

Top Three Real Estate Litigation Issues

Presented by

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Bankruptcy in a Foreclosure

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Bankruptcy in a Foreclosure

▪ The Use and Impact of Bankruptcy on Foreclosure and Foreclosure Alternatives for Distressed Property

- What are the alternatives available to the owners of distressed real estate and their legal counsel to foreclosure?
- What strategies can be used to avoid foreclosure?

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The Initial Consultation

- Key to Giving Competent Legal Counsel
- What is Financial Distress?
- Primary Causes of Financial Distress
- Strategies for the Debtor

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To Retain or Not to Retain

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Dealing with the Likelihood and Emotional Impact of Foreclosure

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What Types of Programs Are Available?

- **Two types of programs for dealing with property in financial distress:**

- Non-Retention Programs

- Foreclosure
 - Deed in Lieu of Foreclosure (and HAFA)
 - Short Sale (and HAFA)
 - Deed for Lease

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What Types of Programs Are Available?

- **Two types of programs for dealing with property in financial distress:**

- Retention Programs

- Loan Modification – Federal Programs
 - HAMP
 - PRA HAMP
 - Loan Modification/Restructuring – Internal Lender Programs
 - Refinancing

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Factors to be Considered

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Illinois' Hardest Hit Program

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HAMP and PRA HAMP

- HAMP Modifications
- Qualification
- Features
- Proposed Changes to HAMP

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HAMP Net Present Value (NPV) Test

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HAMP Trial Payment Period

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HAMP Servicer Incentive Compensation

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HAMP Borrower Incentive Compensation

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PRA (Principal Reduction Alternative) HAMP

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HAFA - Home Affordable Foreclosure Alternatives Program

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Tax Issues in Forgiven Mortgage Debt

▪ IRS Publication 4681 exceptions:

- qualified principal residence;
- debts discharged in bankruptcy;
- insolvency on balance sheet basis (i.e., more liabilities than assets);
- certain farm debts; and
- non-recourse loans.

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Tax Issues in Forgiven Mortgage Debt

- **Mortgage Forgiveness Debt Relief Act of 2007 (extended through 2012)**
 - Forgiven debt classified as a negotiated settlement in contested foreclosure.

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Impact and Use of Bankruptcy

- **The Use of a Chapter 7 Bankruptcy in Foreclosure**

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Impact and Use of Bankruptcy

- **The Use of a Chapter 13 Bankruptcy in Foreclosure**

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Impact and Use of Bankruptcy

- The Use of a Chapter 11 Bankruptcy in Foreclosure

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Impact and Use of Bankruptcy

- When Investors or Servicers Go Bankrupt

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Impact and Use of Bankruptcy

- Leverage through Potential Foreclosure Defenses

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Tax Assessment Appeals

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Controlling Property Taxes

To Improve Cash Flow

Michael J. Elliott



What will we talk about today?

- Minimizing taxes
- Deferring payment of taxes
- Tax redemptions and sales



How to minimize taxes?

... and increase cash flow

- Reduce assessments
- Maximize exemptions



Reducing assessments

Different appeal venues -- different outcomes

Assessor and
Board of Review



Reduced tax bill

PTAB or Court



Tax refund



Reducing assessments

Timing

Assessor and Board
of Review

Once a year
30-day window



PTAB or Court

30-day window (PTAB)
75- or 165-day window (Court)
Must have appealed to Board of Review



Arguments

What do we need to prove?

- | Factual errors | Market Value | Uniformity |
|----------------|---------------------|------------|
| ➤ Permanent | ➤ Purchase price | |
| | ➤ Appraisal | |
| | ➤ Sales comparables | |



Maximizing exemptions

What exemptions may apply?

- Home owner exemption
- 7% assessment cap
- Senior citizen exemption
- Senior citizen assessment freeze
- Long-term homeowner exemption
- Home improvement exemption




Deferring payment of taxes

... as another means of increasing cash flow

- Senior citizen tax deferral program
- Intentional non-payment of taxes







Tax sales and redemptions

What you need to know to avoid losing your property



Delinquent taxes

- County has a tax lien
- Lien is of highest priority
- Interest of 1.5% per month
- Penalty interest

Tax sale

- What is it?
 - Timing
- Interest Rate

Tax deed

When does a tax deed issue?

No timely redemption



Tax buyer follows the rules



Tax deed will issue



Pre-requisites for obtaining a tax deed

What must the tax buyer do?

1. Pay the subsequent taxes
2. Strictly follow procedural rules
3. Give notice to affected parties



Redemption

Redemption Date

Residential 2 ½ years

Non-Residential 6 months
where 2 or more
years' taxes are
delinquent or
forfeited

All other cases 2 years



Note: Residential is 6 or fewer units

Redemption

Extension

Extended Date Up to 3 years



Redemption

Logistics

- Estimate of redemption
- Moving target
- Full payment by cashier's or certified check



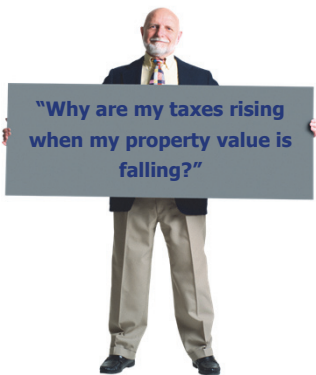
Redemption

Advice

- Hire a pro (potential for malpractice)
- Otherwise, follow these steps
 1. Order a tax search
 2. Delinquent taxes, open items, forfeited taxes, and sold taxes?
 3. Multiple tax sales?
 4. Get necessary estimate(s) of redemption



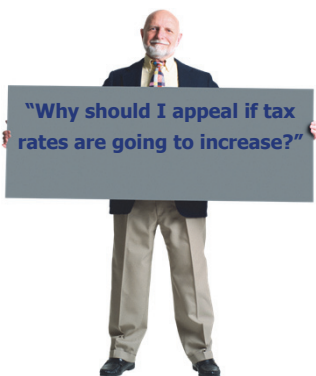
Commonly Asked Question #1



Commonly Asked Question #2



Commonly Asked Question #3



Questions



City of Chicago Building Code Cases

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How does it happen?

- Complaint
- Inspection

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What happens if the inspector finds a violation?

- Issue an administrative citation.
- File a building or demolition court case.

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Department of Administrative Hearings

- The Department of Administrative Hearings is an independent quasi-judicial body that adjudicates matters of “public health, safety, welfare, morals, and quality of life.”

– http://www.cityofchicago.org/city/en/depts/ah/supp_info/the_hearing_process.html

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How to Prepare for an Administrative Hearing

- **Do you have any defenses?**
 - Not an owner or manager of property, and not in control of property
 - Other defenses
 - Mitigating circumstances
- **Call the inspector or attorney prior to the hearing date.**

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How to Prepare for an Administrative Hearing

- If it is an item that is non-compliant, try to repair before the hearing date. If it can't be repaired, e.g., permits needed for work, then start that process.
 - I've tried to get my permits and there is a "hold" on my address.
 - Why the rush; can't I just continue the case?
- **Attend. Don't be defaulted!**

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The Hearing

- Everyone fills out an appearance on a City of Chicago form *each time* they attend.
- There is a "costs" charge *each time* you continue the case.

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The Hearing

- **Are repairs done?**
 - Can you request a compliance dismissal?
- **If you go to hearing, have your evidence and witnesses ready.**

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Building and Demolition Court Complaints

- Brought under the Illinois Unsafe Property Act, 65 ILCS 5/11-31-1, *et seq.* and the Chicago Municipal Code § 13-12-130.
- Seeks:
 - Injunction
 - Compliance or Demolition
 - Costs
 - Fines

IN THE CIRCUIT COURT OF COOK COUNTY
MUNICIPAL DEPARTMENT - FIRST DISTRICT

THE CITY OF CHICAGO, a municipal corporation,
Plaintiff, Case Number: **12 M 1**
vs. **[REDACTED]**
Defendant. No. **CHICAGO, IL 60605**

SUMMONS

TO **[REDACTED]**

YOU ARE HEREBY SUMMONED and required to file an appearance, answer, or otherwise plead to the complaint, a copy of which is attached. If you fail to appear or otherwise answer, a judgment by default may be entered against you for the relief sought in the complaint.

This case will be heard in Courtroom 1105 of the Richard J. Daley Center, 50 W. Washington Blvd., Chicago, IL **[REDACTED]** 2012, at 9:30 a.m.

TO THE OFFICE:

This summons must be returned by the officer or other person to whom it was given for service, with endorsement of service and fees, if any, immediately after service, but no later than **[REDACTED]**. If service cannot be made, this summons must be returned so endorsed.

Date summons issued: _____

Clerk of the Court **[REDACTED]**
By Deputy Clerk **[REDACTED]**

City of Chicago Department of Law
Building and License Enforcement Division
30 N. LaSalle Street, Room 300
Chicago, Illinois 60602
Street Number 312.7442.110

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How to Prepare for Building Court

- Know condition of the property.
- If client owns the property, know client's plan or time it will take client to identify plan.
- If client is mortgage holder, determine whether client has "controlled" property.

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How to Prepare for Building Court

- If client is property manager, review contract with owner and discuss plan with owner.
- Review allegations with client and know answers.
- File appearance.

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The Court Hearing

- Arrive early to discuss with inspector and City Assistant Corporation Counsel.
- Be prepared with plan.
- Be prepared to cross-examine inspector.
- Order will require, at a minimum, that you make arrangements for inspection prior to next court date.

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Possible City Motions

- Receiver
- Interior Inspection
- Preliminary Injunction

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City of Chicago Vacant Property Ordinance

- Does it apply to you?
 - Have you controlled the property?
 - New ordinance requires action even without control.
- Beginning 45 days after default, mortgagee is to inspect property on a monthly basis to determine whether it is vacant.

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**City of Chicago
Vacant Property Ordinance**

- Within the latter of 30 days after the building becomes vacant (and unregistered) or 60 days after a default, maintain and secure the residential building in 11 specified ways.

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**City of Chicago
Vacant Property Ordinance**

- **11 Specified Security Methods**
 - Broadly “maintain and secure the exterior of the building”;
 - Secure the doors and windows of the building;
 - Maintain grass and weeds below ten inches in height;
 - Cut and remove all dead or broken trees, tree limbs, or shrubbery;

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**City of Chicago
Vacant Property Ordinance**

- **11 Specified Security Methods**
 - Remove any accumulation of debris, trash, or litter on the exterior lot of the building;
 - Reasonably maintain fences and gates;
 - Reasonably maintain the structural integrity of stairs that lead to the main entrance to the building;

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**City of Chicago
Vacant Property Ordinance**

▪ **11 Specified Security Methods**

- Post a sign no smaller than 8.5 by 11 inches in a location on the building such that it is visible from the nearest public street or sidewalk with specified contact-related information;

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**City of Chicago
Vacant Property Ordinance**

▪ **11 Specified Security Methods**

- Secure the building with commercial-quality metal security panels or method deemed equivalent by the building commissioner if the property is found by an administrative hearing officer or judge to be open on two separate occasions at least thirty days apart;

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**City of Chicago
Vacant Property Ordinance**

▪ **11 Specified Security Methods**

- Keep the exterior free of vermin and rodents; and,
- Clean all toilets and drain all plumbing and heating systems to winterize the building.

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When is a property not “vacant”?

- An unoccupied building, which is undergoing construction, renovation, or rehabilitation that is proceeding diligently to completion and the building is in compliance with all applicable ordinances, codes, regulations, and legislation;
- A building that is seasonally occupied but otherwise secure;

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When is a property not “vacant”?

- A secure building on which there are bona fide rental or sale signs; or
- A secure building that is subject to a probate, quiet title, or other disputed ownership lawsuit or “there is otherwise a building that is secure and in substantial compliance with all applicable ordinances.”

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Chicago Building Code Scofflaws

- Building owners with controlling interest in at least three residential properties that have habitual, extensive, or serious building code violations.
- Scofflaws are ineligible for any new city contracts.

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Chicago Building Code Scofflaws

- The list of scofflaws is updated once a year in December and building owners may appeal being included on the list. Last year, only one company appeared on the list.
- There are seven Scofflaws for 2012.

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The Seven Scofflaws

- Alliant Southside, LLC
- R&G Properties – Robert Michael and George Michael, Partners
- Melvin Eurby
- Zachariah George, LLC – George Zachariah, Manager
- Mohammed Siddiqi
- Tanner Kapan d/b/a Goksel, Inc.
- Woodlawn Redevelopment Corporation No. 2

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THE USE AND IMPACT OF BANKRUPTCY ON FORECLOSURE AND FORECLOSURE ALTERNATIVES FOR DISTRESSED PROPERTY

- **What are the alternatives available to the owners of distressed real estate and their legal counsel to foreclosure?**
- **What strategies can be used to avoid foreclosure?**

Because of the lingering downturn in the national economy, the value of residential real estate has continued to decline and, because of modern mortgage financing devices and the dynamics of the mortgage market, the decline may continue for the foreseeable future.

In giving legal representation to debtors under mortgage loans on financially distressed properties, it is essential to have a working knowledge of the array of foreclosure alternatives and possible strategies that may incorporate more than one of the foreclosure alternatives combined with the leverage derived from foreclosure defenses and bankruptcy.

I. THE INITIAL CONSULTATION

- A. Key to giving competent legal counsel to a debtor/homeowner in financial distress is understanding:
 - 1. What is the cause of the financial distress?
 - 2. Is the financial distress over, indefinite, or permanent? And\
 - 3. Depending on the answers to 1 and 2, what does the debtor homeowner want or need to accomplish?
- B. The term “financial distress” means that the property is “underwater,” meaning the readily-obtainable market value of the property is less than the debt owed under all liens and encumbrances on the property (including mortgages and judgment and tax liens) and/or the owner(s) of the property are in financial distress because of income inadequate to service all current debt.
- C. The primary causes of financial distress are:
 - 1. unemployment;
 - 2. underemployment due to reduction of work hours or compensation;
 - 3. unemployment or underemployment due to illness or injury;
 - 4. loss of income from second jobs, side jobs, or spousal income;
 - 5. increased household debt, such as credit cards, installment loans, or medical bills; and
 - 6. if the property is commercial or income producing, negative cash flow.
- D. Some foreclosure alternative strategies work better if the financial distress is over, but the default cannot be cured from the current income and liquid assets. Once the cause of the financial distress is understood, strategies for the debtor will become much more obvious.

II. TO RETAIN OR NOT TO RETAIN: THAT IS THE QUESTION

- A. Given the needs of the debtor and their current status, perhaps foreclosure is not the worst answer. The average residential foreclosure in Illinois is reported to take about 19 months, during which the debtor cannot make mortgage payments and will presumably not pay their property taxes.

During this time, the debtor should be encouraged to continue to pay association assessments and hazard insurance.

- B.** If the debtor already has another place to live and simply wants out of the remaining debt, letting the foreclosure proceed may be a viable alternative, but the risk is that:
1. the mortgage lender bids less than the remaining debt and, in doing so, establishes a deficiency;
 2. the mortgage lender seeks a personal judgment against the debtor for the deficiency; and/or
 3. there are junior mortgages or other judgment liens that (even if those liens are foreclosed) the other creditors will seek personal judgments on.
- C.** To the extent the remaining debt is dischargeable, the debtor may consider bankruptcy protection.

III. DEALING WITH THE LIKELIHOOD AND EMOTIONAL IMPACT OF FORECLOSURE

Because borrowers in financial distress are frequently told that they must be “reportably delinquent” (i.e., 60-90 days in default) under their mortgage loans to be considered for loss mitigation, foreclosure alternatives are often intertwined with a comprehensive foreclosure defense strategy.

This is often necessary due to “dual tracking” by the mortgage loan servicers in which a foreclosure complaint is filed at the same time a request for loan modification or short sale approval is complete and in consideration.

It is important that clients understand the foreclosure time line and that it is likely that the servicer will file a foreclosure suit before the short sale or a loan modification is approved.

IV. WHAT TYPES OF PROGRAMS ARE AVAILABLE?

- A.** There are two types of programs for dealing with property in financial distress:
1. Non-Retention Programs under Which the Owner Will Not Retain Ownership and Possession
 - a. Foreclosure
 - b. Deed in Lieu of Foreclosure (and HAFA)
 - c. Short Sale (and HAFA)
 - d. Deed for Lease
 2. Retention Programs under Which the Owner Intends to Retain Ownership and Possession
 - a. Loan Modification – Federal Programs
 - i. HAMP
 - ii. PRA HAMP
 - b. Loan Modification/Restructuring – Internal Lender Programs
 - c. Refinancing
- B.** Based on the initial consultation with the debtor, there are a number of factors to be considered in determining which of the various Retention and Non-Retention Programs might be useful:
1. Is the financial distress temporary or indefinite?
 2. Is the property severely underwater?
 3. What are the goals of the property owner(s) and debtors?
 4. What are the financial capabilities of the owner(s) and debtors?

5. Have the owner(s) and debtors been previously approved for a retention program? If so, did they default?
6. Who are the “players” in the mortgage loan (i.e., the servicer, the trustee, the investor, the mortgage insurance company)?
7. What is the financial status of the mortgage holder/investor?

V. ILLINOIS’ HARDEST HIT PROGRAM

- A. \$345 million in federal funds allocated to approximately 15,000 Illinois families.
- B. Up to \$25,000 in aid over 18 months.
- C. Eligibility:
 1. property located in Illinois and the primary (and only) residence of all borrowers/owners;
 2. documented income drop of 25% due to unemployment or underemployment through no fault of their own;
 3. household income at or below 120% of the area median income;
 4. principal balance of not in excess of \$500,000;
 5. 1 to 4 unit building if at least one is occupied by owners/borrowers;
 6. fixed or adjustable rate loans only (no interest-only or negative amortization);
 7. current servicer must agree to accept the payments; and
 8. no conviction of mortgage-related felony in prior 10 years.

VI. HAMP (HOME AFFORDABLE MODIFICATION PROGRAM) AND PRA (PRINCIPAL REDUCTION ALTERNATIVE) HAMP

- A. Originally, HAMP aimed to at help 7 to 9 million homeowners in default or at imminent risk of default by reducing monthly debt service to sustainable levels. HAMP modifications are accomplished by:
 1. reducing the interest rate to as low as 2% APR fixed rate;
 2. stretching the amortization for up to 40 years; and
 3. reducing or deferring a portion of the principal balance.

The HAMP documents are available through www.financialstability.gov.

- B. Qualification:
 1. A borrower will qualify for HAMP if the verified income documentation demonstrates that the “monthly mortgage payment ratio” to the modification is greater than 31%. The “monthly mortgage payment ratio” is the ratio of the borrower’s current monthly payment to the borrower’s monthly gross income (or, in the case of co-borrowers, the borrowers’ combined monthly gross income).
 2. The “monthly mortgage payment” includes the monthly principal, interest, property taxes, hazard insurance, flood insurance, and condominium or homeowners’ association fees (including any escrow payment shortage amounts subject to a repayment plan).
 3. There are additional qualifications for ARMs scheduled to reset within 120 days after the evaluation.
- C. Features
 1. First lien mortgage loan originated on or before January 1, 2009 (separate program for second mortgages called “2MP”).

2. The current unpaid principal balance prior to capitalization must be no greater than:
 - a. 1 unit \$729,750
 - b. 2 units \$934,200
 - c. 3 units \$1,129,250
 - d. 4 units \$1,403,400
3. Has not been previously modified under HAMP.
4. Mortgage loan is delinquent or risk of default is imminent.
5. Includes foreclosures, property in active mortgage litigation, and bankruptcy (at lenders' discretion).
6. Loan is secured by a 1 to 4 unit property, one unit of which is the borrower's principal residence.
7. The property must not be vacant or condemned.
8. Borrower's financial hardship is documented (HAMP Hardship Affidavit) and represents that they do not have sufficient liquid assets to make the monthly payments (supporting documentation cannot be more than 90 days old).
9. May also include borrowers who received Chapter 7 discharge in a case involving the first mortgage lien who did not reaffirm the debt.
10. Requires an escrow account for taxes and hazard and flood insurance to be established before the end of the Trial Period.

D. Proposed changes to HAMP announced in 2012 include:

1. secondary evaluation with more flexible debt-to-income ratios;
2. application to investment properties used as rentals;
3. increased use of principal reductions;
4. tripling of incentives for investors who agree to write-down an underwater borrower's principal balance; and
5. offering the same incentives to Fannie Mae and Freddie Mac.

VII. THE HAMP NET PRESENT VALUE (NPV) TEST

All loans eligible for HAMP must meet a standardized NPV Test. If the NPV result under the proposed modification is greater than the NPV of the unmodified loan, the result is considered to be *positive* and the lender must offer the modification.

If the NPV Test is *negative*, the lender has the option of modifying the loan at its discretion.

If the mortgage is serviced on behalf of a third-party investor and the NPV Test is negative, the servicer must obtain investor approval. If the NPV Test is negative and the modification is declined, the servicer must consider the borrower for other options to avoid foreclosure, including alternative modification programs, deeds-in-lieu and short sales.

VIII. HAMP TRIAL PAYMENT PERIOD

This is *not* a temporary modification. The Trial Payment Period is three months in duration. The borrower must be current at the end of the Trial Payment Period to receive a permanent loan modification. The first payment under the Trial Payment Period is the first day of the month following the lender's mailing of the offer. The difference between the trial plan payments and the scheduled payments remains payable under the loan and is not deferred or forgiven.

IX. HAMP SERVICER INCENTIVE COMPENSATION

- \$1,000 for each completed modification;
- \$500 if borrower was not in default under the original mortgage loan;
- \$1,000 (or ½ of the reduction in the borrower's annualized monthly payment), whichever is less, for each of the following three years if the borrower's monthly mortgage payment is reduced by more than 6% under the HAMP modification.

X. HAMP BORROWER INCENTIVE COMPENSATION

- A. \$1,000 (or ½ of the reduction in the borrower's annualized monthly payment), whichever is less, for each of the following five years if the borrower's monthly mortgage payment is reduced by more than 6% under the HAMP modification and the loan remains in good standing.
- B. If the HAMP application is rejected or not properly considered:
 - 1. Require the lender/servicer to specify in writing the reason(s) why the lender/servicer declined the application.
 - 2. Treat the rejection as any other rejection of credit (applicable state/federal laws).
 - 3. Try, try again! Resubmit the application as many times as necessary, especially if the borrower's financial situation and debt ratio have changed or are likely to soon change.

XI. PRA (PRINCIPAL REDUCTION ALTERNATIVE) HAMP

- A. Principal Reduction Alternative (PRA) gives servicers the flexibility to offer principal reduction relief to borrowers whose homes are significantly underwater. Lenders must be non-GSE and this program does not cover loans owned, guaranteed or insured by FHA/VA, Freddie Mac, or Fannie Mae.
- B. PRA is a deferred principal reduction program that allows a borrower to earn the full principal reduction over a three-year period.
- C. Loan to value at 115% or greater for first lien modification on non-GSE loans.
- D. Borrowers remaining in good standing within the modification trial period earn one-third portions of an initially-deferred principal reduction forgiven on first, second, and third anniversaries from the participating lender.
- E. The lender/servicer/investor can receive incentives and potential tax benefits for complying with requirements and reporting.
- F. Be aware of the addition of Equity Sharing Agreements. Investors may enter into equity share agreements with borrowers (to recoup some or all of the unreimbursed portion of the principal forgiveness if the property value increases in the future) in conjunction with a PRA and earn investor incentives as long as borrower protections are included in the equity share agreements.
- G. PRA with a participating lender is beneficial to the borrower because:
 - 1. with a reduction in principal, there is restored hope that equity in the home is again achievable; and
 - 2. borrowers with second liens will see a similar reduction in principal as to the second lien, but under a different program (2MP).
- H. According to a **DSNews.com** (Default Servicing news provider) article dated July 1, 2011, entitled Treasury: Nearly 5,000 HAMP Mods Carry Principal Reductions, there is a median principal amount reduced for active permanent modifications of 32.2% (or about \$69,500). As of July 2011, only 4,911 PRA mods were listed as active.

- I. According to a **DSNews.com** article dated January 9, 2012, entitled HAMP Mods Pass 900,000 as Servicers Tackle Seconds, Negative Equity, through November 2011, 38,243 permanent PRAs are active with 15,875 in trial periods. As of that date, median principal reduction was around 31.3% or about \$66,308.

XII. HAFA - HOME AFFORDABLE FORECLOSURE ALTERNATIVES PROGRAM

(April 5, 2010 effective through 2012)

- A. Minimum eligibility requirements are the same as in HAMP, but are unable to retain the home.
- B. Servicers must determine if a short sale is appropriate.
- C. Servicers will establish property value and minimum acceptable net return in accordance with investor requirements, based on appraisal or BPO issued no more than 120 days before the date of the short sale.
- D. Standardized Short Sale Agreement and Offer Acceptance Letter.
- E. Must give borrower at least 90 days to market and sell the home (or up to 1 year).
- F. No foreclosure during first 90 days.
- G. Home must be listed with a licensed real estate broker with local experience.
- H. Servicer must agree not to negotiate a lower commission after an offer has been received.
- I. Incentives of:
 1. \$1,000 to servicer for successful short sale or DIL;
 2. \$1,500 to borrowers to help with relocation expenses;
 3. up to \$1,000 towards the release of junior liens (\$1 from government for every \$2 paid by the investor).

XIII. TAX ISSUES IN FORGIVEN MORTGAGE DEBT

- A. **IRS Publication 4681 exceptions:**
 1. qualified principal residence;
 2. debts discharged in bankruptcy;
 3. insolvency on balance sheet basis (i.e. more liabilities than assets);
 4. certain farm debts; and
 5. non-recourse loans.
- B. **Mortgage Forgiveness Debt Relief Act of 2007 (extended through 2012)**

Forgiven debt classified as a negotiated settlement in contested foreclosure.

XIV. THE IMPACT AND USE OF BANKRUPTCY ON FORECLOSURE AND FORECLOSURE ALTERNATIVES

- A. **The Use of a Chapter 7 Bankruptcy in Foreclosure**
 1. A Chapter 7 bankruptcy is used to clear out debt so that a modification is possible.
 2. The filing of bankruptcy does not stop a homeowner from negotiating a modification unless the mortgage debt has been reaffirmed.
 3. This type of agreement is a reinstatement of the loan documentation as if no bankruptcy had ever been filed.
 - a. Lenders may require a reaffirmation before approving a modification.
 - b. However, the borrower may still owe more on the mortgage loan than the property will be worth in the near future.

- c. It is important to clear out debt so that the borrower can afford a modified payment.
 - d. It may be advisable to delay the modification process until other debts are discharged in order that the modified payment is sustainable.
4. Discharging the Balance of Loans after a Short Sale
- a. A foreclosure may be worse on the borrower's credit record than a bankruptcy. Foreclosure indicates shows that the borrower was unable or unwilling to resolve their financial problems; however, after bankruptcy, the borrower has no further debt.
 - b. For this reason, if a lender will not release the remaining deficiency after a short sale, the borrower may have been saved from foreclosure, but not from liability for the debt.
 - c. The deficiency resulting from a short sale is handled differently, depending on the servicer of the mortgage and the investor by:
 - i. releasing the lien and releasing the debt;
 - ii. making a cash contribution to release of the debt; or
 - iii. releasing the lien but not the debt.
 - d. Chapter 7 bankruptcy may be used as leverage to negotiate a payment plan or a reduction in the amount requested. Since the lender has just been provided with the client's financials, they know the borrower's financial condition.
 - e. The Means Test
 - i. Pursuant to 707(b)(1) of the Bankruptcy Code (11 U.S.C. 707(b)(1)), "After notice and a hearing, the court, on its own motion or on a motion by the United States trustee, trustee (or bankruptcy administrator, if any), or any party in interest, may dismiss a case filed by an individual under [chapter 7] whose debts are primarily consumer debts, or, with the debtor's consent, convert such a case to a case under chapter 11 or 13
 - ii. In considering whether the granting of relief would be an abuse, the court shall presume abuse exists if the debtor's current monthly income generally, and multiplied by 60, is not less than the lesser of:
 - (1) 25% of the debtor's non priority unsecured claims in the case or \$7,025, whichever is greater; or
 - (2) \$11,725.

B. The Use of a Chapter 13 Bankruptcy in Foreclosure

- 1. If the debtor is in foreclosure, the automatic stay enjoins further action in the foreclosure.
 - a. Stops a sheriff's sale from proceeding.
If Chapter 13 is filed after the sheriff's sale, it is too late. (See *Annie Pearl Josephs*, 93 B.R. 151, 1988)
 - b. Will also stop discovery if case is filed before entry of judgment. Will have to start over again in Chapter 13 proceeding to procure discovery. (Use Rule 2004.)
- 2. How Chapter 13 Can Help
 - a. If the homeowner was contacted by an out of state company that promised to lower his interest rate and then did nothing, but homeowner saved mortgage payments, Chapter 13 can be used to bring loan current again. Plan can either

cure over 60 months or money held in savings can be used to reduce balance at the beginning of the plan.

b. Lien Stripping

The lien must be completely unsecured.

c. Must get valid market analysis.

(Does not have to be an appraisal; analysis by CIN Legal has held up.)

d. Cannot be the first mortgage unless debt is cross collateralized and other collateral is sufficient to cover value of debt.

e. “Cram Down” or “Strip Down”

When property is not the borrower’s residence.

i. Can devalue the lien instead of getting rid of it completely.

ii. Strips down lien to value of the property that secures it.

iii. The debtor pays 100% of secured portion over 60 months and a percentage of the unsecured balance (based on the percentage creditors would receive if there were a liquidation instead of a repayment) over 60 months. The difference between the amount paid and the amount owed is discharged.

f. Also stays collection actions against co-debtors (11 U.S.C. § 1301)

g. Debt Limit

i. \$1,081,400 if secured; and

ii. \$360,475 if unsecured

h. If the Debtor (or the debtor and spouse) do not owe liquidated, non-contingent unsecured debts of \$50,000, or liquidated, non-contingent secured debts of \$200,000 (Sec. 109(d)).

C. The Use of a Chapter 11 Bankruptcy in Foreclosure

1. If Debtor does not qualify to file a chapter 13 because they exceed the debt limits, but have the same need for protection as those who need chapter 13 relief.

2. If the Debtor is a corporation, LLC, professional corporation, or partnership.

3. If the Debtor owns property that is subject to the appointment of a receiver or in which a receiver has been appointed.

If the receiver has not yet taken over, the filing of the Chapter 11 will stop the appointment of the receiver (See 11 U.S.C. 543 (b)):

a. if the receiver has been in place for less than 120 days. (See 11 U.S.C. 543(c)(3));

b. if the receiver is causing more damage than protection of the property. (See 11 U.S.C. 543(d)).

4. If the lender is not cooperating with a modification of the mortgage, the plan of reorganization can do that for them. See 1123 (5)(E). You need to be sure that other creditors will agree to plan, the plan is essentially fair to all creditors, and will need to go to “cram down” (See 1129(a)(1) 16).

D. When Investors or Servicers Go Bankrupt

In re: Residential Capital, LLC, et al., 12-12020 (MG), In the United States Bankruptcy Court, Southern District of New York.

E. Leverage through Potential Foreclosure Defenses

Bear in mind that a successful modification may be construed to be a novation of the original contract and available foreclosure defenses may be lost or waived by acceptance of the modification, even if the modification agreement does not expressly provide for waiver of defenses and counter-claims. Therefore, the benefit of the modification should be weighed against the availability of real and material foreclosure defenses and counter-claims.

One of the more prevalent foreclosure defenses is lack of standing in that the Plaintiff does not exist or cannot demonstrate that it is the proper assignee and holder of the Mortgage Promissory Note.

Under the *Wigod* case, non-compliance with the provisions of HAMP may give rise to foreclosure defenses and counter-claims, but the lender/servicer's material non-compliance with the provisions of the Making Home Affordable Program may also be the basis for denial of confirmation of the foreclosure sale under 735 ILCS 15/1508(d)(5):

(d-5) Making Home Affordable Program. The court that entered the judgment shall set aside a sale held pursuant to Section 15-1507, upon motion of the mortgagor at any time prior to the confirmation of the sale, if the mortgagor proves by a preponderance of the evidence that (i) the mortgagor has applied for assistance under the Making Home Affordable Program established by the United States Department of the Treasury pursuant to the Emergency Economic Stabilization Act of 2008, as amended by the American Recovery and Reinvestment Act of 2009, and (ii) the mortgaged real estate was sold in material violation of the program's requirements for proceeding to a judicial sale. The provisions of this subsection (d-5), except for this sentence, shall become inoperative on January 1, 2013 for all actions filed under this Article after December 31, 2012, in which the mortgagor did not apply for assistance under the Making Home Affordable Program on or before December 31, 2012.