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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.

### **A Sign of the Times: Loan Modifications, Short Sales, Deeds in Lieu, Foreclosures and Bankruptcy**

For the last several years, we have lived in a changed world – one with a weak economy and a challenging real estate market, amongst other things. Unfortunately, many property owners have had personal experience with the difficult real estate market, having been forced to make tough decisions about how best to deal with properties they could no longer afford to keep. This in turn has led many brokers to learn first hand about options available to distressed property owners, as brokers tend to be one of the first resources property owners turn to when faced with a tough decision. This article will first address these options, then discuss how a property owner's circumstances will impact the choices they make, and finally discuss how brokers should communicate with their clients about their options.

### **Options Available to Property Owners**

#### **Loan Modifications**

A property owner who needs temporary relief to retain his or her property may consider seeking a loan modification. Many lenders may be willing to alter the terms of a property owner's loan, either temporarily or permanently, in order to allow the property owner to continue to own the property. The obvious advantage of a loan modification is that it allows a property owner to keep the property, rather than being forced to sell the property or allow it to go into foreclosure. However, loan modifications can be challenging to obtain, as they can take many months to go into effect, and often require the property owner to repeatedly contact the lender in order to move the process forward. In addition, lenders have very strict qualifications for property owners seeking loan modifications, and may not be willing to consider loan modifications for properties other than principal residences.

#### **Short Sales**

A short sale takes place when the proceeds from a sale of property are not enough to cover underlying encumbrances against the property and all other costs associated with the sale.

A property owner may consider entering into a short sale when he or she would like to sell a property, wants to avoid a foreclosure, and has experienced a hardship that may encourage his or her lenders to accept less than what is owed against the property. In addition, a property owner may consider a short sale simply for business purposes – he or she cannot justify throwing more money into a property that will not be worth what is owed against it in the foreseeable future. A property owner will benefit from a short sale in that he or she will be able to sell the property and cut his or her losses. However, a short sale can have a negative impact on the seller's credit, may result in continued liability to the lender on the loan against the property, and could have adverse tax consequences.

### **Deed in Lieu of Foreclosure**

A deed in lieu of foreclosure may be used by a property owner to cut short the timeline associated with a foreclosure, and to negotiate relief from the shortfall between the value of the property and the balance on the underlying loan (the “deficiency”). Because a deed in lieu of foreclosure is negotiated between the property owner and lender, it may not have the same outcome as a foreclosure, and may not benefit the property owner any more than would a foreclosure. However, it can be useful to a property owner who can successfully convince a lender that deeding the property back will save the lender from expending time and money in a foreclosure, in return for a release from any “deficiency” liability.

### **Foreclosure**

Foreclosure is the typical end result in a situation in which a property owner defaults on an underlying loan against property, and is unwilling or unable to bring it current. Some property owners find themselves facing foreclosure because they have experienced a hardship, and have no better option than to allow the property to go into foreclosure. Other property owners may be strategic in allowing foreclosure to take place, such as in a situation in which they have other properties they are trying to retain, know that a property will not be worth the balance owed on the underlying loans anytime in the near future, or wish to occupy the property through the foreclosure sale date without making payments. Foreclosure can be beneficial to those who are able to avoid any post-foreclosure liability to the lender. However, as with any other option, foreclosure will undoubtedly have a negative impact on the property owner's credit, which will impact his or her ability to obtain financing in at least the near future. In addition, the property owner may be subject to tax liability in certain situations.

### **Bankruptcy**

Bankruptcy is an option considered by property owners who have significant debts and/or are attempting to salvage equity in a property. In bankruptcy, a property owner may be able to restructure debt, or may even be successful in doing away with the debt entirely. Although bankruptcy has a negative impact on a property owner's credit, it may be the only way that a property owner can retain his or her property, save equity through a homestead exemption, or deal with significant debt.

## **Which option is appropriate for a property owner?**

Each of these options may work for one property owner, but not another. For instance, each option may have different tax consequences for different property owners, depending on the type of underlying loan against the property, the use of the property, the amount of the shortfall between the value of the property and the amount of the loan, and so on. Although many property owners may qualify under an exception to federal tax liability for any forgiven debt, those who own rental properties or who took equity out of the property may not. Tax consequences will undoubtedly impact which option is chosen by a property owner, assuming the property owner has any real choice.

In addition, each option may result in a different liability owed to a lender. For instance, in a negotiated short sale or deed in lieu of foreclosure, the lender and borrower will enter into an agreement as to the liability, if any, owed to the lender after the fact. In some short sales, a lender may be willing to agree to cancel the entire amount of the debt owed by the property owner, whereas in others, the lender will not. If a property owner knows that he or she will avoid liability owed to a lender in a foreclosure, but the lender will not agree to cancel the full debt in a short sale, the property owner may decide to allow the property to go into foreclosure.

A property owner will also base his or her decision as to which option is right for him or her based on the impact that decision will have on his or her credit. Unfortunately, in any distressed situation, a lender will make a negative credit report to the credit reporting agencies, which report will negatively impact a property owner's credit score. However, opinions differ as to the impact each of the above options will have on a property owner's credit score. Some argue that a bankruptcy is a decent option because it will only impact a person's credit for a specific period of time, whereas a foreclosure or short sale will have an unknown impact. Others argue that a short sale is better than foreclosure from a credit standpoint. And still others argue that a foreclosure will not be overly detrimental, as the property owner may be able to qualify for a new loan only one to two years after the foreclosure takes place.

Because each of these options involves a multitude of factors, property owners are well advised to speak with a professional who can advise them about which option may suit them best. As stated previously, many times a property owner will first speak with his or her real estate broker about available options. Although a real estate broker is certainly capable of listing a short sale property on behalf of his or her client, a broker should first advise the client to seek counsel as to whether a short sale is an appropriate option. In some circumstances, a property owner will be better off pursuing another option.

## **Conclusion**

A distressed property owner faces a tough decision regarding how best to address his or her situation. Because this decision involves many variables, and can have a number of outcomes, distressed property owners should seek counsel from professionals such as attorneys, tax advisors and others regarding how best to protect themselves and their assets. Real estate brokers, as a frequent first point of contact for distressed property owners, may wish to maintain a list of professional advisors to whom they can refer their distressed clients. In addition, brokers should ensure that they document their advice to clients to seek professional guidance on their

situation, in writing. Such documentation will serve as protection for the broker, but will also ensure that the broker's clients are being pointed in the right direction.

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.

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