

## COMMERCIAL CONNECTION

## Foreclosures, short sales have consequences

## IRS will want taxes on cancellation of debt

"If ya don't pay, ya don't stay" goes the old saying in the mortgage business. And many in Lee County are not paying, and therefore not staying. Foreclosure filings tripled from 2006 to 2007 in Lee County. And filings this year will likely be higher than last year. (An interesting byproduct of this is that Lee County courts and judges are clogged with foreclosures, creating delays in all other types of suits.)

This situation is not going unnoticed by the media. Recently, national news publications reported that Cape Coral/Fort Myers has the highest foreclosure rate in America, with one in every 86 homes in foreclosure. Indeed, most local real estate attorneys, including yours truly, have been inundated with foreclosures, short sale and deed in lieu questions from borrowers. This is understandable, since there are many tax and legal consequences to foreclosure, so borrowers in this position should always seek professional legal and tax help. Unfortunately, though, there are usually few "loopholes" or legal "technicalities" available to get a foreclosure suit thrown out. This is not Hollywood.

But a borrower's big question is usually, "can the lender come after me for everything I own?" That concerns deficiency judgments, and will be covered in this article. But don't forget the IRS. It has far more power than

any lender.

A "deficiency" arises when the fair market value of the property is less than the loan balance plus the attorney's fees and costs incurred in the foreclosure action. If that is the case, the lender can seek a "deficiency judgment" against the borrower. This is the "going after" that so many borrowers are so afraid of. Generally, in its Motion for Summary Judgment of Foreclosure, the lender will ask the court to reserve jurisdiction for a deficiency judgment. The lender then has 10 months from the date of entry of the Final Summary Judgment of Foreclosure to file its Motion for Deficiency Judgment. If the lender does file this motion, the court will then conduct an evidentiary hearing to determine the amount of the deficiency judgment against the borrower. Roughly, the court will calculate the deficiency by subtracting the fair market value of the property as of the foreclosure sale date from the outstanding loan balance.

Of course, if the fair market value of the property exceeds the outstanding loan balance, then there is no deficiency and the lender would not be entitled to a deficiency judgment. (Note that the lender must have gotten personal service of process upon the borrower in the foreclosure action in order to obtain a deficiency judgment.) Interestingly enough,



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though, at present, most lenders in Lee County are not pursuing their rights to a deficiency judgment, due to the time and effort involved. But that may change.

No one knows what the lenders will do in the future. We only know what they can do under the Florida law. And they can pursue a deficiency judgment if the property value is lower than the loan balance. If the lender does get a deficiency judgment, they can enforce that judgment and try to collect upon that judgment like any other judgment. Note that Florida is a rather debtor friendly state, though, so collecting on a debt here can be tough.

There are alternatives to foreclosure, such as deeds in lieu of foreclosure and short sales. A "deed in lieu of foreclosure" occurs when the borrower simply gives back the property to the lender by signing and delivering to the lender a simple deed, via either a quitclaim deed or a warranty deed. Such a transfer may occur prior to or during the pendency of a foreclosure lawsuit. The benefits of

deed in lieu to a lender are that it avoids the cost, delays and risk of a full foreclosure. Deed in lieu benefits to a borrower are that it prevents a foreclosure appearing on his or her credit report, and it may help avoid a deficiency judgment (if the lender accepts the deed in lieu as a full satisfaction of the mortgage, which most of them do not).

But if there are any junior lienholders (i.e., a home equity line of credit (HELOC), a second mortgage, HOA or condo liens), then the lender will not accept a deed in lieu, since a deed in lieu does not wipe out those lienholders, whereas a foreclosure does. And frustratingly, some lenders simply won't respond to a request for a deed in lieu for whatever bureaucratic reason.

A "short sale" is where the lender accepts less than the full amount due for a payoff and satisfaction of the loan. A short sale is requested when the borrower is "upside down" and the loan balance exceeds the fair market value of the property. Note, however, that a lender is not required to agree to a short sale, just like it is not required to accept a deed in lieu. But short sales have exploded over the last year. When the whole mortgage meltdown started, many lenders would not agree to them. But some are coming around now. Short sales can also be frustrating, though, because a lender generally will not even discuss a short sale

unless the borrower is in default or the lender either won't respond to a short sale request, or takes forever to respond, or some lenders will verbally agree to something, only to renege at the last minute, or some lenders require the borrower to fill out a lengthy "work out" package, wherein they request detailed financial information that the borrower may not want to give.

When short sales do go through, they can be beneficial: The borrower sells the property, and he or she avoids a foreclosure suit and the risk of a deficiency judgment. But the borrower's credit will still take a hit. And Uncle Sam will still want his "cancellation of debt" tax money.

Of course, there are only two things certain in life. Don't think foreclosures, deeds in lieu and short sales are exceptions to these certainties. But everyone's financial and tax situation is different. A borrower should seek the advice of a CPA if they are facing a foreclosure or one of its alternatives. Generally, the IRS treats "cancellation of debt" whether via a foreclosure, deed in lieu, or short sale, as income, to be taxed at the borrower's tax rate.

The lender is supposed to send the borrower a 1099, and the borrower is supposed to report to the IRS the de facto "income" that the borrower received from the foreclosure, deed in lieu, or short sale. The IRS calculates cancellation of

debt "income" similarly to how a court calculates a deficiency judgment: By subtracting the fair market value of the property as of the foreclosure sale date from the outstanding loan balance. The difference is the "income" to the borrower.

However, the borrower won't be taxed on this income if: The borrower discharges the debt through bankruptcy, or if the borrower is defined by the IRS as "insolvent" at the time of the cancellation of debt, or, effective December 2007, if the loan was on a primary residence, and the loan was taken out to "buy, build, or substantially improve" a primary residence. The last exception phases out after 2009.

See IRS publications 982 and 544 for more information. They are available at [www.irs.gov](http://www.irs.gov). Or, the borrower may be able to show some losses to offset the cancellation of debt income. Again, a borrower should see his or her CPA.

How we got to this mortgage mess has been well documented by others, so there is no need to get into that here. But cheer up. This is beautiful Florida. We all want to live here. Everything is cyclical. Things will turn around. And when things do turn around, we will still be standing, if not prospering.

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# Florida's 'judicial foreclosure' policy requires lawsuit be filed by lender

A few weeks ago in this column, I discussed some of the alternatives to foreclosures, such as short sales and deeds in lieu of foreclosure. But what happens if a borrower simply cannot or will not pay his or her mortgage, and he or she cannot work out a short sale or a deed in lieu of foreclosure?

Remember that lenders don't want to have to foreclose. They are not in the business of owning property. They are in the business of lending money. They want that money back, not the property. But foreclose they will if they don't get paid back.

(And of course, a borrower's credit report is hit hard by a foreclosure).

Florida is a "judicial foreclosure only" state. In other words, to foreclose, the lender must file a lawsuit against the borrower in the circuit court in which the property is located. (Some big states, notably Georgia, California, Texas, and New York, allow non-judicial foreclosure in some instances. But not Florida). Foreclosure is started by the lender sending the borrower a demand letter to pay once the borrower falls behind in payments. Usually the borrower has 30 days to cure the default. Some lenders may work with the borrower by giving the borrower more time to pay, or even reducing the monthly payment. Some lenders, though, will never return calls.

The options can vary greatly from lender to lender. If the borrower can't work it out with the lender, or if the borrower doesn't want to work it out, the lender will eventually foreclose. The lender files a foreclosure complaint in the circuit court in the county in which the property is located. The suit must be filed in that county, not the county in which the borrower resides or the county in which the lender is headquartered. The foreclosure complaint is the "suit." The lender will also record a "lis pendens" in the public records of the county in which the property is located, which tells the world that the property is in foreclosure. The lis pendens cuts off the rights of any lienholder or other party who records its lien or document after the date of recording of the lis pendens. The lis pendens is a very powerful litigation tool. It "ties up" the property so that the seller cannot sell it until the lis pendens is released. The lender must join any junior lienholders (i.e., holders of HELOC's or second mortgages) in the foreclosure action. Otherwise, their interests will not be "foreclosed," or wiped out. The lender must try to get personal service of process of the sum-



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mons and complaint on the borrower and all other defendants. Note that it must get personal service of process on the borrower in order to eventually be granted a deficiency judgment. If the lender can't get personal service of process after diligent effort, it can do service of process by publication, by filing a Notice of Action in a local newspaper, once a week for four consecutive weeks.

If the borrower is personally served, the borrower must file an Answer and Affirmative Defenses with the court and the lender's attorney within 20 days of being served the foreclosure complaint. The borrower must admit or deny the allegations contained in the complaint, and state why the foreclosure should not be granted. But in today's environment, most borrowers have little to no legitimate defense. If the borrower does not file an answer within the 20 days, he or she risks being defaulted, which means he or she essentially loses the case. Also, if the borrower is defaulted, the lender's attorney is not required to mail to the borrower any subsequent information from the court on the case. Obviously that is a huge disadvantage to the borrower, because he or she will not know when and what documents are being filed in the case, nor will the borrower know of hearing dates or locations. So the borrower should always file some sort of an answer.

Assuming no other motions are filed, the lender will then file a Motion for Summary Judgment, which says, in essence, "the borrower has not paid, the material facts are not in dispute, and I am entitled to a Summary Final Judgment of Foreclosure as a matter of law." (The Motion for Summary Judgment usually asks the court to reserve jurisdiction to award a deficiency judgment. But again, presently few lenders are seeking deficiency judgments). The lender sets the hearing on the Motion for Summary Judgment, and sends a

notice of the hearing date, time, and place to all parties who have filed an answer. At the hearing, the judge will usually grant the Motion for Summary Judgment, unless he or she believes that some material facts are in dispute, in which case the judge sets the matter for a non jury trial (no right to a jury trial in a foreclosure case). Assuming the judge does not believe any material facts are in dispute, he or she then signs the Summary Final Judgment of Foreclosure, stating the amount owed under the promissory note and mortgage, plus past due amounts, court costs, and attorney's fees, and setting the property for foreclosure sale. The foreclosure sale is ordinarily held within 20 to 35 days after the Summary Final Judgment of Foreclosure is signed. A Notice of Sale must be published once a week for two consecutive weeks in the county in which the property is located. The Notice of Sale identifies the property to be sold and states the time and place of the sale. The property is then sold at the sale to the highest bidder for cash.

In this market, with foreclosed properties containing little or no equity, the highest bidder is usually the lender. The lender ordinarily bids the amount contained in the Summary Final Judgment, plus a nominal amount, such as \$100. The lender can do this because it gets a credit towards its bid equal to the amount due under the Summary Final Judgment. Immediately after the sale, the clerk of court will issue and file a Certificate of Sale, which identifies the winning bidder. The borrower has a redemption right and may stop the foreclosure sale at any time before the filing of the Certificate of Sale by paying off the amount contained in the Summary Final Judgment. Objections to the sale must be made within 10 days from the date of issuance of the Certificate of Sale. If there are no objections and 10 days have elapsed, the clerk issues the Certificate of Title to the winning bidder, and disburses the sale proceeds (if any) as per the Summary Final Judgment. The Certificate of Title acts like a deed, and it conveys title to the winning bidder. The new owner is entitled to immediate possession of the property.

If the borrower or tenants are still in the premises, the new owner is entitled to a writ of possession, usually without having to file a new eviction suit.

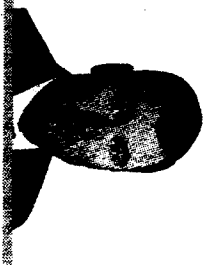
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## Lenders don't seem to be pursuing deficiency judgments

BY NED HALE

Special to The News-Press



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A few months ago, I ran into an attorney in the hallway of the Lee County Courthouse. This attorney represents many lenders in foreclosure actions. I asked him if lenders were seeking deficiency judgments against borrowers in foreclosure suits.

"None of the lenders I represent are. Not a single one," he replied. When I asked him why more lenders were not seeking deficiency judgments, he replied with a less than flattering comment about the competence of bank executives.

Fast forward to a couple of weeks ago, when I heard another such active foreclosure attorney state in open court in a foreclosure hearing that only one major institutional lender is currently seeking deficiency judgments in this county, and that lender was only seeking them in foreclosure actions involving investors in Cape Coral vacant waterfront lots.

In a foreclosure suit, a "deficiency" arises when the fair market value of the property on the date of the foreclosure sale is less than the outstanding loan balance plus the attorney's fees and costs incurred in the foreclosure action. In plain English, it is

the lender's fees and costs, minus the fair market value of the property as of the foreclosure sale date. The difference is the amount of the deficiency judgment.

In this market, that difference can be tens of thousands, even hundreds of thousands, of dollars. Note however, that the lender, not the borrower, has the burden of proving the fair market value. As long as the borrower has made a written appearance in the foreclosure suit by filing a written answer with the court in the foreclosure suit, the borrower is entitled to attend the deficiency judgment hearing and present the expert testimony of an appraiser to attempt to prove that the actual fair market value is higher than the lender believes, thus leading to a lower deficiency judgment. (Of course, if the fair market value of the property exceeds the outstanding loan balance plus attorney's fees and costs, then there is no deficiency and the lender would not be entitled to a deficiency judgment. But that rarely happens in this market.)

Again, though, the big news is that at present very few large institutional lenders are even bothering to seek deficiency judgments in foreclosure suits. The main reason is that lenders

figure that if someone cannot pay his or her mortgage, then he or she probably cannot pay a deficiency judgment either, and the lender could waste money on an attorney chasing a deficiency judgment and not collect a dime. Instead, lenders focus on getting title to the real estate in a foreclosure suit so they can resell the property and recoup some of their losses. (Note though, that a few smaller banks and hard money lenders are regularly seeking deficiency judgments.)

Nevertheless, it is still quite surprising that more lenders do not at least try to get deficiency judgments more often, since obtaining them does not involve a great deal of extra time or work. If lenders were to get deficiency judgments in all cases, they most certainly would eventually be able to collect on some of them, which would likely more than pay for the attorney's fees on the uncollected ones. But since banking executives do not seem to understand this logic, I must echo the comments of the attorney I talked to at the courthouse about their overall competence.

One very interesting point about a deficiency judgment is that a lender cannot seek one unless it has obtained personal service of process upon the bor-

rower in the foreclosure suit.

Personal service of process can be had in a number of ways, but it most often occurs where a process server does a hand-to-hand transfer of the foreclosure suit and summons directly to a borrower or to a borrower's family member aged 15 or older at the borrower's residence. If a lender cannot affect personal service of process — most often because it cannot find a borrower — then the lender must follow a procedure called "constructive service of process."

This is an expensive and time-consuming process whereby the lender publishes a document called a notice of action in a local newspaper, and it must file additional documents with the court. Lenders hate having to resort to constructive service of process due to the additional time and expense involved, but they regularly do it when they have to.

Once a lender follows all of the requirements for constructive service of process, it can proceed with the foreclosure suit and eventually gain title to the real estate, but courts in Florida have ruled that if a lender has relied on constructive service of process in a foreclosure suit, then it is not entitled to a deficiency judgment against the borrower.

A lender must have had personal service of process upon the borrower in order to obtain a deficiency judgment. Simply put, no personal service, no deficiency judgment. This makes sense, because if a borrower has not been served the summons and complaint, then he or she may not know about the case and therefore may not be able to defend himself or herself. Overall, though, the courts' requirement of personal service of process for entitlement to a deficiency judgment greatly benefits borrowers, since personal service of process cannot be had on many of them. Some really cannot be located, and some intentionally conceal themselves.

In those unusual cases where a lender does seek and obtain a deficiency judgment, it is the lender's burden to collect on that judgment. Many borrowers are terrified that they will lose everything if the lender comes after them, but in actuality only a portion of a borrower's assets are at risk. What assets are protected and what assets are at risk will be the subject of a future article.

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# Most lenders not seeking deficiency judgment

Florida often seen as 'debtor friendly'

*"I have been through some terrible things in my life, some of which actually happened." — Mark Twain*

Lee County recently received the dubious distinction of having the highest foreclosure rate in the entire country for 2008.

Most borrowers here facing foreclosure accept the fact that they will lose the real estate, but nearly all fear that a foreclosing lender will also obtain a money judgment (called a "deficiency judgment"), against them and then try to seize their assets in an attempt to collect.

The deficiency judgment would be calculated by taking the difference between the fair market value of the real estate and the loan balance. As I have stated in this column previously,

though, most foreclosing lenders are not bothering to even ask the courts for a deficiency judgment, and therefore most borrowers have nothing to worry about. But to paraphrase the above Mark Twain quote, the fact that something is unlikely to happen does not stop us from fretting about it.

And even complacent borrowers should at least be informed about what assets are at risk in the unlikely event that a lender does obtain a deficiency judgment. (Note too that Florida law on asset seizure described in this article applies to all types of civil judgments in Florida, not just deficiency judgments by a foreclosing lender.)

The general rule in Florida is that all assets belonging to a debtor are subject to seizure by a judgment creditor (a lender with a deficiency judgment against a borrower is considered to be a

judgment creditor), unless that asset falls under a specific exemption to seizure.

Examples of assets which are subject to seizure include real estate; personal property such as cars, boats, jewelry and furniture; bank accounts; certificates of deposit; corporate stock; mutual funds; income from a trust; and even future wages.

What makes Florida law unique, however, is that compared to other states, it provides for a relatively high number of exemptions to seizure. For that reason Florida is often seen as a "debtor friendly" state.

Florida's best known exemption is its homestead exemption, under which a debtor's homestead is fully protected from outside creditors, up to one half acre if the homestead is located within a municipality, and up to 160 acres if it is

located outside a municipality. There is no dollar limit to this exemption. Of course, this exemption only applies to outside creditors — If a borrower does not pay the mortgage recorded against the homestead itself, the lender can still foreclose on the homestead and can still attempt to seize other assets. So in the foreclosure context, Florida's

homestead exception only protects the homestead of a borrower who has lost investment real estate to foreclosure. (In the non foreclosure context, Florida's homestead exemption provides a debtor with great asset protection, since it completely protects what for many people is their biggest asset: the equity in their home).

Another interesting exemption to seizure in Florida is the marital property exemption. Under this exemption, any property, real or personal, that is owned together by

spouses in the marriage cannot be seized to pay the debt of one of the spouses. So if only one spouse owns, say, investment real estate in his or her name only, and the lender forecloses and seeks a deficiency judgment, then the lender cannot seize any assets owned by the spouses together as husband and wife.

This can be a very useful exemption for married debtors, since most married couples own much of their assets together as husband and wife.

Other assets exempt from seizure include up to \$1,000 in personal property, the proceeds and the cash value of life insurance policy, the proceeds and the cash surrender value of an annuity (don't just ignore those life insurance and annuity salesmen offering you a seminar and a free lunch!), disability, worker's compensation, and unemployment

benefits, certain wages of a "head of household" wage earner, and certain qualified profit sharing and pension benefit plans such as IRAs, and 401(k)'s, as well as prepaid college tuition plans such as 529's.

This article has simply described what assets a foreclosing lender can potentially seize from a borrower in order to satisfy a deficiency judgment in a foreclosure suit. The process which the lender must follow to seize an asset, such as execution, levy, and garnishment, and related issues such as fraudulent conveyances and bankruptcy, will be covered in future columns. For now, though, the overly concerned need only to remember what Mark Twain said.

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