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Should I Stay or Should I Go?
Options for Underwater Homeowners in California

After almost five years, the U.S. housing market continues to struggle. California has been particularly hard hit. Zillow reported in August 2011 that housing values in California dropped 7.2% between 2010 and 2011. Different sources estimate that between one-quarter and one-third of California homeowners are underwater on their mortgages. In some regions, such as the Inland Empire and the Sacramento area, 50% of homeowners are believed to be underwater.

If you are one of the many homeowners who owe more on your mortgage than your house is worth, there are several options available to you; however, each has its drawbacks. The following is a guide to navigating the financial and legal considerations, and understanding your options if you have an underwater home.

Determine the Liability to Your Lender(s)
When considering options for staying in your home or leaving it, you should understand your

potential liability to the lender(s). If a homeowner defaults on the promissory note and the home is foreclosed, under certain circumstances, the lender may seek a deficiency judgment. When this happens, the lender can go beyond the security (your home, whose value is now less than the loan amount) and seek recovery from you, the homeowner, for the unpaid balance of the debt (the deficiency).

California has a number of anti-deficiency laws that protect homeowners. These laws are complex and vary in effectiveness depending on your circumstances. One of the most powerful and useful anti-deficiency laws is Code of Civil Procedure section 580d. This protection bars a deficiency judgment when the lender elects a non-judicial foreclosure (also known as a trustee sale) rather than a judicial foreclosure. Both of these types of foreclosures are explained under Option 5, below. Regardless of the inadequacy of the non-judicial foreclosure sale proceeds to cover the debt, there is no further recovery for the foreclosing lender.

A second anti-deficiency protection concerns how your property was financed and whether there was a purchase money loan. The most common type of purchase money loan in the residential context occurs when the promissory note is secured by a residential property of four or fewer units and is occupied, in whole or in part, by the borrower. Under Code of Civil Procedure section 580b, if the loan is purchase money, the lender has no right to recover a deficiency judgment after foreclosure, regardless of which foreclosure method is chosen. In other words, a purchase money loan may bar your lender's right to recover the shortfall between the sale price and the amount of the outstanding loan balance following either a judicial or non-judicial foreclosure. That is not necessarily the case with a non-purchase money loan.

Determine Eligibility for the Mortgage Forgiveness Debt Relief Act of 2007 (Applicable through 2012)

When debt is canceled or forgiven, the canceled amount may be taxable. The Mortgage Debt Relief Act of 2007 generally allows taxpayers to exclude from income the canceled debt on their principal residence. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for the relief. This provision applies to debt forgiven in calendar years 2007 through 2012. Up to $2 million of forgiven debt is eligible for this exclusion ($1 million if married filing separately). The exclusion does not apply if the discharge is due to services performed for the lender or any other reason not directly related to a decline in the home's value or the taxpayer's financial condition. More information, including detailed examples can be found in IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments. Also see IRS news release IR-2008-17.

California law largely conforms to the federal Mortgage Forgiveness Debt Relief Act for discharges that occur in tax years 2007 through December 31, 2012. However, California limits the amount of qualified principal residence indebtedness to $800,000 for taxpayers who file as married/registered domestic partners (RDP) filing jointly, single, head of household, or widow/widower, and to $400,000 for taxpayers who file as married/RDP filing separately. You should consult with a qualified CPA or tax attorney regarding these and any other tax matters.

Options for the Underwater Homeowner

Option 1: Status Quo

With this option, you remain in the home and continue to make timely payments. If this option is chosen, and the intent is to remain for the long-term (at least five years), the homeowner should, at a minimum, make interest-only payments to prevent the principal from increasing (also called negative amortization). For those borrowers with adjustable loans, the uncertainty of future interest rates and periodic changes in interest rates may make this option unpredictable and unrealistic. When deciding whether or not to remain in the home, an important consideration is the cost of alternative housing. Renting a similar property may be less expensive than staying in your home.

Upside: Your credit score should not be negatively affected if you do not default on your mortgage. You retain your home.

Downside: You continue to pay on a loan valued in excess of the home.
If the interest rate is not fixed, it may rise in the future, resulting in unpredictable and increased monthly payments.

Option 2: Seek a Loan Modification

A loan modification is a permanent change in one or more of the terms of a borrower's loan. A loan modification agreement can make a home loan more affordable by lowering the interest rate, increasing the number of years of the loan, and/or reducing the principal. Lenders typically require the borrower to submit substantial documentation to establish his or her financial distress, such as tax returns, paycheck stubs, bank statements, and a hardship letter. The borrower's financial distress is weighed against the borrower's ability to afford a modified loan. The federal government has become more involved in modifications by creating incentives for financial institutions to engage in loan modifications, and through outright regulation in an effort to reduce foreclosure rates. However, these programs (HAMP, HARP) have failed to substantively change the bleak housing landscape.

Sometimes a permanent modification is preceded by a temporary loan modification wherein homeowners comply on a trial basis, by providing the required documentation to a lender and making all agreed-upon payments towards the temporarily modified loan. However, lenders do not always provide homeowners who have satisfied all requirements of a temporary loan modification with a permanent loan modification.

Upside: A successful loan modification should result in a fixed interest rate providing a predictable monthly mortgage payment.

Downside: Notwithstanding the recent involvement by the federal government, many lenders are unwilling or unable to make loan modifications on a broad scale. Additionally, there may be tax consequences, as the IRS may view savings from a loan modification as income. The Mortgage Forgiveness Debt Relief Act, effective through December 2012, may offer protection. A proposed loan modification should be reviewed by a tax expert.

Option 3: Short Sale

A short sale refers to a transaction in which a secured lender agrees to accept less than the outstanding loan balance as full satisfaction of the loan obligation. Unlike loan modifications, lenders are not required to consider a short sale. However, lenders often consider short sales to avoid the cost, delay, and uncertainty of a foreclosure and the subsequent costs related to marketing and selling the property. Factors that lenders tend to consider when evaluating short sale proposals are the amount of the proposed payment shortfall and market conditions in the area where the property is located. As with loan modifications, lenders typically will require the borrower/seller to submit substantial documentation to establish his or her financial distress, such as tax returns, paycheck stubs, bank statements, and other financial information.

As of July 2011, California Code of Civil Procedure section 580e provides that when a lender approves a short sale in writing, the lender cannot later seek payment for the unpaid loan balance. The law also prohibits a lender from demanding a seller contribution as a condition of short sale approval. Previously, it was common for a lender to require the seller to contribute some cash to approve the sale. Section 580e assures homeowners that a short sale will not result in a deficiency owed to the lender.

Upside: Upon sale of the home and subsequent shortfall between sale price and loan obligation, the lender agrees that there is no borrower deficiency (and therefore no personal liability) on the outstanding loan balance. Lenders are prohibited by law from requiring a borrower to compensate the lender in exchange for a lender's written consent to a short sale.

Downside: To qualify, lenders will typically require the seller to submit substantial documentation to establish his or her financial distress. After a lender agrees that a property is eligible for a short sale, the lender then needs to accept an offer. Forgiveness of debt is generally taxable as ordinary income. A proposed short sale should be reviewed by a tax expert regarding the application of the Mortgage Debt Relief Act of 2007. A short sale also would result in a reduction in the seller's credit score similar to that of a foreclosure for approximately the same length of time. See the FICO Analytics Blog for more details.

Option 4: Deed in Lieu of Foreclosure

Under this scenario, a borrower deeds the property to the lender in satisfaction of the secured debt. Essentially, the borrower and lender work out an agreement to turn over the property to the lender. There is no obligation on the part of lenders to accept the property in satisfaction of the loan amount. Lenders are wary of obtaining property by a deed in lieu because of potential liens and claims that may be outstanding but not recorded. With a foreclosure, on the other hand, there are no such concerns for a lender. A borrower should only agree to a deed in lieu of foreclosure if there is agreement with the lender that there is no deficiency after the conveyance.

Upside: If the lender agrees to relieve you from any deficiency after the deed in lieu is complete, this can be a relatively quick way to release yourself from the burden of an unaffordable mortgage.

Downside: This transaction results in approximately the same negative effect on your credit score as a foreclosure. If the lender accepts the property in satisfaction of the loan even though the loan balance exceeds the fair market value of the property, the transaction is treated as cancellation of indebtedness income and may be taxed. As with the other options, a proposed deed in lieu should be reviewed by a tax expert.

Option 5: Foreclosure

Two types of foreclosures exist: judicial and non-judicial. Whether a foreclosure is judicial or non-judicial is up to the foreclosing lender, not the borrower.

5a: Judicial Foreclosure

Here, the lender files a complaint in superior court that requests the court to:

(1) Determine that the loan is in default;
(2) Order that the security be sold to satisfy the loan balance;
(3) Declare that the debtor is liable for any deficiency arising from an insufficient sale price at the foreclosure sale; and
(4) Enter a deficiency judgment.

It is more costly for a lender to pursue a judicial foreclosure than a non-judicial foreclosure, and as a result, lenders in California rarely opt for a judicial foreclosure.

Upside: The judicial foreclosure process takes several years. During this time, the borrower remains in the home and makes no mortgage payments. For a limited time, the borrower has a post-foreclosure right of redemption to buy back the home at the foreclosure price plus costs.

Downside: The borrower most likely will be liable for a deficiency judgment, and assets beyond the home are available to satisfy the shortfall owed to the lender. The borrower's credit score will suffer.

5b: Trustee Sale/Non-judicial Foreclosure

A deed of trust typically contains a power of sale clause that grants the lender or trustee the right to sell the property at public auction, without resorting to a court for authorization, upon default in the payment of the debt. A trustee sale bypasses the courts altogether, which means that the matter is usually handled in significantly less time than a judicial foreclosure. The entire process often can be completed in about four months after the Notice of Default is recorded. A trustee sale is not subject to the borrower's post-sale right of redemption. By opting for a non-judicial foreclosure, a foreclosing lender is precluded by California law from seeking a deficiency judgment after the sale. The overwhelming majority of foreclosures in California occur through a trustee sale.

Upside: California statute bars a deficiency after a non-judicial foreclosure.

Downside: A second in priority lender, under certain circumstances, may seek a deficiency. The borrower's credit score will suffer.

The challenges that underwater homeowners face are often daunting and the appropriate option is not always apparent. If you have any questions regarding the options listed in this paper, or have other real estate legal concerns, we invite you to contact us at 510-379-8839 or info@tubmanlawgroup.com.

About Tubman Law Group, P.C.

Tubman Law Group assists real estate investors and homeowners in purchases, sales (including short sales), property leases, and unlawful detainers (evictions). We also operate in the niche area of Mobilehome Law, helping park owners navigate this specialized area of law.

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