

COOPERATIVE SHORT SALE: A NEW SOLUTION FOR HOMEOWNERS IN DISTRESS

After three years with no meaningful assistance from the banks or the government, U.S. homeowners may have at long last been presented with a workable solution to their mortgage problems.

The concept of a cooperative short sale is straightforward. The homeowner with an upside-down¹ property finds an investment group with which to collaborate towards bringing about a short sale of the property. Once the short sale is consummated, the former homeowner signs a lease agreement with an option to repurchase the property² within a designated period. If successful, the participant gets out of the mortgage(s) and has a chance to get the property back at market value—a sort of round-about principal reduction.

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The effect of the program is that the participant gets out from under an inflated mortgage and is provided an opportunity to keep the property at market value.

I. Comparison with Other Loss Mitigation Options

At the moment, none of the options available to homeowners in distress are particularly desirable. There is foreclosure defense, which is a necessary and effective measure in most scenarios. After all, unless the homeowner puts up some resistance to the foreclosure proceedings, the lender will simply foreclose on the property and eject the homeowner.³ For the homeowner who has no interest in retaining the property—even at market value—defending against foreclosure for as long as possible can make good economic sense. The downside, however, is severe damage to credit rating and, depending on the jurisdiction, exposure to deficiency judgments.⁴ Also, for the homeowner who really wants to keep the home, and could do so if it were not so upside-down,⁵ foreclosure defense alone is not a long-term solution. It's a strategic means of delaying the inevitable.

Loan modifications are very difficult to accomplish and never reduce principal,⁶ anyway. There is a small percentage of homeowners who can make use of loan modifications in their current form (*i.e.* HAMP), which consists of homeowners whose properties are not terribly upside-down and who may have fallen behind on payments but can actually afford the existing mortgage⁷ on a foregoing basis. Unfortunately, loan modifications have failed to provide the majority of homeowners with any meaningful relief.

¹ The term “upside-down” refers to the situation where the amount owed on a property is greater than the market value of the property. These days, it is quite typical for homes to be worth fifty-percent (50%) or less than the mortgage(s) secured by the properties.

² Or a right of first refusal.

³ This analysis may vary depending upon jurisdiction. The author practices in a state that requires judicial foreclosures.

⁴ In this context, the term “deficiency judgment” refers to the scenario where the lender sues the borrower for the difference between the amount of the loan and the current market value of the property.

⁵ In the author's experience, the majority of homeowners fall into this category.

⁶ There are some rare exceptions, which typically involve a note the lender has great difficulty enforcing due to predatory lending practices, securitization, and/or robo-signing.

⁷ Perhaps, with a reduced monthly payment.

One can do a short sale and, perhaps, negotiate away the deficiency judgment.⁸ This is an acceptable outcome for some homeowners but not for those who want to keep their homes. After all, most homeowners have *something* invested in the property (*i.e.* money, time, energy, affection, etc.) and giving it up is usually painful.

Bankruptcy under Chapter 13 or Chapter 11 (reorganization) should be a better solution than it sometimes turns out to be. First, there are the unfortunate limitations to what can be done with a primary residence. Homeowners can strip off junior liens, such as second mortgages, and they can cure arrearages over a defined period,⁹ but they cannot reduce the amount of the first mortgage on the primary residence. That fact alone takes reorganization off the table for many homeowners. As for the investment properties, which are subject to cram down¹⁰ under the bankruptcy code, there is the hassle to consider. Under the best of scenarios, reorganizing under the bankruptcy code means submitting to the scrutiny of the trustee and creditors and living under that scrutiny for a minimum of three (3) years.¹¹ Even if everything goes as smoothly as possible, the debtor's credit rating will be severely damaged by the process. Moreover, for homeowners who have significant assets, bankruptcy under any chapter is not a good option. Reorganizing under the bankruptcy code looks good on paper and is an option homeowners should consider, but it does leave a lot to be desired.

The cooperative short sale addresses many of the above shortcomings. It offers a permanent solution to the mortgage problem without filing for bankruptcy and without losing the property. To be fair, a cooperative short sale may not resolve the issue of deficiency judgments. However, asset protection planning¹² and/or negotiations with the lender can mitigate this problem.¹³

II. Legal Implications of Cooperative Short Sales

The banking industry has done a good job of convincing realtors and homeowners that anything along the lines of a cooperative short sale amounts to fraud. The argument, presumably, is that such a sale is not an arm's length transaction. There is only one scenario where this might be true.

There are a few homeowners who have enough cash to purchase their own property through short sale and who create a trust or Delaware¹⁴ company for this purpose. Even though there might be some validity to the non-arms-length-transaction argument in this scenario, there is still very little downside to taking this approach, and the benefits far outweigh any possible detriments. Unfortunately, even with the current depressed home values, this option is still unrealistic for most homeowners.

With the cooperative short sale, however, the purchaser is in fact a legitimate third party. The argument that a *bona fide* purchaser of real property cannot enter into a lease agreement with the former owner of the property—or do whatever else it pleases with the property—flies in the face of one of the most

⁸ The chances of accomplishing a waiver of deficiency are much greater if the short sale is done in combination with a vigorous foreclosure defense.

⁹ Five years in Chapter 13.

¹⁰ The term "cram down" refers to the act of reducing the amount of the mortgage to the current market value of the property.

¹¹ More typically, five (5) years is the minimal period. Know also that some trustees and creditors are unpleasant.

¹² The fact that the homeowner is not under the aegis of the bankruptcy court allows for much greater flexibility in this regard.

¹³ The homeowner is encouraged to seek professional assistance in this regard.

¹⁴ An offshore entity is also a viable option but comes with its own set of considerations.

fundamental doctrines of American law. A cooperative short sale *is* an arm's length transaction, and any contract language that attempts to bar the same would likely be struck down by the court.

Even if we take the worst case scenario, where a local judge finds the sale is not arm's-length or that cooperation between the purchaser and former homeowner somehow contravenes contract language or doctrine of law, what would be the lender's damages?

If the property was sold for the current market value, what difference does it make to the lender who purchased it? And, the fact that the lender approved the short sale makes it pretty hard to argue that the sale price was unfair. There simply are no damages.

III. Good Candidates and Factors for Success

The cooperative short sale is a welcome new alternative, but it will not work for everyone. Ultimately, investment companies have to make money and minimize risk, so they have to consider both the homeowner's financial circumstances and the value of the property. That reality, unfortunately, will eliminate this alternative for a certain percentage of homeowners. Good candidates for this kind of program are those who can make regular payments based on market value and whose properties are valuable enough to mitigate the company's risk.

The financial assessment can be done early on and the parameters are predictable. What is not predictable is the lender's willingness to approve a short sale with terms acceptable to the investment company and/or the homeowner. Implementation of the government's HAFA¹⁵ program has made getting short sales approved a bit easier, which is encouraging. Perhaps a more powerful incentive is the difficulty lenders have had finalizing their foreclosures due to effective defense attorneys and the over-burdened court system.

In reality, most of the parties' interests seem to align pretty well. After all, short sales are one way for lenders to get non-performing assets off their books while receiving the benefits of mortgage insurance and/or governmental incentives.

Notwithstanding, experience teaches us to be conservative in setting expectations of bank decision-makers, so consider approval of the short sale an unknown factor.

Also, there are some parties whose interests may not fully align, such as homeowner associations and junior lienholders. Handling those negotiations is more art than science, and may require a good deal of persistence.

Accordingly, the cooperative short sale is not a panacea, but it is a very interesting alternative for homeowners to consider and an important new addition to the arsenal of attorneys whose practice includes foreclosure solutions.

~ Jeffrey Harrington, Esq.¹⁶

¹⁵ Home Affordable Foreclosure Alternatives Program.

¹⁶ Harrington Law Associates PLLC · West Palm Beach, FL