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.
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.