granted in the event the lender shows that the security is likely to be impaired. Further decline in market value may be considered to be impairing the security

b) Reasons for Considering Bankruptcy:

- i) Discharge debt to a Sold Out Junior. Let's say that a foreclosure by the holder of the first deed of trust results in the holder of the recourse second becoming a "sold out junior lienholder", and the second may soon obtain a judgment against the homeowner. A bankruptcy filing after the judgment will generally discharge the obligation to the second.
- ii) Discharge a Deficiency Judgment. If a judicial foreclosure results in a deficiency judgment, the bankruptcy filing generally discharges that obligation as well.

- iii) Exclusion of COD Income. A debt discharged in bankruptcy is excluded from taxation under IRC §108(a)(1)(A). Accordingly, a bankruptcy may be helpful where another reason for excluding the cancellation of debt income (such as the qualified personal residence debt exclusion) does not exist.
- iv) Lienstripping: If the property is encumbered by a first and a second, and the value of the property has declined to the point where the value is less than the amount of the first and second, the lien of the second (or a portion thereof) can be “stripped” away in a Chapter 13, and the second treated as an unsecured debt and therefore partially or wholly dischargeable. The debtor may benefit if the property later increases in value. An involuntary lien (such as a judgment lien) may also be stripped.
- v) Lienstripping is not allowed in a Chapter 7 liquidation bankruptcy.
- vi) Although bankruptcy judges have broad powers, currently in neither a Chapter 7 nor a Chapter 13 bankruptcy (the most common bankruptcies for individuals) may the judge modify the terms of a note secured by a first lien on a residence.

8) Summary: Factors Favoring Each Option

The following is a VERY GENERAL guide to starting an analysis of which alternative may be more appealing:

- a) Stay the course
 - i) Borrower is solid, has steady income, can make payments on all debt
 - ii) Property is fine for current needs; borrower wants to stay
 - iii) There is equity in the property now or the owner expects the market to turn around and to build equity soon
 - iv) The loan(s) have reasonable interest rate and payments
- b) Loan modification
 - i) Property fits the borrower’s needs for the near-term future
 - ii) Loan terms need work: interest rate too high now, loan has negative amortization or will re-set soon to higher payment
 - iii) Borrower is in that “goldilocks” zone and qualifies for modification:
 - (1) not too rich, not too poor (can’t have too many or too few assets)
 - (2) has enough income, but not too much to make the current payment affordable
 - (3) property is only slightly underwater (the property value is less than the loan balance(s), or not too much equity)
 - iv) Borrower suffered an involuntary hardship, a health issue, a drop in income
 - v) Borrower willing to go through the time and effort of negotiating a modification
- c) Short sale
 - i) Borrower is concerned about protecting credit somewhat (as compared to a foreclosure)
 - ii) Borrower qualifies under the HAFSA program for a pre-approved short sale.
 - iii) Property worth less than the amount of the debt
 - iv) Payments too high to continue
 - v) Borrower is not concerned about fraud in the initial loan application, so filing a hardship application will also be of no concern
 - vi) Borrower is willing to list and show the property
- d) Deed in lieu of foreclosure
 - i) Borrower can’t hang on and is willing to stand an adverse impact on his or her credit
 - ii) Property upside down: value is less than the debt
 - iii) No junior or involuntary liens, or if there are, there is a plan to deal with them by

- (1) assumption of those debts by the lender; or
- (2) payment of those debts by someone
- iv) No exposure to continued liability for any further liability because the lender is willing to release the borrower
- v) Borrower acknowledges the possible adverse impact on credit rating, at least with an institutional lender
- e) Foreclosure
 - i) Borrower can't "hang on" (continue making payments)
 - ii) Property upside down: there's no equity
 - iii) Borrower is willing to move out
 - iv) Non-recourse debt so borrower won't face a deficiency judgment
 - v) Borrower wants the certainty of knowing that there will be no deficiency judgment.
 - vi) If it's recourse debt,
 - (1) the lender has chosen a non-judicial foreclosure that will preclude a deficiency judgment, and
 - (2) there is no recourse junior lien that could become a "sold out junior"
- f) Bankruptcy
 - i) Borrower has substantial unsecured debt that will be discharged in a Chapter 7 (or discharged or at least reduced in a Chapter 13)
 - ii) Continuing payments on the secured debt is not out of the question if the unsecured debt is reduced or eliminated
 - iii) Borrower has some equity in the property, and wants to obtain the benefit of the statutory homestead exemption amount in an inevitable foreclosure
 - (1) see CCP § 704.730 for varying amounts
 - iv) The borrower wants to keep the property, and it has one or more junior liens and the value has decreased below the amount of the liens, lien stripping may be available to wipe out part or all of the 2d lien.

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