

## ADVISING YOUR CLIENT IN FORECLOSURE

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“I am behind in my payments,”<sup>1</sup> “I am in foreclosure or about to be served with papers,” and “I want to keep my home.”<sup>2</sup> This is the mantra many attorneys across the country have been hearing during the Great Recession.<sup>3</sup> Home foreclosures in the United States reached record heights in 2010.<sup>4</sup> As of June 30, 2011, Flor-

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1. As one commentator observed,

The Mortgage Bankers Association’s (MBA) National Delinquency Survey shows the delinquency rate for mortgage loans on one-to-four-unit residential properties increased to a seasonally adjusted rate of 8.44 percent of all loans outstanding as of the end of the second quarter of 2011. That’s up slightly from the first quarter but down nearly one and a half percent from the second quarter of 2010. The delinquency rate includes loans that are at least one payment past due but does not include loans in the process of foreclosure. The percentage of loans in the foreclosure process at the end of the second quarter was 4.43 percent, down nine basis points from the first quarter and 14 basis points lower than one year ago.

Mark Huffman, *More Homeowners Falling Behind on Mortgage Payments*, <http://www.consumeraffairs.com/news04/2011/08/more-homeowners-falling-behind-on-mortgage-payments.html> (Aug. 22, 2011); see also Nick Timiraos, *Home-Loan Delinquencies Rise Again*, Wall St. J. A3 (Aug. 23, 2011) (describing an increase in delinquent mortgages).

2. This is often compounded by additional problems such as: “I lost my job,” “I have major medical bills,” “I have five children,” or “I make only \$25,000 a year.” A more egregious problem could be complicated by defective Chinese drywall contaminating the property, making the home value worthless, and leaving the client with no place to live—or worse yet—with two mortgages. See Anthony Westbury, *Anthony Westbury: Chinese Drywall Problems Forcing Some into Foreclosure*, <http://www.tcpalm.com/news/2009/jul/06/anthony-westbury-chinese-drywall-problems-some/> (posted July 6, 2009, 4:15 p.m. ET) (discussing a case in which issues resulting from defective Chinese drywall forced homeowners to leave their home).

3. See generally Suzy Khimm, Wonkblog, *The Great Recession in Five Charts*, [http://www.washingtonpost.com/blogs/ezra-klein/post/the-great-recession-in-five-charts/2011/09/13/gIQANuPoPK\\_blog.html](http://www.washingtonpost.com/blogs/ezra-klein/post/the-great-recession-in-five-charts/2011/09/13/gIQANuPoPK_blog.html) (posted Sept. 13, 2011, 12:52 p.m. ET) (analyzing the 2010 U.S. Census and stating that “Americans are earning even less than they did 13 years ago” (emphasis in original)). In 2010, the real median income had fallen to \$49,455, which is the lowest since 1997. *Id.* The poverty level had also risen to 15.1%, which is its highest since 1993. *Id.*

4. Associated Press, *U.S. Home Foreclosures Hit New Record, but Many Face Challenge*, <http://www.foxnews.com/politics/2010/10/14/record-number-foreclosures-face-challenge-court/> (Oct. 14, 2010). “Today there are least 4.2 million homeowners . . . in the delinquency and foreclosure process.” Kevin G. Hall, *Mortgage Modifications Are Still*

ida's Office of the State Courts Administrator found that 260,815 foreclosure cases were pending at the start of the year, and approximately 117,000 new cases were filed in Florida.<sup>5</sup>

But what do you say to the client who comes into your office? What options do you provide a client who is facing home foreclosure? This Article summarizes the state of foreclosures and the slew of options available for the homeowners who walk into the general practitioner's office. This Article first introduces the current national foreclosure crisis. Next, in Part II, this Article discusses the basic aspects of representing a client in foreclosure. In Part III, this Article explains deficiencies, followed by income tax consequences in Part IV. Part V details the impact a foreclosure has on one's credit, and Part VI differentiates between judicial and nonjudicial foreclosures. Part VII details foreclosure defense tactics, and Part VIII examines mediation as an alternative to foreclosure. Part IX describes the processes of both Chapter 7 and Chapter 13 bankruptcy. Part X examines the process of stopping a foreclosure with a deed in lieu, and Part XI describes the short sale process. Next, in Part XII, the Article details stopping a foreclosure with a modification, refinance, or redemption. Part XIII examines the homeowner's options of either renting or staying in the foreclosed home. Part XIV explains the process for setting aside a foreclosure sale, and Part XV provides a summary. The answers may not be simple, and the right answer depends on the particular facts of each homeowner's situation. Every practitioner, however, should know enough to be dangerous—and effective—in the area of foreclosures.

### *I. CURRENT STATE OF FORECLOSURES IN THE COUNTRY*

One only needs to read the news to see the condition of foreclosures in this country.<sup>6</sup> More homeowners are losing their

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*Messed Up, 4 Years Later*, <http://www.mcclatchydc.com/2011/09/29/125642/mortgage-modifications-are-still.html> (Sept. 29, 2011).

5. Gary Blankenship, *Foreclosure Backlog Cut by 40%: But Many Cases May Find Their Way Back to Court*, Fla. B. News 1, 1 (Sept. 15, 2011).

6. See e.g. Christine Dunn, *Foreclosures Climbing*, Providence J. A1 (Sept. 20, 2011) (stating that the amount of foreclosures in Rhode Island has become a "persistent problem" and that the high housing costs are burdening both homeowners and renters); Jon Prior, *Foreclosures in 2011 to Break Last Year's Record: RealtyTrac*, <http://www.housingwire>

homes than at any other time in history, and more homeowners are behind on their mortgages than ever.<sup>7</sup> Bankruptcy filings are approaching the highest levels seen in years.<sup>8</sup>

The time it takes for a foreclosure to be completed in this country is staggering.<sup>9</sup> Some homeowners are staying in their homes without making payments for well over a year.<sup>10</sup> This delay can be blamed on a number of factors: poor documentation of loans,<sup>11</sup> delay by lenders in implementing a loan modification, litigation over pooling and servicing agreements,<sup>12</sup> the courts'

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.com/2011/01/12/foreclosures-reach-record-high-in-2010-realtytrac (posted Jan. 12, 2011, 11:01 p.m. ET) ("Lenders filed a record 3.8 million foreclosures in 2010, up 2% from 2009 and an increase of 23% from 2008, according to RealtyTrac. But 2011 could be even worse. RealtyTrac follows filings across the country that include notices of default, scheduled auctions[,] and REO. The number in 2010 would have been higher were it not for the foreclosure moratoria banks announced in October when employees were found to be signing and filing affidavits improperly in what has become known as the robo-signing scandal. RealtyTrac CEO James Saccacio said as many 250,000 foreclosures will likely be resubmitted and added to the numbers for 2011. Daren Blomquist, who edits the RealtyTrac monthly reports, said the record set in 2010 will not last for long. 'We don't think we've peaked yet nationwide,' Blomquist told HousingWire. 'We're expecting the 2011 numbers to be slightly higher than 2010, and then start the downward trend toward "normalcy" in 2012.'").

7. See *supra* n. 1 and accompanying text.

8. See Craig D. Robins, *Bankruptcy Filings Are Reaching Record Numbers Again*, <http://longislandbankruptcyblog.com/bankruptcy-filings-reaching-record-numbers/> (Jan. 13, 2011, 1:30 p.m. ET) (stating that over one and a half million consumers filed for bankruptcy in 2010, the most since two million were filed in 2005).

9. See David Kestenbaum, NPR Housing Blog, *How Long Does Foreclosure Take?* <http://www.npr.org/blogs/money/2010/10/26/130833818/foreclosure> (Oct. 26, 2010, 12:57 p.m. ET) (stating that the average judicial foreclosure takes 271 days).

10. See *id.* ("So after 13 months of not paying the person gets a foreclosure notice . . . and that's where the clock starts on 'days in foreclosure.'").

11. State attorneys general conducted a fifty-state investigation that resulted in proposals to the banking industry concerning "lost paperwork, long delays, misinformation[,] and lack of feedback from the servicers." Brady Dennis, *State Attorneys General Tackle Mortgage Servicing*, <http://www.washingtonpost.com/wp-dyn/content/article/2011/03/17/AR2011031704964.html> (posted Mar. 18, 2011, 4:54 p.m. ET).

12. Generally:

Litigation has arisen where a mortgagor is in default on its mortgage, thereby affecting the value of the pooled assets, or is otherwise out of compliance with the terms of the mortgage. The purchaser of the pooled assets (i.e., the financial institution investing in the mortgage-backed securities) or the mortgage servicer may sue the seller (i.e., the investment bank offering the mortgage-backed securities) for breach of contract. The purchaser of the pooled assets may also sue the seller for breach of the representations and warranties under the PSA [Pooling and Servicing Agreement]. The causes of action for a breach of a securitization agreement claim mirror those for breach of contract[.]

inability to staff the large amount of foreclosure cases,<sup>13</sup> mandatory mediation,<sup>14</sup> loans made in which there was inadequate collateral, forging of application documents, securitization,<sup>15</sup> inappropriate high-value appraisals on properties, dropping home values, adjustable-rate mortgages, predatory lending, corporate greed, robo-signing,<sup>16</sup> court rules that allow abuse, and a lack of interest by lenders.<sup>17</sup> In short, numerous factors contributed to the perfect foreclosure storm. The reality is that—regardless of the cause of the delay in completing the foreclosures—until the housing market is back on track and the foreclosure backlog is resolved, America will be stagnant in economic growth.<sup>18</sup>

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Robert M. Abrahams, 8 Bus. & Com. Litig. Fed. Cts. *Business and Commercial Litigation in the Federal Courts*, vol. 8, § 90:12, 430 (Robert L. Haig ed., 2d ed., Thompson/West 2005).

13. Foreclosure cases have inundated court dockets. “Clearing the pipeline in New Jersey, which like New York handles foreclosures through the courts, would take 49 years. In Florida, Massachusetts[,] and Illinois, it would take a decade.” David Streitfeld, *Backlog of Cases Gives a Reprieve on Foreclosures*, N.Y. Times A1 (June 19, 2011) (available at <http://www.nytimes.com/2011/06/19/business/19foreclosure.html?pagewanted=1&r=1>).

14. See e.g. Fla. Sup. Ct., *Managed Foreclosure Mediation Program*, [http://www.floridasupremecourt.org/pub\\_info/foreclosure.shtml](http://www.floridasupremecourt.org/pub_info/foreclosure.shtml) (accessed July 15, 2012) (providing information on Florida’s mandatory mediation program).

15. See generally *Transfer and Assignment of Residential Mortgage Loans in the Secondary Market* (ASF White Paper Nov. 16, 2010) (available at [http://www.americansecuritization.com/uploadedFiles/ASF\\_White\\_Paper\\_11\\_16\\_10.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_White_Paper_11_16_10.pdf)) (discussing the market for mortgage loans).

16. See Derek Kravitz, *Fannie Mae Cited for Not Stopping Robo-Signing*, [http://www.huffingtonpost.com/2011/09/23/fanne-mae-robo-signing\\_n\\_977471.html](http://www.huffingtonpost.com/2011/09/23/fanne-mae-robo-signing_n_977471.html) (Sept. 23, 2011) (“Mortgage industry employees—including law firms employed by Fannie Mae—signed documents they hadn’t read and used fake signatures on foreclosure cases across the country. The practices, known collectively as ‘robo-signing,’ resulted in a suspension of foreclosures last fall and a probe by all 50 state attorneys general into how corners were cut to keep pace with the crush of foreclosure paperwork.”).

17. See Todd Ruger, *Lenders’ Latest Foreclosure Strategy: Waiting*, <http://floridahomereliefteam.org/NewsandArticles/Lenderswaitingtoforeclose.aspx> (July 12, 2009) (stating that lenders are avoiding taking possession of homes because they are responsible for maintaining property they retake).

18. Laura D’Andrea Tyson, N.Y. Times Economix Blog, *Recovering from a Balance-Sheet Recession*, <http://economix.blogs.nytimes.com/2011/08/26/recovering-from-a-balance-sheet-recession/?src=busln> (updated Aug. 26, 2011, 10:04 p.m. ET) (“Many economists . . . warned in 2008 that the economy would not recover until the housing market recovered, and the housing market won’t recover until the debt overhang from the housing bubble is reduced through programs that shift some of the burden to creditors from debtors.”).

## II. THE PRACTICAL ASPECTS OF REPRESENTING HOMEOWNERS IN FORECLOSURE

Perhaps the most difficult aspect of representing homeowners in foreclosure cases is the lack of funds for the defense. Compared to the homeowner in foreclosure, the resources and money available to most lenders seems unlimited. After all, if a homeowner cannot afford the basic need of housing, hiring an attorney may fall to the bottom of the list of priorities. This plays a major role in why up to ninety-seven percent of homeowners in foreclosure are unrepresented.<sup>19</sup>

The unfair reality is that a foreclosure lawsuit can, and should be, one of the most document-intensive types of cases and can require hours of discovery. The sheer number of mortgage documents,<sup>20</sup> disclosure requirements,<sup>21</sup> laws and regulations<sup>22</sup>—not to mention the computer systems<sup>23</sup> that make the foreclosure process work correctly and accurately—are no match for the unrepresented homeowner in foreclosure. This can also be a challenge for a practitioner because of what is known as the “alphabet soup” of regulations<sup>24</sup> in the mortgage industry, which often takes years to master, even by the lawyers that represent the lenders.

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19. Rebecca Berfanger, *Court Programs, Economy among Focuses of Foreclosure Conference*, <http://www.theindianalawyer.com/court-programs-economy-among-focuses-of-foreclosure-conference/PARAMS/article/25214> (Nov. 24, 2010). “In Milwaukee, a study done by Legal Aid Society of Milwaukee, Chief Staff Attorney Catey Doyle, demonstrated that 97% of homeowners in Milwaukee go through the foreclosure process unrepresented.” J. Michael Collins & Andy Lewis, *Foreclosure Meeting Presentation 4*, [http://www.uwex.edu/ces/cced/documents/DaneCounty\\_foreclosure\\_meeting\\_southmadison.pdf](http://www.uwex.edu/ces/cced/documents/DaneCounty_foreclosure_meeting_southmadison.pdf) (accessed July 15, 2012).

20. See Todd Ruger, *Judges Studying Home Suits*, Herald Trib. BN1 (Jan. 2, 2011) (available at <http://www.heraldtribune.com/article/20110102/article/101021039>) (stating “the amount of paperwork is overwhelming”).

21. See e.g. FDIC, *Regulation Z (Truth in Lending) Early Disclosure Requirements*, <http://www.fdic.gov/news/news/financial/2009/fi109026.html> (June 1, 2009) (discussing and summarizing revisions to mortgage disclosure laws).

22. See Ruger, *supra* n. 20, at BN1 (calling foreclosure defense “sophisticated and quickly evolving”).

23. See Jeremy Hobson, *Some Courts Say Computer System Doesn't Own Mortgages*, <http://marketplace.publicradio.org/display/web/2010/10/07/pm-some-court-says-computer-system-doesnt-own-mortgages/> (Oct. 7, 2010) (“The MERS system, which stores mortgage data electronically, is being scrutinized by homeowners who are wondering why their foreclosure notices are invalid.”).

24. The mortgage industry is riddled with regulations and vocabulary that can cripple a practitioner who does not have familiarity in the area of mortgage law. For example, the following are just a sampling of the federal laws and regulations that surround the mort-

Moreover, without a regulatory risk,<sup>25</sup> a class action risk,<sup>26</sup> or some other “Ford Pinto Case”<sup>27</sup> media-relations problem, there is little reason for a lender to refrain from moving a foreclosure forward. For many lenders, the bottom line is that the homeowner entered into a contract, missed mortgage payments, and failed to follow through on his or her commitment. This results in the homeowner feeling like a number instead of an individual, with no help in sight because the foreclosure case forges ahead with no viable solution and without major consequences.

In addition, for the typical legal practitioner learning about foreclosure defense, it is more than just learning how to defend a lawsuit and advise a client. An understanding of the mortgage industry—regulations, laws, tangential areas of bankruptcy, modifications, and a dedication to a practice area of astronomical proportions—is a necessity. To fully counsel a client with a foreclosure lawsuit, a legal practitioner has to understand in detail all the options available to the client. Those options extend beyond the scope of knowledge that can be produced in this Article.<sup>28</sup> In other words, to really be of value to a client facing foreclosure, a practitioner has to learn several areas of the law to give a client a full range of options.

The emotional side of helping a homeowner in foreclosure is a minefield, and quite often the lawyer acts as a psychologist as

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gage industry: HMDA (Home Mortgage Disclosure Act), RESPA (Real Estate Settlement Procedures Act), TILA (Truth in Lending Act), ECOA (Equal Credit Opportunity Act), FCRA (Fair Credit Reporting Act), GLBA (Gramm-Leach-Bliley Act), OFAC (Office of Foreign Assets Control), and BSA (Bank Secrecy Act). Couple all that regulation with the required knowledge of state law associated with mortgages, the UCC (Uniform Commercial Code), and recording regulations, and the average legal practitioner can be quickly overwhelmed when working on a foreclosure matter.

25. See *supra* n. 24 (providing a list of regulations). See e.g. Dick K. Nanto, *The Global Financial Crisis: Analysis and Policy Implications* 9 nn. 36–37, 112 (Cong. Research Serv. RL34742 2009) (available at <http://www.fas.org/sgp/crs/misc/RL34742.pdf>) (discussing policy and regulatory oversight responses to the economic and foreclosure crises).

26. See e.g. *Countrywide Settlement*, <http://www.countrywidesettlementinfo.com/FAQs.htm>; select What does it mean to give up my right to be part of a class action lawsuit against Countrywide? (accessed July 15, 2012) (stating that foreclosure settlement payments require homeowner to forego the right to join a class action lawsuit).

27. See Gary T. Schwartz, *The Myth of the Ford Pinto Case*, 43 Rutgers L. Rev. 1013, 1015–1017 (1991) (describing a multi-million dollar products-liability case in which a corporation was held criminally liable for the much-publicized deaths of three girls).

28. See generally John Rao et al., *Foreclosures: Defenses, Workouts, and Mortgage Servicing* (3d ed., Nat'l Consumer L. Ctr. 2010) (providing a full treatise of information to assist the legal practitioner).

well as a legal counselor. Telling people they have to move from their home can be quite difficult, and ultimately, the legal process has to be flexible enough to accommodate the emotional adjustment. Clients may want to stay in the home as long as possible, often citing a number of reasons why they cannot move: “I cannot find a place that takes dogs,” “My children will lose their friends and school district,” “I have accumulated fifteen years of stuff to move, and I am not sure how I am going to do it,” and “I cannot afford a down payment on a new place.” The end result is that rather than making an immediate decision on a course of action that will allow a client to move on with life, the client delays the inevitable, resulting in preventable tax consequences.<sup>29</sup>

Perhaps one of the biggest challenges is the client who insists that a neighbor, friend, or relative was able to stay in a foreclosure house for free,<sup>30</sup> or was able to obtain a large principal reduction through a modification, and that the client, therefore, is entitled to keep the home in question. Or perhaps a client insists that mortgage documents were signed under fraud,<sup>31</sup> with bad appraisals,<sup>32</sup> or because of some other impropriety on the lender’s part.<sup>33</sup> Often the homeowner fails to understand that the lender

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29. See *Canceled Debts, Foreclosures, Repossessions, and Abandonments*, IRS Pub. No. 4681, at 4 (2010) (available at <http://www.irs.gov/pub/irs-pdf/p4681.pdf>) [hereinafter *Canceled Debts*] (stating that reduced debt owed to the seller of a purchased property does not qualify as taxable income if the homeowner reduces her “basis in the property by the amount of the reduction of [her] debt to the seller”).

30. See *e.g. Greene v. Gib. Mortg. Inv. Corp.*, 488 F. Supp. 177, 181 (D.D.C. 1980) (enjoining foreclosure proceedings permanently and voiding the note and mortgage).

31. See *First Charter Nat’l Bank v. Ross*, 617 A.2d 909, 911 (Conn. App. 1992) (discussing how the defendant’s husband had misrepresented the identity of the mortgage documents that he had the defendant sign); see also *Jones v. Adams Fin. Servs.*, 84 Cal. Rptr. 2d 151 (Cal. App. 2d Dist. 1999) (discussing how a blind creditor was tricked into signing mortgage documents).

32. See David Streitfeld, *Appraisal Shift Gives Lenders More Power, and Draws Critics*, N.Y. Times A1 (Aug. 19, 2009) (available at 2009 WLNR 16127480) (discussing how many appraisers during the housing boom inflated values and ignored defects in homes to facilitate the granting of mortgages); see also *Ware v. Indymac Bank, FSB*, 534 F. Supp. 2d 835, 839 (N.D. Ill. 2008) (discussing the plaintiffs’ allegations that the defendant had overstated the purchase price of the plaintiffs’ home on the loan application); *Callahan v. First Merit Mortg. Corp.*, 2005 WL 3867346 at \*\*1–2 (Ohio Mun. Sept. 22, 2005) (explaining how the difference between the plaintiffs and the defendant’s appraisal of the plaintiff’s home interfered with the plaintiff’s objective of obtaining the lowest mortgage rate without points).

33. See *e.g. Greene*, 488 F. Supp. at 179 (stating that the court “need not decide this case on any statutory basis[,] for this entire transaction was tainted with fraud and misrepresentation”).

has absolutely no obligation to work with the homeowner (or any interest in doing so) by reducing the principal or cutting the interest rate.<sup>34</sup> Explaining to clients that stories of free homes or dramatic modifications are generally not the normal way of things can be difficult when clients emotionally believe they are entitled to keep their homes at all costs.<sup>35</sup>

There are several steps a lawyer can take when trying to help clients with the emotional side of losing their home to foreclosure. The first step is the clinical approach, which is to carefully lay out the options and the various consequences to the client. The emotional strain of being sued, however, can make it difficult for some to understand the best choices for their particular situation, which means an attorney must be both empathetic and firm in explaining the options. The second step is to lay out a plan of attack with backup options for the client. For example, start with the response to the foreclosure lawsuit as the initial step, then have the client attend mediation while requesting modification, and then ultimately lay out the worst-case scenario for the client, such as bankruptcy or deed in lieu, as the final backup plan. Using a step-by-step approach of options in such an order can lead to the client's emotional acceptance of losing the home, while at the same time working through every possible option for the client to keep the home.

In short, the best approach for a practitioner with a client in foreclosure is to advise the client there are no guarantees of remaining in the home. Explain the process both verbally and in writing, and be sure the client understands that failure to positively act may result in an outcome that does not conform to the client's wishes. Finally, be sure to understand what options and consequences there are for a client who is facing foreclosure so that both the client and the attorney are prepared for any contingency.

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34. A favorite mantra of the homeowner is: "I just don't understand why the bank will not work with me, since it does not make sense for the bank to take the home." Explaining to the homeowner that it is in the bank's best interest to take the home for numerous reasons, such as unloading the corporate books of assets at the end of the year, obtaining tax benefits, or selling deficiencies for profit, can be difficult.

35. Many times rumors of immediate relief from foreclosure woes can actually be traced back to foreclosure scams. Fannie Mae, *Beware of Scams*, <http://www.fanniemae.com/>; *select* Helping Homeowners & Communities, *select* Beware of Scams (accessed July 15, 2012).



### III. DEALING WITH DEFICIENCIES

One of the biggest concerns for a homeowner is the deficiency judgment from a foreclosure sale. When the foreclosure is completed and the sale of the home is not enough to cover the proceeds of the loan, in some states the lender can go after the difference.<sup>36</sup> This was not necessarily a risk for homeowners when the mortgage boom began, but as property values declined and lenders lost more of their secured collateral, deficiency judgments have become much more common.

The real value that has yet to be determined from foreclosures is the profits gained from a deficiency, and any homeowner facing a foreclosure should be advised of such by an attorney. One of the biggest concerns for a client in foreclosure is whether the client resides in a deficiency-judgment state. In states that do not have an anti-deficiency statute, a lender can sue for the difference in price between the price at which the house is sold in foreclosure and the amount that was still due under the note to be paid.<sup>37</sup> A deficiency judgment can be quite crippling for a client because it creates an unsecured debt<sup>38</sup> that if pursued to judgment, can result in wage garnishments and other assets being sold to satisfy the difference.<sup>39</sup>

Often, the amount of a deficiency must be proved by a lender in a separate lawsuit,<sup>40</sup> which may give the homeowner a second bite at the apple to fight the foreclosure and sale. Also, most states impose a statute of limitations for pursuing a deficiency, which can assist the homeowner if the lender waits long enough to pursue the deficiency.<sup>41</sup>

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36. Forty-one states and the District of Columbia permit deficiency judgments. Rao et al., *supra* n. 28, at app. E, 905–927 (providing a summary of state foreclosure laws and indicating which states permit deficiency judgments).

37. *Id.* at § 14.3.1–2, 481. For examples of anti-deficiency statutes, see Alaska Stat. § 34.20.100 (Lexis 2008); Ariz. Rev. Stat. Ann. § 33-814G (West 2007); Cal. Civ. P. Code Ann. § 580d (West 2009). A deficiency judgment can also be limited. See Iowa Code Ann. § 654.26 (West 2009) (specifying limited circumstances under which a deficiency judgment may be sought); 14 Me. Rev. Stat. Ann. § 6323 (2008) (limiting deficiency to amount established on date of sale).

38. Rao et al., *supra* n. 28, at § 14.3.5, 485.

39. *Id.* at § 14.3.1, 481.

40. *Id.* at § 14.3.4, 484.

41. *Id.* at § 14.3.2, 481–482 (noting that only fifteen states impose no limitations on the ability to pursue deficiency judgments). A number of states have statute-of-limitation dates as short as three months for filing claims for mortgage deficiencies. *Id.* at § 14.3.2,

Deficiency judgments can also be sold on the secondary market.<sup>42</sup> There is a billion-dollar market for the buying and selling of debt in America, and deficiency judgments are not immune to capitalism and corporate profit.<sup>43</sup> Because of the current stalling and glut of foreclosures in the legal system, the real value of these deficiencies has yet to be determined. The amount of a deficiency judgment can sometimes be limited based upon equitable grounds,<sup>44</sup> but again the homeowner is often not in a position to pay for a legal defense. The good news is that a deficiency is treated as unsecured debt in a bankruptcy proceeding and can be discharged accordingly.<sup>45</sup>

#### IV. FORGIVENESS OF DEBT: INCOME TAX CONSEQUENCES

To effectively deal with the tax consequences of a foreclosure, a client facing foreclosure must have an excellent attorney and an excellent accountant. It is a grave mistake for an attorney to give both tax and foreclosure advice to a client without understanding the client's full financial picture: past, current, and future. It is best to work with an accountant—selected by the client—to assist with the tax consequences of a foreclosure. More importantly, it is wise to be aware of the various tax consequences, so the client can fully consider the tax strategy as part of the foreclosure.

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482. Florida has no specific requirements and places the determination of the statute of limitations within the "sound judicial discretion of the court." Fla. Stat. § 702.06 (2011).

42. See Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 Duke L.J. 1399, 1406 (2004) (noting the drastic expansion of the secondary market). Further, "close observers of the housing scene are convinced this is just the beginning of a surge in deficiency judgments. Sharon Bock, clerk and comptroller of Palm Beach County, Fla., expects 'a massive wave of these cases as banks start selling the judgments to debt collectors.'" Jessica Silver-Greenberg, *House Is Gone but Debt Lives On*, <http://online.wsj.com/article/SB10001424053111904060604576572532029526792.html> (Oct. 1, 2011).

43. See Rick Jurgens & Robert J. Hobbs, *The Debt Machine: How the Collection Industry Hounds Consumers and Overwhelms Courts* 22 (Nat'l Consumer L. Ctr. 2010) (available at <http://www.nclc.org/images/pdf/pr-reports/debt-machine.pdf>) (noting that "billions of dollars of debt obligations, legal claims[,] and judgments chang[e] hands each year").

44. See Rao et al., *supra* n. 28, at § 14.3.2, 482 (describing the "fair value" and "upset bid" concepts imposed by some states that modify the deficiency based on certain equitable values).

45. *Id.* at § 14.3.5, 485. The deficiency may become secured, however, if a judgment lien is obtained prior to the bankruptcy being filed. *Id.*

Serious tax consequences can arise if a loan is forgiven through the foreclosure process, modification, short sale, or deed in lieu.<sup>46</sup> The general rule is that debt forgiveness is considered income for tax purposes.<sup>47</sup> Loan proceeds not returned to the lender are taxable when forgiven by the lender.<sup>48</sup> The lender will issue IRS form 1099-C, Cancellation of Debt,<sup>49</sup> to the client and to the IRS to give notice of the tax due.<sup>50</sup>

Sometimes, the cancellation of debt is not taxable to the client.<sup>51</sup> For example, if the client files for bankruptcy or can meet an insolvency test, then the loan's forgiveness would be a non-taxable event.<sup>52</sup> A discharge of the debt associated with a principal residence can generally be forgiven as income and is not taxable under the Mortgage Forgiveness Debt Relief Act of 2007.<sup>53</sup> Thus, taxability may depend on whether the home is the primary residence or a rental property. Modification of a primary-residence loan and debt forgiven as a result of foreclosure of the primary residence are excluded from income from 2007 through 2012, so long as the modification or debt forgiven is related to a decline in home value or the taxpayer's financial situation.<sup>54</sup>

At the onset of the foreclosure process, understanding whether the client will have a tax liability associated with the foreclosure is important for the practitioner advising the client. The worst-case scenario would result in the client trading a

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46. See *Canceled Debts*, *supra* n. 29, at 2 (stating that certain canceled debts must be reported as income for tax purposes).

47. *Id.*

48. *Id.*; IRS, *Home Foreclosure and Debt Cancellation*, <http://www.irs.gov/newsroom/article/0,,id=174034,00.html> (last reviewed or updated Oct. 13, 2011).

49. For a recent version of the 1099-C form, see IRS Form 1099-C (2011) (available at <http://www.irs.gov/pub/irs-pdf/f1099c.pdf>).

50. IRS, *Form 1099-C, Cancellation of Debt*, <http://www.irs.gov/formspubs/article/0,,id=239579,00.html> (last reviewed or updated Oct. 11, 2011); IRS, *supra* n. 48.

51. See 26 U.S.C. § 108(a) (2006) (providing exclusions to the requirement of reporting discharged or canceled debt as income).

52. *Id.* The insolvency test states that the homeowner must be insolvent immediately before the cancellation to the extent that the total of the homeowner's liabilities was more than the fair market value of all assets before the cancellation. *Canceled Debts*, *supra* n. 29, at 4.

53. Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, § 2, 121 Stat. 1803, 1803-1804 (2007) (codified as amended in scattered sections of I.R.C.).

54. IRS, *The Mortgage Forgiveness Debt Relief Act and Debt Cancellation*, <http://www.irs.gov/individuals/article/0,,id=179414,00.html> (last reviewed or updated Jan. 24, 2012); see also *Canceled Debts*, *supra* n. 29, at 8 (providing examples of how the act would apply in certain situations).

secured liability for a tax due because unlike the secured liability, the tax due would not be dischargeable in bankruptcy.<sup>55</sup> Therefore, understanding the tax implications of foreclosure can make a huge difference strategically when deciding on a bankruptcy or foreclosure-defense strategy.

### V. CREDIT IMPLICATIONS

Many homeowners are concerned about the impact of a foreclosure on a credit report.<sup>56</sup> Frankly, missed payments result in negative reporting,<sup>57</sup> so by the time a foreclosure starts, the typical homeowner's credit rating is often shot.<sup>58</sup> At this point in the game, it is often wise to advise the client that while the credit report is a snapshot in time, the financial implications of a foreclosure can go beyond negative credit. In fact, no matter which route a foreclosure client chooses—a deed in lieu, a short sale, a modification, or bankruptcy—his or her credit score will take time to repair. It is often better for the client to focus on fixing the financial bleeding and let the credit report take care of itself in time.<sup>59</sup>

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55. Rao et al., *supra* n. 28, at § 14.3.5, 485. See 11 U.S.C. § 523(a)(1) (providing that certain taxes are not dischargeable in bankruptcy).

56. Foreclosures, missed payments, short sales, deeds in lieu, and bankruptcy will make it difficult to obtain credit at the most advantageous rates. See Les Christie, *How Foreclosure Impacts Your Credit Score*, [http://money.cnn.com/2010/04/22/real\\_estate/foreclosure\\_credit\\_score/](http://money.cnn.com/2010/04/22/real_estate/foreclosure_credit_score/) (posted Apr. 22, 2010, 4:44 p.m. EST) (discussing the average hit a debtor's credit score will take from various elements such as late payments or a foreclosure); Experian, *Credit Advice: Impact of Mortgage "Short Sale" on Your Credit Report*, <http://www.experian.com/ask-experian/20080514-impact-of-mortgage-short-sale-on-your-credit-report.html> (May 14, 2008) (indicating that short sales may negatively impact credit reports, depending on how they are filed, and that late payments, foreclosures, and deeds in lieu will always negatively impact credit reports); John W. Schoen, *Which Is Worse: Foreclosure or Bankruptcy?* [http://www.msnbc.msn.com/id/21478416/ns/business-answer\\_desk/t/which-worse-foreclosure-or-bankruptcy/#](http://www.msnbc.msn.com/id/21478416/ns/business-answer_desk/t/which-worse-foreclosure-or-bankruptcy/#) (updated Oct. 29, 2007) (noting that foreclosure stays on a credit report for seven years while bankruptcy remains for ten years).

57. See Christie, *supra* n. 56 (discussing the average reduction a debtor's credit score will undergo from various elements such as late payments or a foreclosure).

58. *Id.* Of course, it goes without saying that a client faces severe problems with keeping a decent credit score when going through the foreclosure process. Missing payments on a mortgage are not reflected positively, and a foreclosure judgment will also be reported on a homeowner's credit. *Id.* (noting the reduction in a debtor's credit score resulting from a foreclosure).

59. *Id.* Maxine Sweet, vice president for public education at Experian, advises people facing foreclosure, bankruptcy, short-sales, or deeds in lieu to "get your finances back in

## VI. JUDICIAL VERSUS NONJUDICIAL FORECLOSURE

In a judicial foreclosure state, the court process can take some time because the homeowner is defending a foreclosure lawsuit. Judicial foreclosure is the primary method of foreclosure for nineteen states.<sup>60</sup> The procedure is for the lender to obtain permission from the court to place the property for sale.<sup>61</sup> Generally, before a court will allow a lender to obtain permission to place a property up for sale, the lender must prove that a valid mortgage is in place and that the homeowner is in default on the mortgage.<sup>62</sup> The homeowner may raise defenses in an attempt to prevent the foreclosure and sale of the home.<sup>63</sup> Many of the defenses are technical or jurisdictional, such as the failure to post a bond or a standing argument.<sup>64</sup> Some defenses can be substantive such as Truth in Lending violations or Unfair and Deceptive Trade Practices concerns.<sup>65</sup>

In a nonjudicial foreclosure, the homeowner must initiate the legal action to save the home.<sup>66</sup> Nonjudicial foreclosures are permitted in thirty states, as well as the District of Columbia.<sup>67</sup> The lender gives notice according to the mortgage, deed of trust, or state statute and then places the property for sale.<sup>68</sup> Notice requirements vary by state, but a lender must strictly follow those requirements.<sup>69</sup> The homeowner must seek an injunction to stop the sale.<sup>70</sup>

Whether a foreclosure is judicial or nonjudicial, it is important for the legal practitioner to advise his or her client to act

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order” and not to worry about their credit scores when facing more pressing issues such as pending foreclosure or bankruptcy. *Id.*

60. Rao et al., *supra* n. 28, at app. E, 905–927. These states are Delaware, Florida, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, Vermont, and Wisconsin. *Id.*

61. *See id.* at § 4.2.2, 104 (stating that the lender must file an action in court and obtain a judicial decree for a foreclosure sale before proceeding).

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.* at § 4.2.3, 104.

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.* at § 4.2.3, 105.

quickly. Time frames for responding to a foreclosure, once filed, are short, and once the home is sold, it is often difficult to vacate a foreclosure sale.

### VII. DEFENDING AGAINST A FORECLOSURE

In foreclosure litigation, there are few types of threats that will make a mortgage company cave and give the homeowner a good deal. The reality is that regulatory threats<sup>71</sup> and class action lawsuits emerging from a suit are reasons why most lenders may strike an outstanding deal with a homeowner in foreclosure.<sup>72</sup> The simple facts at the onset of a foreclosure complaint are always present: (1) money was loaned for a specific purpose; (2) it was not paid back; and (3) it is secured by collateral that the lender may take. In short, the client owes money and must return the collateral.<sup>73</sup>

It is not easy to explain to a client that a principal or interest-rate reduction is unlikely<sup>74</sup> and that to make any headway against a lender, a significant monetary commitment is needed. Moreover, any wins for the homeowner may be by technical procedural defenses that will result in another foreclosure filed against the homeowner down the road anyway, such as dismissal for failure to file a cost bond.<sup>75</sup> A compromise to stay in the home, such as a modification, may result. It is a simple fact that a homeowner will not get to keep the home for free.<sup>76</sup> Even if fore-

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71. For a discussion of nationwide investigations and other litigation regarding legal issues faced by mortgage companies, review *supra* notes 11, 12, and 25 and accompanying text.

72. *Countrywide Settlement*, *supra* n. 26.

73. *Canceled Debts*, *supra* n. 29, at 10 (stating that a lender may repossess the property used to secure a loan if loan payments are not made).

74. See Michael Kraus, *JP Morgan Chase, Wells-Fargo Express Reservations about Principal Reduction*, <http://www.totalmortgage.com/blog/mortgage-rates/jp-morgan-chase-wells-fargo-express-reservations-about-principal-reduction/2960> (posted Apr. 15, 2010) (discussing how many banks are resistant to the idea of principal-reduction programs).

75. See Fla. Stat. § 57.011 (2011) (allowing dismissal of a non-resident plaintiff's action when the plaintiff fails to file a Nonresident Cost Bond).

76. See *Aceves v. U.S. Bank, N.A.*, 120 Cal. Rptr. 3d 507, 512 (Cal. App. 2d Dist. 2011) (noting that at least in a Chapter 7 bankruptcy, "a debtor who discharges an unpaid home loan cannot keep the home"). Even if the homeowner did keep the home, there may be a tax consequence. See *Canceled Debts*, *supra* n. 29, at 2 (discussing the tax implications of any forgiven or canceled debts).

closure is stopped, often the result is a rescinded transaction, and the homeowner will not keep the home.<sup>77</sup>

A vital step in the foreclosure process is gathering and reviewing all of the loan documentation. This is often not an easy or inexpensive task. Obtaining copies of all the documentation from the client may not be simple because the transaction may have occurred many years ago, and the client may not have retained all the paperwork. The original lender often has long since sold the loan and does not have the records or is out of business as a result of the foreclosure crisis. The title company may not have kept the files either. The servicer for the lender may only have a portion of the documents. The assignments may not be properly recorded. The new lender may not have the correct documents from when the loan was purchased. The broker may be missing in action. The lenders' computer systems<sup>78</sup> may not have properly documented all the fees, charges, and escrow calculations. Suffice it to say, mining each source of the loan documentation is a challenge, and it may lead to different documents being provided. If every document is carefully reviewed and audited, the result can be a plethora of defenses to protect the homeowner from foreclosure.

There are numerous defenses available in foreclosure actions. The problem for any practitioner is mining through the morass of loan documents to find them. The large majority of foreclosure defenses center on technicalities and failure to follow the rules in

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77. See *Castrillo v. Am. Home Mortg. Servicing, Inc.*, 670 F. Supp. 2d 516, 527 (E.D. La. 2009) (noting that when an obligor rescinds, the obligator must ultimately turn over the property to the lender). Note, though, that *Castrillo* further stated that no right of rescission exists for "residential mortgage transactions" or for "refinancing" agreements, potentially leaving homeowners in an even worse position. *Id.*

78. Servicer and lender computer systems pose the biggest challenge for the foreclosure industry in this Author's opinion. Most attorneys of foreclosure cases do not have the resources to conduct an extensive discovery process to uncover a potential pattern of incorrect calculations and disclosures made by forms in these computer systems. Some of the mortgage escrow and lending calculations are still conducted in DOS programming, and the banks have struggled to upgrade the complicated systems. The systems are programmed to laws imposed by fifty different states, forms for each lending product, and numerous legislative changes. As each of these changes is made, it can create unforeseen problems down the road. For example, a simple index change throughout a mortgage loan computer system input via a programming change can impact numerous adjustable rate loans that a bank makes on a daily basis. Auditing each and every loan to ensure that each loan has been properly updated is simply an impossible nightmare.

the foreclosure process.<sup>79</sup> The typical defense centers around who has the right to foreclose. This can result in a number of different levels of arguments. For example, problems with identifying the holder of the note,<sup>80</sup> the entity with standing,<sup>81</sup> the holder of the assignment,<sup>82</sup> the validity of note endorsements,<sup>83</sup> or the validity of the note that is being foreclosed upon.<sup>84</sup>

Challenging lending practices is another way to defend against a foreclosure. Ways to challenge the validity of a foreclosure transaction include: challenging broker actions; unfair and deceptive trade practices,<sup>85</sup> challenging violations of the Real Estate Settlement Procedures Act (RESPA),<sup>86</sup> Truth in Lending Act (TILA),<sup>87</sup> or Home Ownership and Equity Protection Act (HOEPA),<sup>88</sup> or nonpayment of credit insurance. The Equal Credit Opportunity Act (ECOA)<sup>89</sup> and Federal Housing Act (FHA)<sup>90</sup> also

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79. See e.g. *Miller v. Cote*, 179 Cal. Rptr. 753, 756–757 (Cal. App. 4th Dist. 1982) (finding that a notice of default must be strictly complied with and any foreclosure sale resulting from a “statutorily deficient notice” is invalid); *Chase Home Fin. LLC v. Higgins*, 985 A.2d 508, 511–512 (Me. 2009) (vacating a judgment of foreclosure and order of sale upon finding that a genuine issue of material fact existed as to whether the mortgage holder improperly served the debtor with both the notice of default and the mortgagor’s right to cure). Technical defenses also depend on state law and various procedures in state court. See Rao et al., *supra* n. 28, at § 1.2.5, 5 (noting that several states have enacted their own respective laws involving home loan protection).

80. See e.g. *Kluge v. Fugazy*, 536 N.Y.S.2d 92, 93 (N.Y. App. Div. 2d Dep’t 1988) (finding that a plaintiff cannot bring an action for foreclosure when only assigned the mortgage and not the note).

81. See e.g. *In re Wilhelm*, 407 B.R. 392, 398 (Bankr. D. Idaho 2009) (holding that a party seeking to foreclose must show actual injury from non-payment—in addition to showing an interest in the note—to meet the constitutional standing requirement).

82. *BAC Funding Consortium Inc. ISAOA/ATIMA v. Jean-Jacques*, 28 So. 3d 936, 937 (Fla. 2d Dist. App. 2010).

83. *Brotheridge v. Option One Mortg. Corp.*, 67 So. 3d 254, 255 (Fla. 2d Dist. App. 2010).

84. *Roth v. Bank of Am., N.A.*, 23 So. 3d 765, 766 (Fla. 2d Dist. App. 2009).

85. High value appraisals and property flipping are examples of unfair and deceptive trade practices. See *Najera v. NationsBank Trust Co.*, 707 So. 2d 1153, 1154–1155 (Fla. 5th Dist. App. 1998) (holding that reliance on fraudulent trade practices could be a defense to foreclosure).

86. 12 U.S.C. §§ 2601–2617 (2006).

87. A consumer has a right to rescind certain types of mortgage transactions for up to three years when appropriate disclosures were not made. 15 U.S.C. § 1635(a), (f) (2006); see *Beach v. Ocwen Fed. Bank*, 523 U.S. 410, 418–419 (1998) (holding that a federal right to rescind a mortgage under TILA expires three years after consummation of the transaction).

88. 15 U.S.C. § 1639 (2006); 15 U.S.C. § 1602(aa) (2006).

89. 15 U.S.C. § 1691 (2006).

90. 42 U.S.C. §§ 3604, 3605 (2006). See also the Civil Rights Act, 42 U.S.C. §§ 1981, 1982 (2006) as another way to challenge foreclosures under similar theories.



provide opportunities for challenging foreclosures. Other standard lawsuit defenses, such as fraud,<sup>91</sup> usury,<sup>92</sup> unconscionability,<sup>93</sup> estoppel,<sup>94</sup> and invalid agreements<sup>95</sup> are similarly used. A client can also use the Fair Debt Collection Practices Act,<sup>96</sup> tort defenses,<sup>97</sup> breach of contract defenses,<sup>98</sup> and breach of fiduciary duty defenses.<sup>99</sup>

As the foreclosure crisis continues, whether additional unique defenses will be utilized, such as adverse possession, statute of limitations, and *res judicata*, is yet to be seen. Only time will tell whether the use of these additional defenses will be raised and ultimately come to fruition for homeowners facing foreclosure. The most important facet of providing a defense to a homeowner in foreclosure is to buy time in order to work out a solution for the homeowner—whether that solution is based on traditional or experimental approaches to the foreclosure problem.

### VIII. MEDIATION: WORKING OUT A COMPROMISE

Mediation is a process in which the lender and homeowner meet with a neutral third party to negotiate a deal regarding the home. Mediation can result in a home-loan modification, the

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91. *First Charter Nat'l Bank*, 617 A.2d at 911–912 (finding fraud as a defense to foreclosure when homeowner was tricked into signing loan documents).

92. *See Nesbitt v. Citicorp Sav. of Fla.*, 514 So. 2d 371, 371–372 (Fla. 3d Dist. App. 1987) (holding that usury as a defense to mortgage foreclosure is not available to an owner who was not a party to the usurious contract).

93. *Amerifirst Fed. Sav. & Loan Ass'n v. Cent. 21 Commodore Plaza, Inc.*, 416 So. 2d 45, 46–47 (Fla. 3d Dist. App. 1982) (holding that the mortgagee's acceleration was unconscionable when the mortgagee had accepted "substantially all amounts due" from the mortgagor).

94. *Aceves*, 120 Cal. Rptr. 3d at 513–515.

95. *See Countrywide Home Loans, Inc. v. Sotern*, 46 So. 3d 618, 619 (Fla. 2d Dist. App. 2010) (finding that a mortgage agreement is invalid when the mortgagee had actual notice of an equitable owner's interest in the home).

96. 15 U.S.C. § 1692(a)(5) (2006); *see Muldrow v. EMC Mortg. Corp.*, 657 F. Supp. 2d 171, 176 (D.D.C. 2009) (noting that a mortgage is a debt under the FDCPA).

97. *See Nool v. HomeQ Servicing*, 653 F. Supp. 2d 1047, 1053–1054 (E.D. Cal. 2009) (dismissing a predatory lending claim for failure to meet the monetary minimum required by the California code).

98. *See ABN AMRO Mortg. Group, Inc. v. Tullar*, 770 N.W.2d 851 (Iowa App. 2009) (table) (describing that the defense of breach of contract can be asserted in foreclosure proceedings when the lender fails to comply with HUD regulations incorporated in the contract); *Monet v. Chase Home Finance, LLC*, 2010 WL 1240973 at \*2 (N.D. Cal. Mar. 26, 2010) (describing the plaintiff's breach of contract claim against the defendant for failing to provide written notice to the plaintiff upon a change of the loan servicer).

99. *Monahan v. GMAC Mortg. Corp.*, 893 A.2d 298, 303, 314–315 (Vt. 2005).

house's turnover, the mortgage's reinstatement, or no result at all. Some states require that lenders engage in some sort of mediation before foreclosing on a home, either statutorily or judicially.<sup>100</sup> Mediation is often an opportunity for both the lender and homeowner to explore whether the homeowner qualifies for various modification programs, such as the Home Affordable Modification Program (HAMP).<sup>101</sup> Perhaps the best strategic decision for the homeowner in requesting mediation is further delay. Regardless of whether a favorable result occurs, requesting mediation buys the homeowner time to figure out a solution and work through the emotional process involved in losing the home.

### IX. A FULL STOP TO FORECLOSURE: BANKRUPTCY

Bankruptcy is a quick fix to stop a foreclosure and is often the last resort for a client, when it should be the first option for stopping the foreclosure process.<sup>102</sup> Often a bankruptcy is filed the day the home is put up for auction to buy the client more time in the home.<sup>103</sup>

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100. See e.g. Cal. Civ. Code § 2923.5 (2009) (prohibiting a foreclosure until thirty days after the mortgagee is notified of the right to mediation); Conn. Gen. Stat. § 8-265ee (2008) (requiring notice to be sent to the mortgagee before a foreclosure can proceed); Ind. Code § 32-30-10.5-9 (2011) (requiring mediation between the parties before a court can issue a judgment of foreclosure); N.Y. C.P.L.R. Law § 3408 (McKinney 2007 & Supp. 2009) (requiring mediation for loans between January 1, 2003 through September 1, 2008); see also Stuart Rabner et al., *New Jersey Foreclosure Mediation* 1 (N.J. Judiciary, Civ. Prac. Div. 2009) (describing the mediation process available to homeowners in New Jersey); James T. Vaughn, Jr., *Residential Mortgage Foreclosure Mediation Program*, Admin. Directive Pres. J. Super. Ct. St. Del., N. 2009-3 Super. Ct. St. Del., 2-3 (Aug. 31, 2009) (describing the notice requirements before a foreclosure can occur); Sup. Ct. Ohio & Ohio Jud. Sys., *Foreclosure Mediation Resources*, <http://www.supremecourtsohio.gov/JCS/disputeResolution/foreclosure/default.asp> (accessed July 15, 2012) (discussing the process for mediation before foreclosure in Ohio); but see Charles T. Canady, C.J., *Statewide Managed Mediation Program Assessment Workgroup*, Admin. Or., AOSC11-33 Fla. Sup. Ct. (Sept. 26, 2011) (requesting that data collected from the statewide mediation program be used to determine whether the program needs to be continued).

101. Dep'ts Treas. & Hous. & Urb. Dev., *Making Home Affordable.Gov*, <http://www.makinghomeaffordable.gov> (accessed July 15, 2012) [hereinafter *Making Home Affordable.gov*].

102. As discussed *supra* Part II, the reason clients delay filing a bankruptcy when it is often the most immediate and best result is due to the emotional aspects.

103. Once the sale of the home has occurred, the bankruptcy process cannot be used to save the home unless the sale is vacated. 11 U.S.C §§ 547, 549(c); but see *Whittle Dev., Inc. v. Branch Banking & Trust Co.*, 2011 WL 3268398 (Bankr. N.D. Tex. July 27, 2011) (holding that under certain circumstances, a bankruptcy trustee can avoid a prepetition foreclosure sale of a debtor's property as a preferential transfer under section 547 of the

Once a bankruptcy petition is filed, a lender cannot continue the foreclosure process, as an automatic stay will go into place.<sup>104</sup> An automatic stay requires the lender to file a motion to continue the foreclosure process in a Chapter 7 bankruptcy,<sup>105</sup> or in the case of a Chapter 13 bankruptcy, to succumb to delayed payments and lien-stripping while allowing the client to keep the home.<sup>106</sup> Most importantly, bankruptcy is a formidable tool in requiring the lender to file a “proof of claim” in order to be paid on a debt.<sup>107</sup> Bankruptcy often places the lender on the defense by requiring a justification of each and every charge to a homeowner for a loan.

While a practitioner should understand the basics of the potential benefits of bankruptcy in a foreclosure situation, it is important to have an experienced bankruptcy practitioner on hand to properly assist a client in foreclosure.<sup>108</sup> The extent of the bankruptcy code’s ability to assist someone in foreclosure can only be briefly touched upon in this Article.<sup>109</sup>

### A. Chapter 7

Chapter 7 bankruptcy, commonly known as liquidation bankruptcy, is what most clients think of as “walking away from the debt” or “a fresh start.” Essentially, Chapter 7 bankruptcy allows a client to keep certain exempt assets, sell all non-exempt assets

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Bankruptcy Code). If a sale is imminent, a client in foreclosure should see a bankruptcy practitioner as soon as possible.

104. 11 U.S.C. § 362(a)(4) (2006) (barring enforcement of “any lien against property of the estate”).

105. *Id.* at § 362(d).

106. Admin. Off. U.S. Cts., *Chapter 13*, <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter13.aspx>; *select* Advantages of Chapter 13 (accessed July 15, 2012).

107. 11 U.S.C. § 501 (2006); *see In re Koontz*, 2010 WL 5625883 at \*9 (Bankr. N.D. Ind. Sept. 30, 2010) (requiring a chain of title to support a proof of claim).

108. After the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, 119 Stat. 23 (2005) (BAPCPA), it was thought that bankruptcy in America was dead and that a typical bankruptcy client would have a very hard time filing a Chapter 7 bankruptcy. Bankruptcy lawyers welcomed the decline of property values and foreclosures with gusto, in that it brought back a dead area of the legal profession. “BACPA has not resulted in much change. Perhaps, this is because of the poor economic conditions in the United States. Basically, people are still filing bankruptcy and they are filing bankruptcy in record numbers.” Jon L. Martin, *What Was the Effect of the 2005 Bankruptcy Code Legislation?* <http://EzineArticles.com/4207353> (Apr. 30, 2010).

109. *See generally* Henry J. Sommer & John Rao, *Consumer Bankruptcy Law and Practice* (9th ed., Nat’l Consumer L. Ctr. 2009) (detailing basic concepts of a bankruptcy procedure).

for payment to creditors, and walk away from any debt, assuming that the client qualifies based upon the amount of income the client is earning.<sup>110</sup>

If the homeowner is behind on the house payments and would like to simply walk away from the home, payments, and a possible tax liability, this may be the best option for the client. Bankruptcy is less costly than defending a foreclosure action. Moreover, the homeowner is relieved of future payments on the mortgage.<sup>111</sup> If properly timed, Chapter 7 bankruptcy can preempt the foreclosure tax consequences as a result of the forgiveness of debt.

Another reason for a client to utilize Chapter 7 bankruptcy is that it stops all payments on unsecured debt, allowing the homeowner to keep the home by allocating funds only to the secure debt of the home.<sup>112</sup> In order to keep the home in Chapter 7 bankruptcy, the most important thing to keep in mind is that the homeowner must be up to date on the mortgage at the time of filing bankruptcy.<sup>113</sup> Because a homeowner is often behind by the time a foreclosure is filed, Chapter 7 bankruptcy may not work unless a solution for the arrearages is developed through mediation or outside assistance.

## B. Chapter 13

One of the best strategies to stop a foreclosure is Chapter 13 bankruptcy. Chapter 13 bankruptcy is a form of relief that allows debtors to restructure their debt.<sup>114</sup> It is commonly known as reorganization bankruptcy and is an excellent financial strategy for a typical homeowner to keep the home if the homeowner is

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110. The bankruptcy "Means Test" determines whether a debtor can file a Chapter 7 or Chapter 13 bankruptcy. 11 U.S.C. § 707 (2006). A full discussion of the Means Test, how it applies, and the purpose of it is beyond the scope of this Article.

111. See 11 U.S.C. § 362 (filing of bankruptcy operates as an automatic stay preventing foreclosure proceedings). Note that the homeowner may still be liable for Home Owner Association Dues and liability insurance on the property after filing Chapter 7 bankruptcy if he or she decides not to keep the home in the Chapter 7 bankruptcy and the foreclosure process has not been completed prior to filing. 11 U.S.C. § 523(a)(16) (2006).

112. 11 U.S.C. § 362.

113. See *In re Schuessler*, 386 B.R. 458, 480 (Bankr. S.D.N.Y. 2008) (noting that failure to make mortgage payments is cause for relief from automatic stay).

114. See *Matter of Stein*, 36 B.R. 521, 523 (Bankr. M.D. Fla. 1983) (noting that Chapter 13 bankruptcy was designed to allow financially distressed individuals to adjust their debts).

behind on the payments. Chapter 13 bankruptcy allows the homeowner to restructure the payments on the primary residence to catch up on the delinquent amount—often at a zero-percent interest rate.<sup>115</sup> This only works, however, for a homeowner who has regular income. Homeowners who face unemployment or do not have sufficient income to make both the mortgage payments and the amount required to make the loan current over a three- to five-year period will not benefit from Chapter 13 bankruptcy.

In certain instances, Chapter 13 bankruptcy also allows for a homeowner to “strip” a second mortgage on a property.<sup>116</sup> Essentially, if the home’s value at the time of the bankruptcy filing is less than or equal to the first mortgage, then a debtor in bankruptcy is entitled to motion the court to strip the secondary mortgage as part of the Chapter 13 plan.<sup>117</sup> This can be a very effective way to remove a second lien in a down economy. The homeowner, depending on the structure of the Chapter 13 plan, may or may not pay a portion of the secondary lien. In order to retain the benefit of the strip-down and lien avoidance, the homeowner must complete the entire Chapter 13 bankruptcy plan.<sup>118</sup>

Chapter 13 bankruptcy is also a good tool to use to “cram down” a loan on rental property.<sup>119</sup> Generally, a lender can only obtain the value of the collateral in a foreclosure.<sup>120</sup> The bankruptcy courts recognize this theory by allowing the mortgage loan on a rental property to be “crammed down” to the market value at the time of filing.<sup>121</sup>

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115. 11 U.S.C. § 1322(b)(5) (2006). It is important to point out to a client facing a foreclosure the financial-interest costs of a Chapter 13 bankruptcy plan versus a modification. Under the Chapter 13 plan, the arrearages may be paid back in three to five years and the homeowner may be caught up with the mortgage; however, most bankruptcy plans require a fee be paid to the trustee, which may end up costing the homeowner more or less than the typical modification depending on individual circumstances. *Id.* at § 1322(d)(1)–(2) (providing that the time period depends on the income of the debtor); see 28 U.S.C. § 1930 (2006) (detailing the fees owed for different types of bankruptcies).

116. 11 U.S.C. § 506 (2006). A lien may not be stripped down in a Chapter 7 bankruptcy. *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992).

117. 11 U.S.C. § 506(d).

118. Once again, a tax practitioner should be consulted because the delay in the mortgage payments will have a significant impact on the client as a result of the bankruptcy.

119. 11 U.S.C. § 1325(a)(5)(B) (2006).

120. *Id.* at § 506(a)(2).

121. *Id.* at § 1325(a)(5)(B)(ii).

### X. DISMISSING THE FORECLOSURE WITH A DEED IN LIEU

Negotiating a deed in lieu is when the homeowner decides to turn over the keys to the lender and walk away from the home.<sup>122</sup> The Home Affordable Foreclosure Alternatives (HAFA) is a program in which a short sale or deed in lieu is offered to, or requested by, the homeowner.<sup>123</sup> Often the lender may require that the homeowner list the property for sale for a certain period of time before agreeing to a deed in lieu.<sup>124</sup> Sometimes, the lender will offer to pay the borrower's moving expenses in exchange for the deed in lieu.

A deed in lieu may be a good solution for a homeowner who is in a situation in which the monthly costs of homeownership are financially draining the homeowner. The cost of homeownership involves more than just the monthly mortgage payment. Homeowner-association dues, utilities, lawn care, insurance, property taxes, repairs, and maintenance costs can cripple a homeowner's ability to make the mortgage payments. Stopping the bleeding of the monthly cost of homeownership, through foreclosure, may justify tax consequences or a deficiency judgment. Moreover, a deed in lieu can compartmentalize the potential deficiency-judgment amount and limit it to the value on the date that the property is turned in and sold.<sup>125</sup>

If there is more than one lien on the property, however, a deed in lieu can be a challenge. This is because all lienholders must agree.<sup>126</sup> Often, a secondary lienholder will request a cash payment for a deed in lieu even when it would not be entitled to one in a foreclosure or bankruptcy.<sup>127</sup> In addition, a deed in lieu may not be a good option if there is equity in the property because the equity must be turned over.<sup>128</sup> A deed in lieu can also result in a deficiency obligation and tax consequences.<sup>129</sup>

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122. U.S. Dep't Treas., *Supplemental Directive 09-09*, at 2, <http://homeownership.org/realtor/sd0909r.pdf> (Mar. 26, 2010).

123. *Id.*

124. The wise practitioner will advise the homeowner in trouble to list the property as soon as meeting with him or her so that all available options can be pursued.

125. U.S. Dep't Treas., *supra* n. 122, at 2.

126. Rao et al., *supra* n. 28, at § 2.6.8, 40.

127. *Id.*

128. *Id.* at § 2.5.2, 35.

129. *Nash Finch Co. v. Corey Dev., Ltd.*, 669 N.W.2d 546, 549 (Iowa 2003).

### *XI. HEADING OFF A FORECLOSURE WITH A SHORT SALE*

In a short sale, the homeowner sells the property to a new owner at a lower price than the amount of the mortgage due on the property.<sup>130</sup> The HAFSA program is also used for short sales.<sup>131</sup> A client who wishes to sell a property at a short sale can have the foreclosure dismissed in order to complete the sale.<sup>132</sup> The challenge is finding a buyer for the property at a price the lender will accept in foregoing the loan and releasing the lien. Of course, the homeowner also has to consider whether the balance on the loan will result in a deficiency judgment as discussed in Part III or tax consequences as discussed in Part IV.

Short sales can be very challenging because a homeowner is often waiting for someone to make an acceptable offer on the home. Even with an offer, the lender must agree to accept it, and again, second lienholders must be consulted.<sup>133</sup> Many homeowners try to avoid the impact of having a foreclosure listed on credit reports by completing a short sale.

### *XII. STOPPING A FORECLOSURE WITH MODIFICATIONS, REFINANCES, AND REDEMPTIONS*

Another way for a homeowner client to head-off a foreclosure is to modify the loan. Some states, such as Oregon, require servicers to notify homeowners of the option to request a modification.<sup>134</sup> Modification programs can also be explored as part of a mediation or bankruptcy.

Many different modification programs are available. The Home Affordable Modification Program (HAMP) is a federally funded program to help relieve distressed homeowners and provide modifications to home loans.<sup>135</sup> In addition, the HOPE for

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130. Rao et al., *supra* n. 28, at § 2.5.1, 34.

131. U.S. Dep't Treas., *supra* n. 122, at 1.

132. *Id.* at 2.

133. Rao et al., *supra* n. 28, at § 2.6.8, 40.

134. Or. Enrolled Sen. 628, 75th Legis. Assembly, Reg. Sess., 1 (2009).

135. See generally U.S. Dep't Treas., *Financial Stability*, <http://www.treasury.gov/initiatives/financial-stability/Pages/default.aspx> (accessed July 15, 2012) (providing information about the 2008 Emergency Economic Stabilization Act (EESA) and the Troubled Asset Relief Program (TARP)). Modification is also available for second liens. *Making Home Affordable.gov*, *supra* n. 101, at *select* Explore Programs, *select* Lower Monthly Payments, *select* Second Lien Modification Program (2MP) (accessed July 15, 2012).

Homeowners program is for Federal Housing Agency (FHA) insured thirty-year fixed-rate mortgages.<sup>136</sup> The Emergency Homeowners Loan Program (EHLPL) offers a loan to unemployed or underemployed homeowners to pay arrearages.<sup>137</sup>

Advising the homeowner about a modification is tricky, and it requires an understanding of the math involved because modifications may have trial periods,<sup>138</sup> payments may not include taxes and insurance, and lowering the payment may extend the term of the loan.<sup>139</sup> On a typical modification, interest-rate reductions may only be temporary, and interest is often capitalized on the back end of the loan.<sup>140</sup> Moreover, the loan's extension through a modification often results in the homeowner paying thousands of dollars more for a home that is already under water. In addition, some modifications can have unintended tax consequences.<sup>141</sup> Some homeowners may delay an inevitable bankruptcy by accepting a modification with terms that the borrower could not meet if another financial crisis, such as a job loss, were to occur.<sup>142</sup>

Refinancing is another way to prevent foreclosure. This option may require resources that many homeowners in foreclosure do not have: (1) good credit, (2) money, and (3) equity in the home.<sup>143</sup> During the mortgage and real estate boom, refinancing to take out equity from the home was a way of life. During that time, many homeowners used the equity in their home to consolidate payments and pay off unsecured debt, such as credit cards, without understanding the consequences. Unfortunately,

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136. See 12 U.S.C. § 1715z-23(e)(5) (2006) (requiring the interest rate to be fixed and the mortgage to mature at least thirty years from the beginning of amortization).

137. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

138. *Making Home Affordable.gov*, *supra* n. 101, at *select Home, select Understanding the Trial Period* (accessed July 15, 2012).

139. Rao et al., *supra* n. 28, at § 2.6.8, 39, § 2.7.1, 41.

140. *Id.* at § 2.6.8, 39.

141. See Rev. Rul. 2009-19, 2009-28 I.R.B. 111 (stating that benefits from HAMP Pay-for-Performance Success Payments can be excluded from income by homeowners under the general welfare exception); I.R.S. Notice 2011-14, 2011-11 I.R.B. 544, 546 (extending this exclusion to payments made to the homeowner under state and other federal programs).

142. "There is little value to either the homeowner or the mortgage holder in negotiating terms which, if accepted, will not resolve the homeowner's problems for both the long and short term." Rao et al., *supra* n. 28, at § 2.6.1, 35.

143. Karen Blumenthal, *A Battle Plan for Refinancing Your Mortgage*, <http://online.wsj.com/article/SB124277960359137325.html> (May 20, 2009).



as home values dropped, refinances also dropped.<sup>144</sup> Given the low interest rates in the current economy, however, refinancing may be the best option for a homeowner with a steady income.

Redemptions are an unlikely solution for a suffering homeowner, but they do happen.<sup>145</sup> Redemptions are allowed in almost every state.<sup>146</sup> In a redemption, the homeowner tenders past-due amounts along with any fees and costs to the lender before sale.<sup>147</sup> Essentially, the homeowner agrees with the foreclosure suit and pays up. Homeowners can make this happen through outside financing or with help from friends and relatives.

### XIII. RENTING THE PROPERTY OR STAYING IN THE PROPERTY

Some of the options available to clients in foreclosure allow the clients to make the most of their situations. Often, clients will rent out the home and retain the rental proceeds or remain in the home until the foreclosure is complete.<sup>148</sup> More recently, lenders have been asking the court to place the funds received as rental proceeds in trust for payment to the lender pursuant to the note and mortgage terms, taking away the cash-flow benefit to the homeowner.<sup>149</sup>

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144. See Diana Olick, *Refinancing Drop an Ill Wind for Housing Recovery*, [http://www.cnbc.com/id/43654703/Refinancing\\_Drop\\_an\\_Ill\\_Wind\\_for\\_Housing\\_Recovery](http://www.cnbc.com/id/43654703/Refinancing_Drop_an_Ill_Wind_for_Housing_Recovery) (July 6, 2011) (demonstrating that the “refinance share of mortgage applications continues to drop”).

145. See *TCM Props., LLC v. Gunderson*, 720 N.W.2d 344, 348 (Minn. App. 2006) (holding that a Minnesota statute did not prohibit a lender from taking a lien on a homeowner’s property during a redemption period).

146. See Rao et al., *supra* n. 28, at app. E, 905–927 (providing a state summary of foreclosure law). Redemptions can even be allowed after the foreclosure sale. *In re Ragsdale*, 155 B.R. 578, 580 (Bankr. N.D. Ala. 1993); *but see Com. Fed. Mortg. Corp. v. Smith (In re Smith)*, 85 F.3d 1555 (11th Cir. 1996) (holding that a debtor could not modify a statutory right of redemption under a Chapter 13 plan, but must pay one lump sum within one year of the foreclosure date).

147. Rao et al., *supra* n. 28, at § 14.1.2, 463.

148. See Bob Ivry, *Lenders Swamped by Foreclosures Let Homeowners Stay*, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aOluOO8Vy0gc> (Apr. 4, 2008) (demonstrating that banks have been allowing homeowners to remain in their homes during the foreclosure process); Alana Semuels, *Many Borrowers in Default Stay Put as Lenders Delay Evictions*, <http://articles.latimes.com/2010/feb/27/business/la-fi-squatters27-2010feb27> (Feb. 27, 2010) (demonstrating that homeowners have remained in their homes during the foreclosure process).

149. Courts have increasingly appointed lawyers to act as receivers to oversee property that is drifting toward foreclosure. See Cara Buckley, *Politically Tied Lawyers Win Jobs*

Another strategy is to delay the foreclosure process for as long as possible and then file a Chapter 7 bankruptcy petition once the sale date arrives. This maximizes the client's time in the home while not paying rent or a mortgage.

#### XIV. SETTING ASIDE A FORECLOSURE SALE

Every so often, a client will come to you after the property has sold and ask for assistance in setting aside the sale. The client often faces an uphill battle. In most cases, there must be some sort of irregularity in the foreclosure sale or inadequacy of the sale price for a foreclosure sale to be vacated.<sup>150</sup> If the property was sold the day after a bankruptcy was filed, however, the client may also have to attempt to set aside the sale in bankruptcy court.<sup>151</sup> All is not lost upon the sale, but a careful analysis by the practitioner is necessary to determine if any value can be provided after the property's sale.

#### XV. SUMMARY

The homeowner has a variety of options when facing foreclosure. The legal practitioner must dig into his or her toolbox to determine what is best for a particular homeowner. At the end of the day, foreclosure defense requires an individualized analysis, considering tax implications, carrying costs, and the homeowner's income, future plans, and personal housing concerns. There is no one-size-fits-all strategy for the foreclosure

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*Handling Foreclosures in the City*, [http://www.nytimes.com/2011/06/21/nyregion/connected-nyc-lawyers-reap-foreclosure-benefits.html?pagewanted=all](http://www.nytimes.com/2011/06/21/nyregion/connected-nyc-lawyers-reap-foreclosure-benefits.html?pagewanted=all&_r=1) Politically Tied Lawyers Receive Receiverships on the Increase (June 20, 2011) (providing that the number of such receivers appointed by judges in New York City has increased dramatically over the last few years).

150. See Molly F. Jacobson-Greany, *Setting Aside Nonjudicial Foreclosure Sales: Extending the Rule to Cover Both Intrinsic and Extrinsic Fraud or Unfairness*, 23 Emory Bankr. Dev. J. 139, 154 (2006) (providing that the general rule for setting aside sales is that there be inadequacy in the sale price and some irregularity, fraud, or unfairness in association with the sale); e.g. Mary Ellen Podmolik, *Altered Documents Halt Some Cook County Foreclosures*, [http://articles.chicagotribune.com/2011-03-25/business/ct-biz-0326-altered-foreclosures-20110325\\_1\\_foreclosure-affidavits-foreclosure-procedures-foreclosure-pipeline](http://articles.chicagotribune.com/2011-03-25/business/ct-biz-0326-altered-foreclosures-20110325_1_foreclosure-affidavits-foreclosure-procedures-foreclosure-pipeline) (Mar. 25, 2011) (describing instances of robo-signing that have been used to illegally sign foreclosure affidavits).

151. E.g. *In re Searcy*, 313 B.R. 439, 441 (Bankr. W.D. Ark. 2004) (denying the debtors' motion to set aside the sale of their foreclosure property); *In re Perry*, 2006 WL 6594640 at \*1 (Bankr. N.D. Ga. 2006) (granting the debtor's motion to set aside the foreclosure sale).

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arena; therefore, it is important to understand the client's wishes and prioritize solutions accordingly. The best solutions often follow a step-by-step approach using several options to achieve the client's desired result while working to help the client through the foreclosure's emotional aspects and the possibility of the ultimate loss of the home.