The law is rapidly changing in this area.
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Options for Defaulting Homeowners: the Legal & Tax Consequences

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The current real estate market has recently been described as the worst market in 80 years, and the downturn in values following a surge in high loan-to-value loans have combined to cause considerable distress to homeowners, real estate investors, and of course real estate agents. The fall-out from wide-spread defaults by millions of property owners include unprecedented numbers of foreclosures, the collapse of revered financial institutions, and a credit system that has ground to a halt, severely limiting the ability to borrow money for homeowners, large corporations, and financial institutions themselves. Property owners are looking for ways to get out from under the debt that only a year or two ago seemed manageable, when they assumed the housing market would continue to rise indefinitely.

The legal and tax background is also changing. Last December, 2007, Congress enacted legislation to allow some homeowners to exclude from taxation the income from cancellation of debt in a foreclosure or short sale. Then our State legislature enacted new legislation on July 8, 2008, to help property owners in default finding that residential foreclosures increased sevenfold from 2006 to 2007; that more than 84,375 homes were lost in foreclosure in 2007, and that 254,824 loans went into default in 2007. Later in July, Congress also approved a bill (the “HERA” Act) to provide additional programs and some relief for some homeowners. On September 7, Fannie Mae and Freddie Mac were placed in government “conservatorship”. On September 15, 2008, both the bankruptcy of Lehman Brothers and the acquisition of Merrill Lynch by Bank of America were announced. On October 3, 2008 the Emergency Economic Stabilization Act of 2008 (or “Bailout Bill”) was enacted to address the credit freeze and bank failures. All in all, it’s a time of turmoil.

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 evaporated and/or who cannot continue making the loan payments according to the terms of the loan documents.

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 basic options include the following, roughly in order of the extent of possible adverse affects associated with that choice:

1) "Stay the course" – continue making payments on all loans, as agreed
2) Lease the home to a third party giving them an option to buy
3) Renegotiate some or all loan terms
4) Attempt a "Short Refi" of the property
5) Attempt a "Short Sale" of the property
6) Give the lender a deed in lieu of foreclosure
7) Stop making payments and allow a foreclosure on one of the loans to occur
8) File for bankruptcy protection

1) Stay the Course: The owner should always consider fully whether it makes sense to just continue with the property and loan arrangement 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 how long that may take.

2) Lease/Option

It could be beneficial to lease your property to a tenant who also gets an option to purchase the property sometime in the future.

- a) Advantages of a lease/option transaction
    - i) Advantages to the owner:
        - (1) Presumably, more people will be able to get into a lease/option than could buy the property outright, due to the absence of down payment
        - (2) The selling price generally remains the same, or even increases, for the length of the option period
        - (3) Receipt of some option consideration at the commencement or over time is normal.
            - (a) The payment of option consideration up front provides a fund to pay commissions from
        - (4) The owner gets a tenant that, expecting that he or she may own the house in the future, has a greater interest in taking care of the house than a mere renter.
    - ii) Advantages to the tenant/optionee:
        - (1) "Tying up" the property by reserving the right to buy it at a later date, without a large down payment
            - (a) Options involve some option consideration, but the amount is completely negotiable. It sometimes takes the form of:
                - (i) A cash payment on signing of the option
                - (ii) A monthly amount is sometimes added to the rent and defined as option consideration
                - (iii) Sometimes a portion of the rent is defined as option consideration
        - (2) The tenant has some additional time to "clean up" its credit score, to improve the chances for getting a loan.
        - (3) Sometimes the tenant thinks financing will be easier at a later date, because
            - (a) Rates may fall

        (b) The tenant intends to pay off a major debt, thereby improving their credit score
        (c) A major defect in the credit report may be due to fall off, due to the passage of time
      (4) Tenant may feel better about being in a house they may own, approaching pride of ownership
  b) Disadvantages
    i) Disadvantages to the owner:
      (1) The market may rise, and the owner may have committed to sell for a price that looks low by comparison
        (a) But in a steady market or falling market, it can make sense
          (i) Analogous to selling a "covered call" on stock one owns
    ii) Disadvantages to the tenant
      (1) Possible higher "rent" if the option consideration is taken into account and the option is not exercised

3) Renegotiate the loan terms: a "Loan Mod"

  a) Lenders may renegotiate loan terms on a permanent basis, to:
    i) Add past-due payments to the principal balance
    ii) Reduce the interest rate
      (1) Because all of the payment (in an interest only loan) and almost all of the payment (in a fully amortized loan) is allocated to interest, cutting the interest rate in half cuts the payment in half (or close to it, in a recent fully amortized loan)
    iii) Maintain the current rate instead of enforcing or insisting on the planned increase in your variable rate ARM
    iv) Defer part of or all payments for a specific period of time
    v) Extend the maturity date of the loan
      (1) From 15 to 30 years, for example, or
      (2) From 30 to 40 years.
  b) The renegotiated terms may be included in a forbearance agreement to
    i) Temporarily suspend the foreclosure process
    ii) Possibly extend the date of sale
    iii) Retain the delinquent status of the loan unchanged
    iv) Possibly temporarily suspend payments
    v) Forgive late fees or some or all of the interest or debt
  c) Reasons the lender may want to consider renegotiating:
    i) **2008 California Law:** The lender may be required to negotiate, under legislation enacted on July 8, 2008. The Legislature noted that 57% of borrowers that are late do not know that their lender may 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) **<u>Emergency Economic Stabilization Act of 2008:</u>** This legislation, also commonly referred to as the "Bailout Bill" gives the United States Secretary of the Treasury ("Secretary") broad authority to encourage loan modification.
   (1) The Secretary must implement a plan to mitigate foreclosures and to encourage servicers of mortgages to modify loans through available programs.
   (2) The Secretary can use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.
   (3) The Secretary is required to coordinate with federal entities that hold troubled assets (such as Fannie Mae & Freddie Mac) in order to identify opportunities to modify loans, and to consent to reasonable loan modification requests, considering net present value to the taxpayer. These modifications can be reduction in interest rates, loan principal and other similar modifications.

iii) Fear of being criticized in the media

iv) 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).

d) The evidence suggests that owners that are still current will not receive a warm reception to a request to re-negotiate terms. Ironically, an owner that wants to protect her credit rating by re-negotiating the terms rather than going into foreclosure might have to stop making payments in order to have the opportunity to talk in a meaningful way about restructuring the loan terms.

e) Tax consequences of a loan workout:
   i) If the workout arrangement involves a cancellation of part of the debt, there can be tax consequences similar to those set forth in Section 7)k), below. As below, there are exceptions that may apply, such as for an insolvent owner.

4) "Short Refinance" or "Short Refi":

a) Basics: The owner refinances the property to take advantage of the current low interest rates, but because the value of the property has declined, the maximum loan amount available may be less than the amount necessary to pay off existing liens. In order to close, the existing lender must agree to accept less than the amount owed.

b) Although analytically similar to a short sale, it is reportedly less common than short sales, possibly because the absence of exposure to the market or an independent, third party offer may reduce lender confidence that this is the best price that can be obtained.

c) Recently, in June 2008, GMAC and another lender have reportedly accepted a short payoff funded by a new loan from B of A.

d) <u>Housing and Economic Recovery Act of 2008 Enacted.</u> On July 30, 2008, the Hope for Homeowners Act of 2008 passed that allows FHA lenders to refinance distressed loans. This Act was further amended by the <u>Emergency Economic Stabilization Act of 2008</u> enacted October 3, 2008. The basic components are:
   i) Only owner-occupants who are unable to afford their mortgage payments are eligible for the program. Homeowners must certify they have not intentionally defaulted on their loan. Homeowners must have, or are likely to have after an interest rate reset, a mortgage debt to income ratio greater than 31%. Lenders must document and verify borrowers' income with the IRS.

ii) Lenders would have to agree to a reduction in principal to achieve the 90% loan to value requirement, plus waive any prepayment penalties for fees related to the default or delinquency. All subordinate liens must be extinguished before participation.
iii) The new FHA loan is the lesser of the amount the borrower can afford to pay as determined by the FHA or 90% of the current appraised value of the home (or a higher percentage as determined in the discretion of the Board). The new loan would be a 30-year, fixed rate loan of up to $550,440.
iv) Junior liens are prohibited for 5 years and the homeowner would be required to share the newly created equity and future appreciation equally with the FHA. The homeowner's access to the equity is phased-in over 5 years based on a sliding scale of 100% of the equity to the FHA in the first year of the loan, 90% the second year, and so on, but not less than 50%.
v) The program is voluntary for Lenders, but the Emergency Economic Stabilization Act of 2008 authorizes the Secretary to encourage servicers to take advantage of this program.
vi) The program begins on October 1, 2008, and ends on September 30, 2011.

5) **Short Sale:**

a) Basic features: In what often may be the best solution for the owner that cannot continue to carry the property, the owner 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 owner will be "short" of the amount necessary to cover all costs. In that situation, there are essentially three possible ways the transaction can go:
  i) The deal cannot close
  ii) The owner/seller pays sufficient additional money into escrow to pay the shortfall and expedite the closing
  iii) One or more lien holders or other creditors agree 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, even though the owner receives nothing.
    (1) Although not common, GMAC has reportedly approved an "incentive" payment to the Seller of a percentage of the selling price, as:
      (a) An incentive for the Seller to pursue the short sale instead of allowing a foreclosure; and
      (b) An incentive to try for the highest selling price possible under the circumstances; and
      (c) A further incentive not to "trash" the home on the way out.

b) The primary advantages to the owner include the opportunity to stop the bleeding; as in several of the options, the owner will usually not take away any cash on closing, but will be relieved of the obligations to the lender.
  i) 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. A short sale negotiated with the senior lien holder does not automatically affect in any way the junior lien holders.

c) The listing as well as the purchase contract <u>must</u> 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) 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 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.

d) The purchase contract might 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.

e) Note: Taxation on closing of a short may be more onerous than a foreclosure or deed in lieu of foreclosure 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.
    i) As noted below (under the "Foreclosure"section, Para 7 k)), discharge of non-recourse debt doesn't generally result in COD income. But this rule doesn't apply to a short sale, as the IRS treats the short sale, a voluntary, consensual transaction, as a forgiveness of part of the debt. So even where a borrower obtained a new loan to buy her personal residence, the discharge of part of this non-recourse debt can still lead to COD income.
    ii) But the owner may be saved by the Mortgage Forgiveness Debt Relief Act of 2007 and new IRC §108(a) (1) (e), if it is Qualified Principal Residence Indebtedness, or the other exclusion provisions that provide relief in bankruptcy, insolvency, etc. See Section 7 k), below, re the tax consequences in foreclosures.

f) 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 the 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/lien holder) 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.
            (a) Generally, sales to a party with whom the seller has a personal or business relationship are restricted.
    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 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 it
            (b) The second (and lower priority) lender(s) will be asked to reconvey without any payment at all. A junior lien holder in this position will rationally be comparing receiving nothing 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.

g) Experienced Real Estate Broker participation can be helpful
  i) Some brokers have determined that special or additional fees are desired for negotiating short sales.
    (1) Additional commission to the listing office is possible, if the listing office is to do all the negotiations for the seller
    (2) Additional flat fee to the listing office
      (a) Some agents 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.
    (3) Fee to a separate, different office, perhaps 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…").

h) Home Equity Sales Contract regulation. Note the limitations on real estate agents attempting to represent the buyer of a distressed home imposed by the Home Equity Sales Contract Law ("HESC Law") described in CC §1695, et seq.
  i) In short, if the owner/seller is an owner/occupier in foreclosure and the buyer does not intend to occupy the property as his/her personal residence, the HESC rules apply and strict adherence to those requirements is required.
    (1) Previously, a buyer could not be represented by a licensee because of the unavailability of a certain bond which was required but not available in California. Our Commissioner of Real Estate, Jeff Davi, stated about November, 2007, that a legislative fix was under way, but the Courts didn't wait, and held that the requirement for the bond was unconstitutionally vague and therefore unenforceable. Schweitzer v. Westminster (2007) 157 CA4th 1195.
  ii) See CAR's excellent legal "Q & A" re HESC's for specific guidance and detailed requirements, including:
    (1) A five-day right of rescission
    (2) A two-year right of rescission if the transaction is unconscionable
    (3) The agent's duty to prove his or her license is valid
    (4) The agent's duty to provide a written statement that the agent has a license. CAR provides Form DPL.

i) Foreclosure consultant regulation: Note also the limitations on "foreclosure consultants" (including real estate agents) in Civil Code § 2945, et seq., a complicated law with many traps for the unwary.
  i) Major revisions **not included below** were enacted September 25, 2008, by the legislature, but will not become effective until July 1, 2008.
  ii) Applies to transactions involving one to four residential units, one of which is occupied by the owner, and as to which a Notice of Default has been recorded.

iii) Agents are generally subject to special rules if they are:
   (1) acquiring an interest in the property
   (2) receiving compensation prior to providing the service (an "advance fee")
   (3) assisting an owner to obtain the remaining proceeds, if any, following a foreclosure sale

iv) If the agent meets one of these tests, then he or she is considered a "foreclosure consultant" and the following restrictions apply:
   (1) A special contract is required (and a CAR form is not available).
   (2) A three-day right of rescission is required.
   (3) The agent cannot acquire an interest in the residence.
   (4) The agent cannot receive compensation in advance.
   (5) The agent cannot receive a power of attorney from the owner.
   (6) The agent must provide proof of a valid real estate license.
   (7) The agent must provide proof of a bond, but since a similar bond requirement in the Home Equity Sales Contract Law was found to be unenforceable, this one may be unenforceable as well.

v) This and other regulatory schemes are described in CAR's Legal Guide to Foreclosure-Related Transactions. For the newly-enacted provisions about Foreclosure Consultants and some examples of what *not* to do, see CAR's "Foreclosure Scams and the Foreclosure Consultant Law" issued November 3, 2008.

j) 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.

k) Tax consequences of a Short Sale: The tax consequences of a short sale are similar to the consequences of a foreclosure, described in detail below, but could possibly be worse if the transaction involves non-recourse debt. Even if the debt is non-recourse (a purchase money loan for a personal residence, for example) the owner can have ordinary income from cancellation of debt, just as would be the case for recourse debt in a foreclosure.
   i) See the rules for taxation of foreclosures in Section 7) k), below.

6) 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) The owner delivers the signed, acknowledged deed to the lender
   ii) 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. A secured creditor may record a notice of non-acceptance of a deed in lieu of foreclosure recorded without their consent. CC §1058.5.

c) A settlement agreement 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) Generally, the lender's lien is eliminated by merger with its newly acquired title.

e) The posture of the lender will be dictated by the lender's internal policies. The lender may inquire about the financial status of the borrower, and ask for additional consideration if it thinks the value of the property is less than the amount of the debt.

f) The deed does not alter or eliminate any other liens, either junior or senior, other than the lien held by the lender. Streiff v Darlington (1937) 9 C2d 42. Accordingly, a lender will generally accept a deed in lieu only when there are no junior liens which would remain liens on the property in the absence of some negotiated reconveyance from the junior lien holder.

g) Advantages to Owner

i) Stops the "bleeding": cancellation of the debt means stopping any further payments

ii) If the value of the property is less than the debt, the Owner may not think it is giving up anything in return for cancellation of the debt

(1) Note: Like a foreclosure or a short sale, a deed in lieu of foreclosure can result in cancellation of debt income as well as capital gain.

h) Taxation of a Deed in Lieu of Foreclosure

i) Deeds in Lieu are taxed just like foreclosures, as described above in Section 7) i).

7) Stop making payments and allow a foreclosure to occur:

a) If payments are not being made, eventually the lender will probably commence a foreclosure, and the procedures employed and the consequences to the borrower depend on the type of foreclosure selected.

i) Reportedly, a foreclosure proceeding may not be commenced for three to six months after payments cease, depending solely on when the lender decides to take action.

(1) Theoretically, a lender could (prior to enactment of the 2008 California law) foreclose immediately after the first default. Now, it merely has to meet with the borrower following default.

b) **2008 California Law.** Under legislation enacted July 8, 2008, a lender must, prior to commencing a foreclosure, contact the borrower in person or by telephone to asses 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 her 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 can't 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) If the foreclosure is already under way, then the lender must still make the efforts described above and attach a notice to the Notice of Sale that says either:

(1) The borrower was contacted to assess the borrower's financial situation and to explore options for the borrower to avoid foreclosure, or

(2) List the efforts made to contact the borrower. Civil Code §2923.5

vi) These prior notice provisions apply only until January 1, 2013.

c) **2008 California Law.** Maintenance of Foreclosed properties. A further disincentive to foreclose (or an "earmark" for California gardeners, depending on your perspective) is a new requirement, effective immediately, that foreclosing lenders must maintain the exterior of residential properties. Civil Code §2929.3. Violations can result in fines of up to $1,000 per day, and include:
   (1) Permitting excess foliage growth that diminishes property values
   (2) Failing to take action against trespassers and squatters
   (3) Allowing mosquitoes to breed in standing water
   (4) Allowing other public nuisances.
   Violators must be given 14 days to begin remedial action and 30 days to complete it.

d) Of course it is possible that a junior lien holder may not foreclose in the near future, even if the payments are not being made. Factors that would be considered are:
   i) Is the amount of the debt to the holder of the second small in relation to the amount of the senior liens?
   ii) Has the value of the property declined so that the available equity (i.e., the amount of value in excess of the senior debt) is little or nothing?
   iii) Is a deficiency judgment possible, and does the owner have other assets? (See Para. 7 i), below, re when a deficiency judgment is possible.)

e) When the loan is secured by an interest in real property, CCP § 726 provides that there is but one form of action, and that is an action to foreclose on the property, either judicially or non-judicially. Options available to holders of unsecured debt are unavailable to secured lenders. <u>Porter v Muller</u> (1884) 65 C 512; <u>Winklemen v Sides</u> (1939) 31 CA2d 387.

f) If there is only <u>one loan</u> on the property, the procedures and outcomes differ mainly depending on which type of foreclosure that the lender elects.

g) <u>Non-judicial foreclosure</u>
   i) The advantages for the lender are numerous, and as a result, an estimated 95% of all foreclosures will be non-judicial foreclosures under the power of sale in the deed of trust
      (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 redemption described above);
      (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 any note or 6 years for a negotiable note). <u>Flack v Boland</u> (1938) 11 C2d 103, 77 P2d 1090; <u>Sipe v McKenna</u> (1948) 88 CA2d 1001.
   ii) Brief Outline of Procedures in a Non-judicial Foreclosure
      (1) Notice to Owner from the lender
      (2) Lender meeting with Owner to negotiate a modification
      (3) Notice of Default with declaration that lender has contacted borrower
      (4) Three month waiting period

(5) Notice of Sale
  (a) With declaration that lender has contacted borrower (if the lender already filed the Notice of Default prior to enactment of the new law)
  (b) **<u>2008 California Law</u>**: **<u>Notice of Foreclosure to Tenant.</u>**
    (i) New Civil Code §2924.8 requires posting of the property with a notice to the tenants stating that they will be a given a 60 day notice after the foreclosure (see below), unless certain exceptions apply.
(6) Twenty day notice period
(7) Trustee's Sale
(8) Time for reinstatement: Any time up to five days before the sale
(9) No deficiency judgment is permitted following a non-judicial foreclosure. CCP §580d.
(10) **<u>2008 California Law: Notice to Tenants to Vacate.</u>** New Code of Civil Procedure § 1161b is added effective immediately to require that tenants receive adequate notice prior to eviction.
  (a) If the tenant or subtenant is in possession at the time of the foreclosure sale, the tenant shall be given 60 days notice to quit, instead of the usual 30 day notice for a month to month tenant.
    (i) Note that a tenant under a lease that is senior to the foreclosing deed of trust may have rights that continue to the end of the term of the lease. A lessee that is junior to the foreclosing deed of trust loses its rights following the foreclosure, and is subject to the new law.
  (b) This notice to the tenant law does not apply if any party on the note remains in the property as a tenant, subtenant, or occupant of any kind.

  This law also remains in effect until 2013.

h) <u>Judicial Foreclosure</u>
(1) Advantages to the lender:
  (a) 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.
  (b) Expedite application for appointment of a receiver to recover rents during the foreclosure proceeding
  (c) Provides a forum for resolution of disputes between the borrower and lender
(2) Disadvantages to the lender
  (a) Greater cost in attorneys' fees
  (b) Longer time to get to sale
  (c) Possibility of a reinstatement at the moment before judgment is entered, thereby wasting a lot of time in the proceedings.
  (d) Unavailability of title insurance on the sheriff's deed due to borrower's statutory right of redemption
  (e) Short time period within which to seek a deficiency judgment: three months after the sheriff's sale. <u>Paykar Constr. v Bedrosian</u> (1999) 71 CA4th 803
  (f) Possible loss of all remedies if borrower proves there was no default
    (i) No case has decided if the lender's "one action" has been used up.
(3) Right of Reinstatement

(a) The borrower as to whom a judicial foreclosure has been commenced has a right to reinstate the loan at any time up until the date the judgment is entered. Civil Code §2924c.
   (i) "Reinstatement" means to catch up on just the past due payments and late charges, but not pay off the entire balance.

(4) Right of Redemption
   (a) "Redemption" as opposed to the "reinstatement" described above, means to pay back, in full, the amount paid by the purchaser at the foreclosure sale
   (b) A 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
      (i) If the lender waives any right to a deficiency, there is no further right of redemption after the sale
   (c) If the lender has not waived a deficiency judgment, and 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).
   (d) If the proceeds are insufficient to cover the full amount owed to the lender, the redemption period is one year. CCP §729.030(b).

i) <u>Anti-deficiency legislation: Is it recourse or non-recourse?</u>
   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 is made once, at the time the loan transaction is entered into. See Rev. Rul. 90-16.
      (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.
   ii) To summarize all the relevant factors, to qualify for a deficiency judgment, the secured creditor must:
      (1) Hold a note that is *not* "non-recourse" on its face;
      (2) Hold a deed of trust that is *not* purchase money (unless it is a third party lender and the property is not owner-occupied, one to four units residential property ;
      (3) Not have non-judicially foreclosed on any part of the property held as security;
      (4) Have drafted the judicial foreclosure judgment to provide for a deficiency judgment against named defendants ;
      (5) Have received less than the full amount of the judgment indebtedness from the foreclosure sale proceeds;

(6) Apply to the court for a deficiency judgment within 3 months after the foreclosure sale. CCP §726(b); and
(7) Establish that the fair value of the property on the sale date was less than the amount of the debt (to assure that the lender has no incentive to sell the property at a price that's less than the full value)

iii) Non-recourse loans: A deficiency judgment is never allowed:
(1) After a non-judicial foreclosure.
(a) "CCP § 580d. 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 a power of sale contained in the mortgage or deed of trust."
(2) 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
(3) As to a seller-financed note and deed of trust on any property. CCP §580b

iv) CCP §580b and Purchase Money loans. "NOTE: The basic rule has been far more difficult in its application than its recitation would appear. It has caused the bar considerable uncertainty in advising clients on whether a particular loan will be enforced according to its terms or denied recourse status because of the purchase money antideficiency prohibition." [Quote from California Mortgage and Trust Deed Practice] Many cases involving deficiency judgments with seemingly similar fact patterns have been decided in opposite ways by the Courts of Appeal and even our California Supreme Court. In brief, the plain rules are said to apply in "standard transactions", and if the case before the court is a variation on the standard transaction, the court is likely to apply a lengthy factual and policy analysis to determine if the purposes of the anti-deficiency legislation would be met by deciding the case one way or the other. In short, accurate predictions are difficult to make.
(1) In transactions that are clearly within the scope of CCP §580b (a purchase money loan or loans to buy a single family residence or four or fewer units that the borrower intends to occupy) we call this a "standard" transaction and the lenders have no recourse following a foreclosure. In those transactions deemed "nonstandard," application of §580b depends on whether its purposes will be met by giving or refusing deficiency protection to the purchaser. Spangler v Memel (1972) 7 C3d 603, 613; Roseleaf Corp. v Chierighino (1963) 59 C2d 35, 41; Webber v Inland Empire Invs., Inc. (1999) 74 CA4th 884.
(a) An unsecured note, even if given for the purchase price of real property, is not subject to CCP §580b and is fully recoverable despite its purchase money character (Van Vleck Realty v Gaunt (1967) 250 CA2d 81
(b) An action against the guarantor of a purchase money note or the issuer of a letter of credit is also outside the scope of §580b (see Heckes v Sapp (1964) 229 CA2d 549);
(c) Seriatim (i.e., successive) nonjudicial foreclosures of multiple properties do not violate either §580b or §580d (see Dreyfuss v Union Bank (2000) 24 C4th 400; Hatch v Security-First Nat'l Bank (1942) 19 C2d 254); and

(d) If the buyer purchases a corporation's stock to acquire the corporation's real property rather than purchase the property directly, §580b does not apply (Union Bank v Anderson (1991) 232 CA3d 941

(2) The two purposes of 580b are described as "preventing overvaluation and stabilizing property values", and analyzed at length in numerous cases, with a substantial degree of uncertainty.

(3) <u>Construction Loans.</u> One court of appeal held that CCP §580b protection should be applied (i.e., no deficiency judgment) to property owners borrowing funds to build their personal residence, because this protection would "discourage construction borrowing [lending, really] which is 'unsound' because the financed construction is overvalued." Prunty v Bank of America (1974) 37 CA3d 430, 441. In Spangler v Memel (1972) 7 C3d 603, however, the supreme court held that purchasers of raw land who gave a first deed of trust to their construction lender and a second subordinated deed of trust to the seller were not protected against a personal judgment in the seller's favor following a senior foreclosure sale, on the ground that denial of protection to the purchaser is the best way to deter overvaluation in that context.

j) <u>Two (or more) loans on the property</u> 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) <u>Foreclosure by the senior lien holder:</u>

(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 and in the attached chart.

(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 (§580a) to any debt enforcement action by the purchasing junior creditor. Citrus State Bank v McKendrick (1989) 215 CA3d 941.

(3) If the first and the second are held by the same lender, and are linked in some way (such as cross-collateral or cross default provisions) the loans are treated as one (the

"merger of liens" doctrine), and a foreclosure on the first loan will prevent the lender from suing on the second, as a sold out junior. Union Bank v Wendland (1976) 54 CA3d 393, 398.

(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, 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 in 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 there would be no equity to foreclose on.

(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".

k) Tax Consequences of a Foreclosure:

i) Section 108 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. In real estate transactions, the exact calculation sometimes depends on whether the debt forgiven in a:

(1) Foreclosure;

(2) Deed in lieu of foreclosure (see below); or

(3) Short Sale; and

Whether the debt was, in the first place,

(4) recourse, or

(5) 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.

ii) 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.

(i) Recall that capital gain on the sale of a personal residence can be excluded (up to $250,000 for an unmarried person, or $500,000 for a married couple)

in the right circumstances. This exclusion does not apply to or exclude the COD income described below

(d) Recall also that although capital losses are common in today's market, since the price originally paid for many homes is now higher than the expected selling price now (the fair market value), losses on a personal residence are not deductible. Only losses on investment property can be deductible.

(2) COD ordinary 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.

(ii) COD income is reported by the lender on a Form 1099 C, and is includable as ordinary income unless one of the exclusions below applies.

(iii) Note: COD income does not include accrued interest, including any accrued but unpaid interest that becomes part of the principal because of a negative amortization agreement.

(d) COD income can also be excluded for various reasons. The list of circumstances (detailed in IRC §108 and IRS Pub. 908) includes:

(i) bankruptcy

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

(ii) insolvency

1. 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)

(iii) 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. See below.

1. debt must be incurred for acquiring, constructing or improving the residence

a. new debt that merely refinances the same amount of debt incurred for qualified purposes also qualifies; a re-finance that exceeds the original amount of acquisition debt will result in the amount of the original debt qualifying, and the excess not qualifying, unless used to improve the residence.

b. Note that these rules are different than the rules for determining whether a debt is a purchase money obligation for purposes of CCP §580b and therefore non-recourse.

2. as in the sale of personal residence, the seller must have lived there for 2 out of the last 5 years. IRC §121.

3. the maximum amount that can be excluded is $1,000,000 for a married person filing separately, or $2,000,000 for all others. IRC §108(h)(2); §163(h)(2)(B).
4. the debt must have been discharged between January 1, 2007, and January 1, 2013, under the October 2008 Emergency Economic Stabilization Act of 2008.
5. California also allows some COD income to be excluded from taxation, but the limits are somewhat different:
   a. As stated above, for California income tax purposes, the limit of "acquisition indebtedness" is $800,000 for married couples, and 400,000 for single filers. Rev. & Tax. Code §17144.5.
   b. The amount of COD income that can be excluded is $250,000 for married couples, and $125,000 for single filers.
   c. The California exclusion applies to property sold between January 1, 2007, and January 1, 2009
6. As is true for federal purposes, the basis of the property must be decreased by the amount of COD income excluded, thereby increasing the amount of capital gain calculated in the first step.
7. 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.

(iv) Other debt qualified for exclusion if cancelled:

1. qualified farm debt
2. qualified business debt
3. qualified student loan debt

iii) For non-recourse debt, there is no COD ordinary income, but the capital gain portion may be higher. The gain is calculated as:

(1) The total outstanding debt or the FMV, 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.

iv) Mechanism for reporting COD income:

(1) Borrower may receive a 1099 C from the lender that writes off all or a portion of the debt
(2) If it's not excluded for one of the reasons cited, the borrower reports the income on either
   (a) Schedule C, E, or F if the property was used in a business, rental property, or farm, respectively; or
   (b) Line 21 if the COD income arises from a personal residence

l) The Consequences of a “Buy and Fly” or “Buy and Bail”
   i) This is the name given to a recent strategy in which the troubled homeowner buys a new home at today’s depressed prices, while his credit rating is still good, then abandons the former house with the huge mortgage, allowing it to go into foreclosure.
   ii) The Pros of considering this approach:
      (1) If the homeowner hasn’t yet stopped payments on the old house, the credit rating may still be favorable
      (2) The foreclosure on the old house only gets reported after the purchase of the new house
      (3) 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, for a home that may be comparable.
      (4) 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 federal government agency FHA considers this an “unscrupulous practice”. See letter from Asst. Secretary of Dept of Housing & Urban Development dated September 19, 2008.
      (2) The foreclosure will be a huge impact on the credit rating
      (3) The tax consequences of the cancellation of debt could be problematic, if none of the exclusions discussed above apply.
      (4) 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.

8) File for Protection under the Federal Bankruptcy Law:

a) Basics: Under current law, a Chapter 7 or Chapter 13 bankruptcy will delay the process of a foreclosure, but in most cases will not change the eventual outcome.
b) 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”
c) The lender’s hands are not permanently tied, however. During the course of the proceeding, the lender can ask 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 impairing the security
d) Although bankruptcy judges have broad powers, apparently in neither a Chapter 7 nor a Chapter 13 bankruptcy may the judge modify the terms of a note secured by a residence.
   i) It is reported that legislation is being proposed that may alter this, to allow the bankruptcy court expanded power to restructure a secured debt.

ii) In a Chapter 11, the court may approve a plan including a restructuring of secured debt, but qualifying for the Chapter 11, plus the high costs associated with a Chapter 11, will preclude its use for most individual homeowners.

9) Miscellaneous Issues of Importance to Realtors

a) Federal Reserve approved new rules to modify Reg Z on July 14, 2008, to further clarify loan disclosures to borrowers, effective October 1, 2009
b) See CAR's legal article "MLS Short Sale and REO Issues" dated June 17, 2008
c) The takeover of Fannie Mae and Freddie Mac—how will it affect us? Both will be allowed to increase mortgage funding, lowering interest rates initially. CAR suggests that in the long run, mortgages may be more, not less, expensive.
   i) These "government sponsored entities ("GSEs") will be allowed to increase their loan guarantees, increasing availability of mortgage loans.
   ii) The U.S. Treasury could acquire up to 80% interest in the two GSEs.
   iii) The GSEs hold nearly one-half - $5 Trillion – of all mortgages.
   iv) See CAR's online video, "Fannie and Freddie: Why They Matter to You".
d) See CAR's November, 2008, Legal Q&A re "Foreclosure Scams and the Foreclosure Consultant Law"

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