MITIGATING LOSS WHEN YOU HAVE SOMETHING TO LOSE: Deficiency Judgments, Credit Rating & Public Image.

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I am a Florida[1] attorney whose firm focuses heavily on resolving problems with distressed properties. My associates and I have been defending foreclosures and facilitating loss mitigation right from the start of the economic downturn, and we have seen many interesting developments along the way. Just to name a few, we have seen courts reacting wildly to the incredible influx of foreclosure suits, governmental attempts to prod lenders into sharing responsibility for the situation, and homeowners running the full gamut of emotions.

What we are seeing more often in recent months are clients who have significant assets and six-figure incomes coming to realize they need to address their property issues. Almost invariably, investment properties have nowhere near the value of their loans and, more often than not, rental income is not sufficient to cover the mortgage payments. Successful people know how to read the writing on the wall and it seems their earlier moral misgivings, etc. are starting to take a back seat to business realities. Notwithstanding, they have certain concerns because they do have something to lose.

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Deficiency Judgments

Essentially, when a property is foreclosed, sold via short sale, or surrendered through a deed-in-lieu-of-foreclosure, the lender has a statutory right to pursue a deficiency judgment against the borrower for the difference between the market value[2] of the property and the amount of the loan. In 2009, it was very rare to see lenders exercise this right, probably, because they felt it would be throwing good money after bad to spend more money on attorneys only to end up with a judgment that could not be enforced. After all, many homeowners losing their properties were judgment-proof (*i.e.* no assets to attach and wages too low to garnish). Also, declaring Chapter 7 bankruptcy discharges deficiencies, and those homeowners not already planning to declare bankruptcy certain would if confronted with a large deficiency.

In 2010, so far, we are still not seeing lenders go after deficiency judgments, but we are out of the woods yet. The alternative to pursuing the deficiency is for the lender to take the loss and issue a Form 1099, which causes the deficient amount to be imputed against the homeowner as income for tax purposes unless some exception applies. The U.S. government has helped out in this area by passing the Mortgage Debt Relief Act, which protects homeowners against such tax implications if the deficiency is on the primary residence. Note, however, this does not apply to investment properties.

1 Florida is a judicial foreclosure state. The analysis offered herein may not apply to non-judicial foreclosure state.

2 There is a bit more to it than that, but this is close enough for our purposes here.

Accordingly, the prospect of a deficiency judgment is not such a big concern for the homeowner that is in dire financial straits. By contrast, it is a serious concern for financially stable homeowners, especially those for whom bankruptcy is not really an option.

For one thing, affluent homeowners are much more attractive targets for lenders considering a deficiency action. I do not pretend to fully understand the mind of the banking industry, so some of this is speculation. Still, it does stand to reason that a lender would be more inclined to pursue the deficiency where there is a real chance of collecting. Also, affluent homeowners tend to have investment properties, which are usually the ones for which they are seeking a solution. That means, even if our firm is able to prevent a deficiency action, the Mortgage Debt Relief Act will not obviate the tax implications. So, what is the answer?

First, you are still better off with the 1099 than with a deficiency judgment. I am not an accountant nor a tax attorney, so I will not go into some of the techniques they have for reducing or eliminating the tax implications of forgiven debt. Just know that there are some things that can be done even when the deficiency is on an investment property. In reality, even in a worst case scenario, where you have to pay taxes on the full amount of the deficiency, that is still only a fraction of what a deficiency judgment would cost. So, avoiding the deficiency judgment is definitely step one. How do we do that?

The short answer is, "Don't be a push-over." Deficiency judgments do not happen automatically. The lender has to initiate an action and then deal with all the defenses, counter-arguments, etc. that an experienced foreclosure defense attorney will know how to present.

So, avoiding the deficiency judgment is definitely step one. How do we do that? The short answer is, "Don't be a push-over."

For one thing, who can say what the market value of the property really is? At the moment, property values are almost anyone's guess. Yet, the lender's attorney will have to determine that figure with some degree of certainty in order for the judge to calculate the amount of the judgment.

In reality, you can probably avoid the situation altogether by vigorously defending the foreclosure suit from the start. The worst thing you can do is allow the suit to go uncontested because that makes the process cheap and quick for the lender and you will have zero leverage in your negotiations. Do not do that. Get me or someone like me in there to fight for you. Remember, many of these loans have gaps in their ownership history that cause all kinds of problems for lenders trying to foreclose.

If the property is not in foreclosure and you want to dispose of it via short sale or deed-in-lieu before it goes into foreclosure, it is still important to be represented by an attorney. Look, let's be clear about this. The bank is not your friend. I know of several instances where the lender's representative actively discouraged the client from involving an attorney—everything short of actually saying "we won't work with you if you have an attorney." There is good reason for that attitude. For one thing, they do not want someone like me negotiating away deficiency judgments.

Now, when it comes to setting expectations, my firm's policy is to always be conservative and

plan on the worst case scenario. So, I am *not* saying if you hire us you are going to walk away with the house free and clear. You almost certainly will not, even if we do find all kinds of lending violations and the lender's case is riddled with problems. Just the same, you will likely accomplish a few important things.

First, putting up a good fight makes the case long and expensive for the lender. If nothing else, that will dampen their spirits considerably if/when it comes to deciding whether to go after a deficiency. That is the worst case scenario. More than likely it will not come to that because we will be able to negotiate a short sale or deed-in-lieu with favorable terms for you before then. Specifically, we will ask the lender to waive the deficiency and issue a 1099. You may have to be patient and we may need a thing or two to go our way in the suit, but a written waiver is very attainable.

Credit Rating

This is where things get interesting. We can probably deal with the deficiency issue. At least, we have been quite successful in that regard heretofore. However, our typical approach relies on creating leverage for negotiations, and that normally involves the passage of time. After all, every month that goes by is another month the property is a non-performing asset for the lender. Better yet, if the property is rented, those are months of pure profit for the homeowner. Great, but what about your credit rating?

Again, for many of my clients, this is not a big concern. They feel their credit rating is probably about as bad as it can get and their priorities are elsewhere. However, for affluent clients, it certainly is a concern.

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One thing we can do is employ more aggressive tactics that do not depend on the passage of time. For example, I would recommend a forensic audit of the loan. If the loan or refinance occurred during the boom years—say, from about 2002 to 2007—there almost certainly were some violations. It remains to be seen whether those violations are serious enough to create any real leverage, but an audit is inexpensive and only good can come from having one done. The results can be used in the defense and, if the auditor turns up something interesting, it can be a real game-changer.

What we are trying to accomplish in this scenario is to reach a favorable settlement with the lender sooner rather than later. At our firm, when we find lending violations, we put together a settlement proposal with several components, including (i) a summary of the violations and the corresponding legal remedies, (ii) a deadline for response, after which we report the violations to HUD, and (iii) a proposed compromise—usually a loan modification or short sale/deed-in-lieu without deficiency.

The success or failure of this approach will depend upon the lender's personality and the seriousness of the violations. It is a worthwhile expenditure, though, and one of the only approaches I am aware of that is sensitive to the client's credit rating.

Another thing you can look into is credit repair/restoration. I do not pretend to be an expert in this area nor do I vouch for these companies. I am just making you aware of the option. There are

some companies out there that claim to be able to minimize the damage to homeowner's credit rating even during the foreclosure process. From what I know of the subject, it does seem to be theoretically possible, but that is about as much as I can say about it.

Public Image

You might be surprised to learn the identities of certain people looking for solutions to property issues. You would recognize the names of some of my clients, I suspect. It stands to reason, of course. They are affluent people who—like most affluent people—invested in real estate over the last decade. Today, while they probably could afford to continue losing money on those properties, they really prefer an alternative. In these uncertain times, it is dangerous for *anyone* to allow the bleeding to continue. In any event, one does not have to be a celebrity to be concerned about public image.

Nowadays, there seems to be a growing understanding that homeowners have to make difficult business decisions regarding their properties. Even so, some clients worry about how it might be perceived if their names turn up in the public record as defendants in a foreclosure suit. There are a couple of things we can do.

First, my recommendations regarding credit rating are pertinent here. Obviously, clients concerned about public image are also concerned about credit rating.

Nowadays, there seems to be a growing understanding that homeowners have to make difficult business decisions regarding their properties. Even so, some clients worry about how it might be perceived if their names turn up in the public record as defendants in a foreclosure suit.

Also, while protecting credit rating requires an aggressive approach, protecting public image requires an even more aggressive approach. Not only will you want to impose strict deadlines on the lender for responding to your settlement proposals, but you will also closely monitor the pre-foreclosure steps. For example, as soon as the lender's notice of default appears in the mail, you will respond with a demand for verification pursuant the Fair Debt Collection Practices Act. Then, prior to the lender initiating a foreclosure action, you will preempt with an action of your own based upon the results of the forensic audit.

Filing your own action will not prevent the lender from foreclosing, of course. What will happen, though, is that the lender will end up bringing its suit via counterclaim. What you have accomplished, then, is to put your name in the public record as the plaintiff rather than the defendant.

I have one client who has even taken this one step further and made himself a spokesperson for beguiled homeowners. Not only does this protect his public image, but it may even be good PR. But now we are getting beyond the legal realm, so I will leave that issue to other experts.

~ Jeff Harrington, Esquire
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