

When a homeowner finds themselves upside down in their mortgage payments, they have no idea in which direction to turn, and it seems that it is difficult to get answers to questions about what options they have, and how each option will affect their credit. The following is information to help inform your understanding of these options.

FORECLOSURE

Foreclosure is the legal process in which a bank or other secured creditor either sells or repossesses a parcel of real property, home or land, after the owner has failed to comply with the mortgage or deed of trust agreement with the lender. Most frequently, the violation of the mortgage agreement is the default of payment. The completion of the foreclosure process allows the lender to sell the property, and keep the proceeds to pay off the mortgage as well as any legal costs. The length of the foreclosure process varies from state to state.

If the foreclosed property is sold for less than the remaining primary mortgage balance, and there is no insurance to cover the loss, the court overseeing the foreclosure process may enter a deficiency judgment against the borrower. Deficiency judgments can be used to place a lien on the borrower's other personal property, obligating the borrower to repay the difference or suffer the loss of their property. It gives the lender a legal right to collect the remainder of debt out of borrower's other existing assets.

However, there are exceptions to this rule. If the mortgage is classified as "non-recourse debt," then the borrower has no personal liability in the event of foreclosure. This is often the case with residential mortgages. If so, the lender may not go after borrower's personal assets to recoup additional loss.

The lender's ability to pursue a deficiency judgment can be restricted by state laws. In California and some other states, original mortgages (the ones taken out at the time of purchase) are typically non-recourse loans, however, refinanced loans and home equity lines of credit aren't.

If the lender chooses not to pursue deficiency judgment-or can't because the mortgage is non-recourse-and writes off the loss, the borrower may have to pay income taxes on the un-repaid amount if it can be considered "forgiven debt."

Any other loans taken out against the property being foreclosed (second mortgages, HELOCs) are "wiped out" by foreclosure (in the sense that they are no longer attached to the property), but the borrower is still obligated to pay them off if they are not paid out of the foreclosure auction's proceeds.

Deed in Lieu Of Foreclosure

An alternative to foreclosure is a "deed in lieu of foreclosure." In this scenario, the borrower turns the house over to the lender and walks away without owing anything. A deed in lieu of foreclosure offers several advantages to both the borrower and the lender. The main advantage to the borrower is that it immediately releases him or her from most or all of the personal debt associated with the defaulted loan. The borrower also avoids a foreclosure proceeding and may receive more generous terms than he or she would in a formal foreclosure. Advantages to a lender include a reduction in the time and cost of repossessing the property.

However, the lender usually will not proceed with a deed in lieu of foreclosure if the outstanding debt on the property exceeds the current fair market value of the property. So in this market, this option probably won't be available to most homeowners who are upside down.

Short Sale (aka Pre-Foreclosure Sale)

A short sale occurs when a bank or mortgage lender agrees to discount a loan balance, due to an economic hardship on the part of the home owner. The home owner sells the mortgaged property for less than the outstanding balance of the loan, and turns over the proceeds of the sale to the lender in full satisfaction of the debt. In such instances, the lender would have the right to approve or disapprove a proposed sale.

A short sale is typically executed to prevent a home foreclosure. Lenders often choose to allow a short sale if they believe that it will result in a smaller financial loss than foreclosing. For the home owners, the advantages include avoidance of having foreclosures on their credit histories. Additionally, a short sale is typically faster and less expensive than a foreclosure.

Junior lien holders, such as holders of second mortgages, HELOC lenders, and homeowner associations (special assessment liens), may also need to approve the short sale. Frequent objectors to short sales include those who hold tax liens (income, estate or corporate franchise tax - as opposed to real property taxes, which have priority even unrecorded) and mechanic's lien holders. It is possible for junior lien holders to prevent the short sale.

While it is frequently common for a lender to forgive the balance of the loan in question, it is unlikely that a lien holder that is not a mortgagee will forgive any of their balance. Further, it is common for a lender to omit updating the zero balance and settlement option on the mortgagor's credit report, or even flat-out refuse to do so "due to their financial loss."

The Mortgage Forgiveness Debt Relief Act Of 2007

When the lender decides to forgive all or a portion of the debt and accept less, the forgiven amount is considered as income for the borrower, like with a foreclosure, leaving it open to be taxed. However, The Mortgage Forgiveness Debt Relief Act of 2007 contains amendments to remove such tax liability, allowing the borrower and lender to work together to find a solution beneficial to both parties.

Bankruptcy Mortgage Relief

Currently, bankruptcy offers very limited protection to a homeowner who is upside down with their payments. The borrower can file a Chapter 7 which, depending on the state bankruptcy law, will most likely require him or her to surrender the property to the bankruptcy court, or file a Chapter 13 debt repayment plan to spread out prior delinquent payments over a number of months or years in the future. However, no bankruptcy proceeding can modify the terms of an existing home loan on a principal residence. Legislation is being proposed to Congress that would allow bankruptcy judges to modify the terms of an existing mortgage loan. I would not hold my breath. It could take years to make further substantial changes to the bankruptcy laws.

Ramifications For Credit Scores and Tax Liabilities

There are ramifications for credit scores and tax liabilities to be considered with each of the options discussed. Borrowers, with the help of a knowledgeable professional, should take these into consideration before choosing a course in which to proceed.