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Foreclosures Short Sales & Strategic

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Recent developments have implications for underwater homeowners



In today's real estate climate, it has become more and more common for financially able homeowners to stop paying their mortgage loans when their property is worth less than their mortgage balance. This conscious decision to default on the loan is known as a strategic default.

This recent trend has sparked concern on the part of Fannie Mae, which recently stated it would "lock out" homeowners from receiving a new loan for a seven-year period if it is determined that the borrower is guilty of strategic default. The lock-out period replaces the previous five-year period adopted in 2008. Other lenders, such as Freddie Mac, also punish defaulters with lesser lock-out periods.

Fannie also plans to more aggressively pursue deficiency judgments by executing on borrowers' assets, as well as monitoring and studying delinquent loans to identify cases that should receive extra attention. It is important to note that Florida is a recourse state that allows lenders to pursue deficiency judgment post-foreclosure.

Fannie's new measures were adopted to prevent the increasing number of losses that may result if borrowers continue to strategically default on loans. It has been estimated that 12 percent of defaults have been strategic. With almost 25 percent of homeowners currently "underwater," continued strategic default would most certainly exacerbate lenders' mortgage losses. Executives of Fannie believe if the use of strategic default grows, it could worsen the already depressing conditions of the housing market.

Although Fannie has sharpened its penalties, it is also preparing to reduce the lock-out periods for

borrowers experiencing legitimate hardships who cannot avoid foreclosure. The previous waiting period of five years was applied to all borrowers who went into foreclosure across the board, regardless of the borrower's circumstances.

Under the new plan, borrowers experiencing legitimate hardships will receive a two-year lock-out period if they exercise the option of transferring their homes to the lender through a "deed in lieu of foreclosure" or completing a short sale. In the absence of a deed in lieu or short sale, if the borrower can provide documentation of extenuating circumstances or show that an effort was made to negotiate with the lender, the lock-out period may be shortened to as little as three years.

Many struggling homeowners turn to a short sale transaction as way to resolve a mortgage debt and avoid a foreclosure. However, after the transaction, some homeowners may continue to experience collection activities. The collection of a short sale deficiency where a lender forgave the mortgage debt is the collection of an illegitimate debt and a violation of the Florida Consumer Collection Practices Act (FCCPA).

Another common consumer protection issue following completion of a short sale is improper credit reporting. It is a violation of the FCCPA for a creditor to knowingly publish false information about a consumer's creditworthiness. It is not uncommon for completed short sale transactions to be improperly and falsely reported to the various credit reporting bureaus.

The Florida Supreme Court recently ruled on a case that could have implications for homeowners involved in a short sale, foreclosure or deed in lieu of foreclosure.

The Court ruled in favor of the Federal Trade Commission (FTC) in the pivotal case *Olmstead v Federal Trade Commission*. The decision greatly favors creditors in their attempts to collect personal debts from debtors with assets held in single member Limited Liability Corporations (LLCs).

LLCs are business entities created to provide tax benefits similar to that of a partnership, and liability protection similar to that of a corporation. The ruling of *Olmstead* threatens these benefits and protections for LLCs that have only one member (owner).

The issue before the Court stemmed from an advanced-fee credit card scam being operated by the appellants (*Olmstead*). This prompted suit by the FTC for unfair or deceptive trade practices.

The assets of the appellants were frozen and placed in receivership. Several single-member LLCs were among the assets which were placed in receivership. Ultimately, the FTC was awarded over \$10 million in restitution. The FTC was then granted an order compelling the appellants to forfeit all of their rights, title, and interest in their respective LLCs to partially satisfy this judgment.

In light of the foreclosure epidemic and that Florida is a recourse state (banks can pursue mortgage deficiency, often referred to as deficiency judgments), the *Olmstead* case would make mortgage borrowers' LLCs susceptible to bank deficiency judgments stemming from short sales, foreclosures and deeds in lieu of foreclosure.

If you have any questions regarding assets that may be vulnerable to judgment creditors, or for information on strategic default, deficiency judgments and other mortgage and debt issues, contact an attorney who specializes in real estate and bankruptcy.



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