A Reprint from *Tierra Grande*

DILF OR NO DILF

BY JUDON FAMBROUGH

Deed In Lieu of Foreclosure

With foreclosures littering the Texas residential landscape, echoes of the 1980s are resonating throughout the real estate industry. Texas ranked among the top ten states in the nation in number of foreclosures throughout 2006. When confronted with foreclosure, what options are available to homeowners? Which is most attractive to lenders?

Homeowners may end the foreclosure process by paying off the debt before the foreclosure sale begins. This is known as an *equity of redemption,* not to be confused with a *right of redemption* following a sale. Texas recognizes the right of redemption following tax sales only. No right of redemption follows a mortgage foreclosure sale. In all probability, though, homeowners who have defaulted on their monthly payments would lack the financial ability to retire the entire debt before the sale.

A second option is to refinance the debt with another lender, although poor credit records or the time needed to complete the transaction may make this alternative impossible.

The homeowner's third option is to sell the property and pay off the debt. Again, timing is critical. The homeowner should list and sell the property before the home is posted for foreclosure. Potential buyers may avoid making an offer thinking they can get a better price by bidding at the foreclosure sale.

Finally, homeowners may attempt to convey the property back to the lender in exchange for cancelling the debt. This is known as a deed in lieu of foreclosure (DILF), and it requires the lender's consent and cooperation.

Compared with traditional nonjudicial foreclosures under deeds of trust, DILFs present several advantages:

- They are quicker, requiring fewer than the minimum of 41 days needed to foreclose on a home under a deed of trust.
- They are less expensive. The major costs of a DILF are deed preparation and the recording fee. In addition, lenders may require the debtor to pay for a title search and an appraisal before consenting. The foreclosure process under a deed of trust can cost several thousand dollars.
- They are more confidential. The transaction is not publicized, and no public sale occurs. The only public evidence of the transaction is the recording of the deed from the debtor to the lender. The debtor's credit is unaffected.

The income-tax consequences of the debt forgiveness pose a possible disadvantage, so homeowners should seek independent financial advice before executing a DILF.

However, the Mortgage Forgiveness Debt Relief Act of 2007 generally allows taxpayers to exclude income from the discharge of debt on their principal residence. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualify for this relief. Debt forgiveness in lieu of foreclosure appears to fall under these provisions.

The act applies to debt forgiven in calendar years 2007 through 2010. Up to $2 million of forgiven debt is eligible for this exclusion ($1 million if married filing separately). The exclusion doesn't apply if the discharge is due to services performed for the lender or any other reason not directly related to a decline in the home's value or the taxpayer's financial condition.

The amount excluded reduces the taxpayer's cost basis in the home. Further information, including detailed examples, can also be found in IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments.

In the 1980s, lenders hesitated to accept DILFs because they feared other liens and debts burdened the property. Foreclosure eliminated these existing financial burdens, but a DILF did not.

For example, say Lender A holds a first lien on the property; Lender B holds a second. If Lender A forecloses, the sale terminates Lender B's lien and any junior liens. A foreclosure by Lender B has no effect on the first lien. It remains intact.

If Lender A consents to a DILF, the lender takes the property subject to the second lien and any junior liens. This is one of the major reasons why lenders will not consent to a DILF. They want to receive clear title guaranteed by foreclosure.

Legislation passed in 1995 eliminates some of the lenders' concerns (Section 51.006, Texas Property Code). Many Texas lenders and attorneys may not be familiar with this law. It applies to lenders holding liens on properties through deeds of trust but not through contracts for deed. The *Texas Real Estate Forms Manual* labels mortgages for home equity loans as "Deed of Trust (Home Equity Loan)." This suggests that Section 51.006 applies to home equity loans secured by deeds of trust.

Under this statute, a DILF is not final just because a lender consents. The lender may void (rescind or set aside) the arrangement for up to four years after the debtor conveys the property back to the lender if:

- the debtor (homeowner) failed to disclose a lien or other encumbrance on the property before executing the deed, or
- the lender had no personal knowledge of an undisclosed lien or encumbrance on the property at the time.

If, during the four years, the lender discovers the debtor failed to disclose a lien or encumbrance, the lender can:

- void or rescind the deed by executing an affidavit and filing it in the deed records. This restores the lien status of the original deed of trust to the position it held before the DILF. The lender would likely pursue this option while still in possession of the property.
- foreclose immediately on the deed of trust without voiding the deed. The DILF does not affect the lien priority of the deed of trust for purposes of the foreclosure. This option would most likely be pursued when the property has been resold. It clears title for the current owner.

Only one appellate case has addressed this statute. In a memorandum opinion, the Corpus Christi Court of Appeals upheld the validity of the statute on the lender's behalf (*Joiner v. Pactiv Corp., 2005 WL 1907780*, Aug. 11, 2005.) With the recent increase in Texas foreclosures, the law may generate more judicial attention.

In addition to eliminating some risks lenders face in consenting to DILFs, the law gives lenders an incentive to demand a title search and an appraisal.

The title search confirms that no recorded liens exist on the property. This includes second liens, judgment liens, tax liens, unpaid assessments and other debts. The debtor pays for the search and needs to settle outstanding liens before the lender consents to the DILF.

The debtor also pays for the appraisal, which substantiates the value of the home. If the value of the home does not equal or exceed the balance of the debt, the chances of a DILF fade. Here's why.

After a foreclosure, the debtor remains personally liable for the unsatisfied portion of the promissory note and associated foreclosure expenses. When this happens, the lender may seek repayment through a deficiency judgment. Under a DILF, lenders lose the right to recover the deficit.

Consequently, some lenders may require the home's value to greatly exceed the debt, not just equal it, before consenting. Lenders must resell the property to recoup the unpaid debt. Prospective buyers face the possibility of the sale being set aside (rescinded) for as long as four years after the DILF occurs. This impacts what buyers are willing to pay for the property. No doubt, many prospective buyers expect a discount for taking this risk.

DILFS ARE QUICKER, LESS EXPENSIVE AND MORE CONFIDENTIAL THAN TRADITIONAL NONJUDICIAL FORECLOSURES UNDER DEEDS OF TRUST.

Debtors, on the other hand, may favor foreclosure over a DILF when the property value greatly exceeds the debt. Any excess revenue generated by the foreclosure sale goes to the debtors. This is not the case with a DILF. Debtors forfeit their equity.

The final hurdle for homeowners is finding the lienholder who owns the mortgage to discuss the option. If the local mortgage lender still holds the lien, the homeowners may be able to persuade the lender to enter a DILF. However, if the loan has been sold, it may be impossible to find the lienholder. This essentially dooms the chances of getting a DILF.

It will be interesting to see if Section 51.006 changes lenders' attitudes toward DILFs. Only after scrutinizing the results of the title search and the appraisal can lenders assess the wisdom of a DILF.

For more information, see "A Homeowner's Rights Under Foreclosure," Real Estate Center publication 825, at http://recenter.tamu.edu/pdf/825.pdf.

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THE TAKEAWAY

With the frequency of foreclosures on the rise, homeowners facing this crisis need to know their options. Under the right circumstances, working out a deed in lieu of foreclosure with the lender may be an alternative beneficial to both the homeowner and lender. A recent change in Texas statutory law makes it more attractive to lenders.

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Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: Real Estate Center files, p. 1.