

To Our Clients and Friends:

Alternatives to Foreclosure: An Overview

Given the difficult economic times and the exponential rise in defaults on loans secured by real estate, it is imperative that lenders and other lien holders familiarize themselves with some of the more cost efficient and less time-consuming alternatives to foreclosure and the legal issues that may arise in their use. Some of these alternatives are briefly introduced and discussed below.

I. Reinstatement

Reinstatement may be preferable to foreclosure in cases where you have a debtor that has a short-term cash flow problem. Generally, reinstatement agreements require the debtor to make a lump sum payment of the entire amount in default, including interest, attorney's fees and penalties, by a date certain. Once this payment has been received by the lien holder, the loan is reinstated and the debtor resumes payments according to the original payment schedule.

Lien holders should ensure that the reinstatement agreement sets forth the following: (i) the event of default; (ii) a provision that makes it clear that the execution of the reinstatement agreement is not to be considered and does not constitute a waiver of the lien holder's rights under the promissory note or any security agreement; (iii) a provision that makes it clear that if the monies due are not paid by a specific date, the lien holder can proceed forward without prejudice to any of its rights; and (iv) detailed payment provisions. The inclusion of the stipulations in (ii) and (iii) above in the reinstatement agreement is of particular importance, as it preserves the lien holder's right to move forward with foreclosure or one of the other alternatives in the event the debtor fails to make payment by the specified date.

II. Repayment Plans

Lien holders may also want to consider using a repayment plan when dealing with a debtor with short-term cash flow problems. A repayment plan allows the debtor to resume making its regular monthly payments with an additional amount, representing a portion of past due payments, interest, attorney's fees and late fees, added to that payment to cure the delinquency. This alternative is preferable for debtors that may not be able to make the lump sum payment called for in a reinstatement, but may be able to take on a higher monthly payment because of a recent change in circumstances. The lien holder is getting the same sum of money as it would in using a reinstatement, but instead of receiving all of its money at once, the amount is spread out over a finite period.

The repayment plan should contain the same stipulations found in the reinstatement agreement. In addition, the default provisions should permit the lien holder to exercise all of its rights and remedies at law or in equity should the debtor fail to comply with the repayment plan in any respect. Lien holders may also want to include a payment chart detailing the additional payments due each month in addition to the regular payment.

III. Mortgage Modification

Lien holders dealing with a debtor suffering from long term cash flow issues may want to consider entering into a mortgage modification agreement. Under most mortgage modifications, the lien holder agrees to amend the mortgage agreement to extend the life of the loan, resulting in a reduction in the debtor's monthly payments. The lien holder may consider: (i) placing the debtor's delinquent payments and any costs associated with those payments at the end of the loan; (ii) increasing the interest rate and the number of months for repayment; (iii) changing an adjustable rate to a higher fixed rate and giving the debtor more time to pay; or (iv) utilizing the same principal and interest but extending the number of months for repayment.

Lien holders should keep in mind that mortgage modification agreements must be in writing, conform to the same formalities as did the original mortgage, and be recorded in the land records in the city or county in which the property is located. A new promissory note should also be executed by the debtor in instances where there is a change to the interest rate, number of payments or payment dates.

IV. Partial Claim

In cases where the debtor's mortgage is insured, the lien holder may be able to assist the debtor in securing a one-time interest free loan from the mortgage guarantor to bring the account current. The debtor may qualify for an FHA partial claim if his loan is at least 90 days but less than 12 months delinquent, and the debtor can show that he is able to begin paying the full amount of the mortgage payments again. Housing and Urban Development ("HUD") pays the lien holder the amount necessary to bring the mortgage current. In return, the debtor signs a promissory note and HUD places a lien on the debtor's property until the promissory note is paid in full, which is usually the earlier of the mortgage being paid off or the property being sold.

The recovery to a lien holder under a partial claim is similar to that of a reinstatement, but lien holders should keep in mind that the administrative and related costs incurred by the lien holder in procuring the partial claim cannot be recovered from the debtor.

V. Sale, Pre-Foreclosure or Short Sale

If after exploring the alternatives discussed above the lien holder concludes that none of them are a reasonable option, the lien holder may want to consider a sale or pre-foreclosure or short sale. In the case of a sale, a lien holder enters into a forbearance agreement stating a sum certain that is owed and giving the specific amount of time the debtor has to find a ready, willing, and able

purchaser, as well as a timeline for a closing on the property. The forbearance agreement is tantamount to an estoppel letter and the lien holder forbears from exercising any of its remedies during the period stated in the forbearance agreement. If a sale is not achieved by the expiration of that time period, the lien holder may move forward on its legal and equitable remedies.

If a lien holder finds itself in a declining market and the home or property no longer has the same fair market value it did when the loan was made, the lien holder may want to consider a pre-foreclosure sale or short payoff. In a pre-foreclosure sale or short payoff, the lien holder is willing to take less than the full amount owed if it is confident the property can be sold in less than 6 months and the lien holder's appraiser can show that the value of the home meets HUD program guidelines. This alternative relieves the lien holder of the burden and expense of carrying and remarketing a property that would not allow the lien holder to recoup the loan amount even if the lien holder was able to sell the property at its current fair market value.

The forbearance agreement in a pre-foreclosure or short sale should include the same general terms as the forbearance agreement for a regular sale. In addition, lien holders should be certain that the forbearance agreement states the minimum sales price acceptable to the lien holder. Debtor's should be clear that minimum sales price is a net number and that the lien holder must net at least that amount for a short sale to be acceptable.

V. Assumption by a Qualified Buyer

If a lien holder is aware of qualified buyer that would like to assume the existing mortgage, the lien holder may want to consider an assumption. The assuming party is simply substituted for the original debtor on the note and the mortgage. At the closing, any delinquent amount and all applicable fees are paid by the assuming party to the lien holder in a lump sum. It should be noted that the lien holder has the discretion to allow a qualified buyer to assume a loan even if the original loan documents state that the loan is not assumable. Since the assumption clause in a loan document inures to the benefit of the lien holder and not the debtor, the lien holder may modify or waive this provision.

VI. Deed-in-Lieu of Foreclosure

In the case of a deed-in-lieu of foreclosure, the debtor executes a deed transferring ownership of the property to the lien holder in exchange for forgiveness of the debt. There are many issues to consider when deciding whether to accept a deed-in-lieu of foreclosure, and short of foreclosure, this option should be considered a lien holder's last resort in recovering collateral.

VII. Suit on the Promissory Note

If none of the above alternatives are viable and the lien holder still does not want to foreclose, it may want to consider suing the debtor on the underlying indebtedness (i.e., the promissory note). An action for breach of promissory note, breach of contract or similar cause of action may be brought against the debtor if recovery of the collateral does not economically make sense for the

lien holder due to the condition of the property, a loss in significant value or the existence of a superior lien on the property. A suit on the indebtedness will procure the lien holder a judgment against the debtor that may be recorded in the land records in any city or county in which the debtor owns real property. It can also form the basis for the issuance of a judgment lien on the debtor's personal property and entitle the lien holder to post-judgment collection remedies, including levy, execution, garnishment and attachment. In short, the judgment allows the lien holder to obtain payment through sources other than the collateral itself when the debtor has assets subject to collection which are not otherwise covered by the security agreement.

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For information on topics covered in this Real Estate Law Update, please speak with your regular Cooper, Spong & Davis contact, or please contact:

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