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**Maylie & Grayson** is a full service law firm providing representation to real estate brokerages, licensees, Realtor® associations, developers, builders, lenders and investors, providing services in all aspects of real estate including transaction review, land use planning, licensing, mediation, arbitration and court matters throughout Oregon and Washington.

### **Short Sales v. Foreclosures: How the Differences May Impact Your Clients**

In past articles, we have discussed the mechanics of listing and selling short sale and foreclosure properties. We have also addressed the idea that a short sale may not be a better option than foreclosure for some property owners. As a follow up, we thought it would be helpful to compare short sales and foreclosures, and discuss why a property owner may choose one over the other. Although we do not recommend that real estate licensees explain the differences to their clients in detail, or advise their clients on whether they should choose one option over the other, licensees should be familiar with this information in order to better serve their clients.

#### Short Sales

As you undoubtedly know, a short sale occurs when the proceeds from the sale of a property are not sufficient to cover the encumbrances or other expenses that must be paid as part of closing the sale. In our current market, encumbrances such as first and second mortgages commonly create a short sale because property values may have decreased. Other common items that may cause a short sale include closing costs, tax liens, judgments, commissions and mortgage prepayment penalties.

Once a seller learns that his or her sale will be a short sale, the seller typically involves the listing licensee or another professional in attempting to negotiate with his or her lenders. Historically, licensees and sellers had a very difficult time finding a live body at the lending institution with whom to negotiate the short sale. However, as short sales have become increasingly common in the last several years, we have found that lenders are making the short sale negotiation process far easier. That being said, lenders have no obligation to promptly return calls, to negotiate, or to even consider the seller's request that the lender agree to accept less than what it is owed.

In considering a seller's request to pay less than what is owed, a lender will review the seller's financial records in order to determine the seller's financial capabilities, and attempt to verify the current value of the property. A lender wants to know whether the seller has any other assets that could help make up the shortfall. In addition, a lender wants to know the seller's ability to pay in the future. Based on the lender's review of the seller's financial records, the lender may agree to accept less than what it is owed at closing, but in many instances not release the seller from the debt entirely. In this circumstance, the lender may require the seller to execute a promissory note for the debt shortfall at closing. Alternatively, the lender may require the seller to sign an agreement that indicates that the seller acknowledges the lender reserves the right to recover the debt from the seller in the future. We have found that some people believe that the lender has no right to attempt to recover the shortfall from the

seller. In most cases, this is not true. The lender will undoubtedly consider whether it will ever be able to recover the amount from the seller, through a promissory note or otherwise, in deciding whether to agree to accept less than what is owed at closing. The lender will also consider whether the property will sell for more than the price accepted by the seller, and whether the seller will be able to continue making payments on the mortgage.

In the event a lender agrees to accept less than what is owed in order to allow a seller to pass clear title to a buyer, it is important that a seller understand the implications of a short sale. First, there are potential credit implications, as the lender may report any late payments and a short sale to the credit reporting agencies. Second, as discussed above, a seller may not be free from the obligation to the lender in the future, as he or she may have agreed to be liable to the lender either by written agreement or through execution of a promissory note. And third, there may be tax implications to the seller. Historically, “forgiven” debt was taxed by the IRS as regular income to the seller, which meant that the seller would receive a 1099 and be required to pay taxes on that amount. However, in December 2007, the federal government passed legislation that provides relief to sellers who have purchase money mortgages, are living in the subject property, and have not taken equity out of the property in order to purchase something unrelated to the property, such as a car. The law has many intricacies, and will not be helpful to some sellers in this market who obtained home equity loans and lines of credit in order to make purchases unrelated to their principal residences.

As a seller may not actually be free of the “forgiven” debt after closing, a short sale may not be the best option for the seller. If a seller mistakenly believes that he or she would not be liable to the lender in the future, but then learns otherwise, the seller will understandably be unhappy and may look for someone to blame. Unfortunately, we see many claims made against licensees in these situations, as they are viewed as having “deep pockets” (*ie*, insurance), and as the professionals that the sellers were relying on exclusively. For this reason, we recommend that licensees working with individuals considering short sales should advise their clients to consult with legal and/or tax advisors about the implications of a short sale prior to completing one. This advice should, as always, be documented in writing.

The next section will discuss foreclosures, which constitute a distinct alternative from short sales, and often take place after short sales are unsuccessful.

### Foreclosures

A foreclosure is the primary (and most commonly exercised) remedy available to a lender in the event a borrower defaults on a real estate loan secured by a deed of trust. There are two methods of foreclosing – foreclosure through the court system (“judicial” foreclosure), and foreclosure by advertisement and sale (“non-court” foreclosure). This section will primarily focus on the latter type of foreclosure, as it is far more common. A foreclosure by advertisement and sale takes 120 days from recording of the notice of default and election to sell to the foreclosure sale. Typically, a lender does not start the foreclosure process until after the property owner has missed several payments.

In many instances, the property owner will attempt to sell the property during the foreclosure process in order to avoid the foreclosure sale itself. In the event the sale will not generate enough proceeds to pay all encumbrances, closing costs and other amounts required at closing, the seller must attempt to convince one of his or her lenders or other creditors secured by the property to reduce the amount they are owed in order to allow the property to be sold free and clear.

A lender may be inclined to agree to a short sale if it determines the property will not sell for anywhere near what the lender is owed (or in the case of a second lien holder, what the first lien holder and second lien holder are owed). In addition, a lender may be inclined to agree to a short sale if it determines the seller has additional assets that support the lender's ability to recover the shortfall from the seller either through a promissory note at closing or in the future. Furthermore, if the lender decides to go through with a foreclosure sale, it may not be able to seek a deficiency judgment against the property owner, and therefore will have no future ability to recover the shortfall from the property owner.

The lender will follow through with a foreclosure sale if the property owner is unable to cure the default or the property owner is unsuccessful in selling the property, despite the chance that the lender may not recover all that it is owed in the sale. As mentioned above, the lender may not be able to seek a deficiency judgment against the property owner if there is a shortfall between what is owed and what the property is sold for at a foreclosure sale. Oregon law prohibits lenders from seeking a deficiency judgment in a foreclosure proceeding involving a property that is occupied by the owner as a principal residence at the time of a foreclosure sale. Washington law is similar, but the property owner must occupy the property at the time a foreclosure is commenced, not necessarily at the time of a sale. These laws may benefit property owners who are being foreclosed upon, in that they may have no future responsibility to the lenders. If a property owner is living in the property at the time of a foreclosure sale, in Oregon, or at the time the foreclosure process is commenced, in Washington, foreclosure may be a better solution for a distressed property owner than a short sale in certain situations.

A foreclosure will appear on a property owner's credit history, as the foreclosing lender will report the default and subsequent foreclosure to the credit reporting agencies. A foreclosure is likely to negatively impact a property owner's credit rating more so than a short sale, and for a much longer period of time.

For the reasons stated above, property owners should consider whether a foreclosure may be the best way out of their predicament. A property owner may not be concerned about the negative impact a foreclosure will have on his or her credit, and will instead care more about whether there will be future responsibility for the shortfall between a sale price and the amount owed to lenders.

### Conclusion

Distressed property owners would be well served to consider their options prior to deciding to list a short sale or allow their property to go into foreclosure. For some, a short sale is the best option, and for others, a foreclosure. In this regard, licensees should advise their clients and potential clients in writing to seek legal and tax counsel prior to deciding to list a short sale. It is important that property owners make informed decisions based on the options available to them.

This column contains general information only and must not be construed as legal advice. Questions may be submitted directly to Maylie & Grayson by fax at (503) 775-1765, by email at [info@mayliegrayson.com](mailto:info@mayliegrayson.com) or by mail at 7959 SE Foster Road, Portland, Oregon 97206.