



key decision

What do CRSs need to know to counsel clients who may be considering a strategic default on their mortgage?

By Gwen Moran

● **23.1 percent of all U.S. residential mortgages were underwater at the end of 2010.**

Source: CoreLogic

Earlier this year, Joe Bourland, CRS, a REALTOR® with RE/MAX Professionals in Avondale, Ariz., was trying to help a seller with a short sale. The client had purchased the property in 2006 and lived there for two years. In 2008, after a job transfer to Florida, the client turned the property into a rental. Eventually, it became impossible to manage from a distance, and he decided to try to sell the property, which was now worth less than the mortgage owed.

Bourland listed the property and received an offer, but the bank demanded a \$30,000 promissory note from Bourland's client in addition to the deal. Arizona, however, is a nonrecourse state, meaning banks cannot pursue a shortfall from a short sale or foreclosure by demanding assets from or suing the borrower. Bourland thought it would be a simple administrative issue to clear up. He was wrong.

"My client consulted his attorney and they tried to inform the bank that the client

comstock/Getty Images

didn't have to pay, but the lender declined the buy," recalls Bourland. As a result of the failed short sale, the client decided to let the property fall into foreclosure.

In some cases, this scenario, known as a strategic mortgage default, is a business decision for a family, says real estate attorney Lance D. Churchill, co-founder of Frontline Companies, a real estate training company in Boise, Idaho. Even if borrowers can pay the mortgage, when the property value falls to much less than what is owed, they may conclude they are "throwing money into a black hole," he says.

And it seems fewer people are willing to do that. While the numbers of strategic defaults are difficult to track because there is no uniform definition or criteria to measure them, a December 2010 Trulia/RealtyTrac survey found that nearly half (48 percent) of homeowners with a mortgage would consider walking away if the property was underwater — up 7 percent from May 2010. An April 2010 report from Morgan Stanley found that borrowers default at an increased rate, "reaching 17 percent of households defaulting strategically, when their equity shortfall reaches 50 percent of the value of their homes." The study also found that people who know someone who defaulted were 82 percent more likely to do so themselves.

As short sales and foreclosure rates rise, CRSs increasingly find themselves working with clients facing tough financial decisions — including the possibility of walking away from their mortgages. It's in agents' — and their clients' — best interests to make sure they fully understand the laws, regulations and implications surrounding any advice they may give, Churchill says. And agents who can connect such clients with top legal and financial professionals will go a long way toward building client loyalty and referrals for the future.

The Consequences

REALTORS® and their clients must carefully consider the consequences for borrowers who decide to default on their mortgage loans. In June 2010, Fannie Mae announced that defaulting borrowers who walk away from their loans and have the

capacity to pay or did not try to work out payment with the lender in good faith will be ineligible for a new Fannie Mae-backed mortgage for seven years from the date of foreclosure. Borrowers who have extenuating circumstances or hardship may be eligible for a new loan within a shorter period of time. But Churchill suggests that Fannie Mae has never adequately defined its criteria for a strategic default, so it's unclear how that provision will be enforced, he says.

If a client has substantial assets or lacks extenuating circumstances, such as job loss, divorce, illness or other hardship, it may not be possible to qualify for a short sale to begin with, says Travis Waller, CRS, with RE/MAX Advantage Plus in Teaneck, N.J. Other roadblocks to qualifying for a short sale might include multiple liens on a property, such as tax liens or a second mortgage. In those cases, homeowners may choose to strategically default to prevent spending money on a property that will never regain its value.

New Jersey, like most states (except Alaska, Arizona, California, Iowa, Minnesota, Montana, North Carolina, North Dakota, Oregon, Washington, and Wisconsin), allows lenders to seek reimbursement for any shortfall resulting from a short sale or foreclosure. Steven J. Elliott, CPA, tax director with accounting firm Schwartz & Co., in Bellmore, N.Y., says REALTORS® need to be careful when they talk to clients about potential tax consequences for any debt that is forgiven as part of the short sale or foreclosure. Unless a borrower has filed for bankruptcy or can prove insolvency — more liabilities than assets — lenders can pursue legal action for the difference in what was owed and what was received, he says. In some states, there is a window of only a few months in which lenders can do so. Therefore, it's critical that agents know how the laws in their state could affect their client's situation.

Giving Good Counsel

Of course, REALTORS® cannot give legal or financial advice and must always refer clients to legal, financial and tax professionals about such issues. And it's critical

for agents to be well-versed in the laws and regulations that affect their interactions with clients. One such rule is the Federal Trade Commission's (FTC) Mortgage Assistance Relief Services (MARS) Rule, issued in November 2010. Although it is targeted to mortgage relief companies, FTC materials state that the rule covers real estate agents who promote their services as a way to help consumers avoid foreclosure, such as getting a lender's approval for a short sale. Under the rule, agents must disclose that they are not affiliated with the government, advise borrowers that lenders may not agree to mortgage adjustments, and tell them that not paying the mortgage could result in damage to their credit rating and the loss of the home.

Waller now deals 100 percent in short sales. He says one of his biggest challenges when counseling clients considering strategic default is their emotional state. "They're angry that they pay so much for a home and then the home is worth 40 percent less than what they bought it for. They ask, 'Why should I keep paying for something that's not worth the value?'" he says.

When attending meetings with homeowners facing such tough financial decisions, Waller always brings proof that the clients are not alone. He brings listings of available homes sold in the previous three months, as well as lists of homes with payments that are at least 90 days late. Once they see the overwhelming number of properties that are embroiled in similar circumstances, they begin to relax and can make more informed, analytical decisions, he says.

If a client does decide to default, Churchill says a plan is in order: Get good legal and financial counsel and look at the move as a business decision rather than a moral one. "Some people think that they're breaking the law. This is certainly not a criminal violation. It's a contract issue," he says. "If you're 20 or 30 percent or more underwater and you don't have other options, it might be something to consider." 🏠

Gwen Moran is a writer based in Wall Township, N.J., and is a frequent contributor to *The Residential Specialist*.