Short Sales & Deficiency Judgments

November 2009

As a foreclosure defense attorney in Florida, I get lots of questions about deficiency judgments. With today's economy and real estate market, my clients often find themselves faced with the prospect of disposing of a property via short sale. Naturally, they want to know about the possibility of having a judgment entered against them for the difference between the sale price of the property and the amount due on the loan.[1]

First, Florida Statute §702.06 does provide mortgagees the right to seek a deficiency judgment upon foreclosure or short sale of the subject property. Florida courts have done little to curb that right, though certain exceptions may apply in some parts of the state. For example, in some districts, if the foreclosing party purchased the note at a substantial discount, the court may not allow a deficiency judgment. *See* Jonas v. Bar-Jam Corp., 170 So. 2d 479, 480 (Fla. 3d DCA 1965). In today's real estate market, where most loans have been sold multiple times, this particular protection can be very valuable. However, this is only available where the local court adheres to this policy.[2]

Another potential protection exists in that the statute puts the award of deficiency judgments "within the sound discretion of the court." That means there is a greater chance of the judge denying or limiting requests for deficiency judgments, especially where the court happens to be consumer-friendly. There is never any guarantee, but my experience indicates that most judges are sympathetic to the plight of homeowners in distress.

Moreover, there are certain legal limitations that always apply to deficiency judgments. Specifically, no deficiency judgment is possible where the market value of the property is greater than the amount due on the loan. Naturally, this is not often the case in today's market, but it does come into play in some situations. For example, if the house is only a little bit "upside-down," then it probably would not be worth the time and money it would cost the bank to obtain a deficiency judgment. Thinking from this prospective leads us to the business considerations that weigh heavily in the way lenders actually handle these matters.

The foregoing paragraphs focus on the law. As an attorney, I have to advise my clients of the applicable law and the worst case scenario. That has been accomplished, and now we can turn our attention to the business realities of this industry. In reality, even though lenders do have the right to seek a deficiency judgment, they very rarely do. The most intuitive explanation for this restraint is that lenders believe (i) it may be difficult to obtain a worthwhile judgment because of consumer-friendly judges, and (ii) even if they get a judgment, they will not be able to collect on it.

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[1] My answer, and my analysis here, is limited to Florida, a state that requires judicial foreclosure, because in non-judicial foreclosure states—such as California—deficiency judgments are virtually a non-issue.

[2] The court's decision in Ahmad v. Cobb Corner, Inc., 762 So. 2d 944, 947 (Fla. 4th DCA 2000) flatly rejects this restriction to deficiency judgments.

Lenders will typically attempt to get as much financial information from the borrower as possible during the short sale approval process. One obvious reason for this due diligence is to determine collectability of a deficiency judgment. In theory, if the deficient amount is substantial and the borrower has assets to pay the judgment, then the bank is incentivized to go after the deficiency judgment. As a practical matter, however, banks are not law firms and they are not particularly interested in spending their time and resources litigating. So, typically lenders will "write off" the deficiency and use the loss as a tax deduction.

I have seen one variation, which is where the lender sells their cause of action—that is, their right to seek a deficiency judgment—to a third party. There are companies and individuals out there who buy up judgments and causes of action for pennies on the dollar and then attempt to collect. We know this industry exists but, in actuality, practitioners have not seen much of this kind of activity in the distressed property arena. I can only speculate as to the reasons, but one possible explanation is that such companies may fear they will have an even more difficult time collecting than the lender would. *See* Jonas v. Bar-Jam Corp., 170 So. 2d 479, 480 (Fla. 3d DCA 1965).

The last key element in this analysis is the specter of bankruptcy. Home loans are secured debts that are not dischargeable through bankruptcy. However, once the property has been foreclosed or disposed through short sale, the deficiency is considered unsecured debt. Therefore, even where the lender or some third party is successful in obtaining a deficiency judgment against the borrower, the borrower has the option of declaring bankruptcy and erasing the debt.

In our current economic crisis, many people are forced into bankruptcy even without a deficiency judgment and it seems likely that—if borrowers were to start getting stuck with deficiency judgments—many of them would seek bankruptcy protection. This consideration is no doubt a powerful deterrent to lenders and third parties. After all, they would not want to go through all the time and expense of obtaining the judgment just to see it melt away in bankruptcy proceedings.

For these reasons, while a deficiency judgment is always a theoretical possibility, it is probably very unlikely in most situations. Foreclosure defense attorneys like me are always alert to new trends, and we have a close eye on this issue because it could very well change the industry if lenders start aggressively pursuing deficient amounts. Also, it is always possible that some state or federal legislation might come along and change the analysis, just as the Mortgage Forgiveness Debt Relief Act changed the tax analysis.

This field of law seems to be in an almost constant state of flux, so you should always address your particular situation to an attorney licensed in your state.

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