

Homeowners Under Threat of Foreclosure Seek “Short Sale” *

With the burst of the so-called housing bubble on a national scale, values of residential properties can easily fall below the mortgage debt load assumed by the owners. Stated another way, more and more folks are finding themselves “upside down” with the combined debt load represented by the mortgages on their homes—meaning that the home is not worth what they owe. When coupled with a job loss causing depletion of the family income, a foreclosure of the homestead looms as a dismal possibility.

Under threat of foreclosure, homeowners may ask the lender, be it one or more, to permit a short sale. The garden variety short sale in this context goes like this: homeowner finds a buyer for the house; there are not sufficient projected sales proceeds to pay off the closing expenses plus pay off all of the mortgaged debt against the home; the lender is asked to accept less than he is owed as a payoff to release the mortgage so the sale can go through; the lender may agree to do that; there could be onerous conditions, unintended consequences, or both.

It is critical that a homeowner seeking a short sale fully investigate and understand the conditions that will be imposed on him before signing a complex legal document binding him to those conditions. Some homeowners get so excited with the prospect of getting out from under the mortgage debt that they will sign anything that is put in front of them.

Following are some of the more prominent issues that should be analyzed before approaching a lender to request a short sale.

(1) The homeowner might still be liable for what is known as a deficiency. When the borrower signs a promissory note he will usually obligate himself to an unconditional promise to pay. The mortgage is only security. The lender does not agree to look only to the mortgaged property for the source of his payment. So, if the full debt is not paid out of the closing of the sale, there will be a deficiency. The lender may try to collect the deficiency by seeking a personal judgment in a court action against the defaulting homeowner.

(2) If the lender does not seek a deficiency as described in paragraph 1 above, and actually discharges the debt, there may be Federal income tax consequences to the homeowner. The amount of the discharged deficiency could be considered by the Internal Revenue Service as a distribution taxable as ordinary income. Internal Revenue Code § 108 mandates that treatment, with some exceptions specified. If the debt is discharged, the lender could feel obligated to issue a Form 1099 to the IRS and the homeowner, indicating the distribution to the homeowner of miscellaneous income.

(3) If the homeowner has more than one mortgage

against the home, there will be the necessity to coordinate with each of the lenders as to which lender will “take the hit”, and for how much. Each lender’s reluctance to “give” could make the transaction virtually impossible; or, at least, very time consuming for reasons including those set forth in paragraph 4 below.

(4) Institutional lenders are extremely busy these days with distressed property problems brought about by the housing bubble burst. They are reported to be understaffed leading to long delays in responding to requests to indulge in debt workout solutions. Therefore, the homeowner should not wait until the last minute to make application for the short sale. He should not expect an instant response to such a request, particularly from a large institutional lender.

The list is not meant to be an exhaustive one. It is rather meant to alert the reader that a lender-approved short sale may not be the end of the homeowner’s financial woes. There could be dire financial consequences. Accompanying each response to a request for a short sale will be forms to fill out and an agreement to sign. Each lender will have his own approach and mind set as to what he needs in the way of a “pound of flesh” from the borrower. The transactions vary in format. One cannot generalize on the approach that a particular lender might take.

We have had experience reviewing the kinds of forms and agreements that would likely come from an institutional lender as a requirement to document the transaction. We would welcome the opportunity to be of service in providing the necessary analysis and coordination to assist a financially troubled homeowner in successfully concluding a short sale.

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**The analysis applies to both Missouri and Kansas real estate. The term “mortgage” is used in its generic sense. The term “Deed of Trust” would equally apply to transactions in Missouri, a state where Deeds of Trust are in more common usage than are Mortgages, as documents that create a lien on real estate to secure payment of a debt.*