

The Homeowner's Guide to Bankruptcy and Short Sales



Seattle Short Sales, Inc.

1-800-603-3525

www.SeattleShortSales.com



*Written by Jonathan Smith,
Attorney at Law and Seattle Short Sales, Inc.*

Legal Disclosure Notice

The contents of this document are NOT legal advice or a substitute for legal advice. This is information offered for informational purposes only. Please seek the assistance of a qualified legal professional for guidance with regard to issues specific to your transactions and state law in the state and county of your residence.

Important Notice

© 2010 Seattle Short Sales, Inc.® All Rights Reserved. All materials in this package are protected by United States Copyright law. This material in any form, or parts thereof, may not be published, reproduced, or distributed to third parties and/or used in any manner without the express written permission of Seattle Short Sales, Inc. You may not alter or remove any trademark, copyright or other notice from copies of the content. Recipient agrees to respect and protect the confidential information from any unauthorized persons and/or from falling into the hands of the public domain.



The Homeowner’s Guide to Bankruptcy and Short Sales

TABLE OF CONTENTS

Introduction..... 2

About bankruptcy..... 4

What bankruptcy means for home ownership..... 5

 Stopping foreclosure through declaring bankruptcy..... 6

 Bankruptcy versus foreclosure..... 7

How bankruptcy works..... 8

Chapter 7 bankruptcy..... 10

 Specific example..... 12

Chapter 13 bankruptcy..... 13

 Specific example: Stripping a junior lien..... 14

 Specific example: Chapter 13 debt reorganization..... 15

Chapter 11 bankruptcy..... 16

 What is a strategic plan?..... 17

 Specific example 1: Short sale followed by Chapter 7 bankruptcy..... 18

 Specific example 2: Starting with Chapter 13 bankruptcy and moving to Chapter 7..... 18

 How to come up with the right plan..... 19

How declaring bankruptcy affects a client’s future..... 20

 Credit score..... 20

 Future home purchases..... 21

How to find more information about bankruptcy for your clients..... 22





The Homeowner's Guide to Bankruptcy and Short Sales

INTRODUCTION

Many people are afraid of the idea of declaring bankruptcy - but this is often because they don't have all of the information about what declaring bankruptcy actually means. They fear bankruptcy because they believe it means losing everything they own. In reality, though, most people who declare bankruptcy don't lose anything at all.

For many people, declaring bankruptcy can be the fastest route to regaining financial stability and rebuilding their credit score. Declaring bankruptcy can stop a foreclosure proceeding, allowing time to work out a more favorable solution. And for some distressed homeowners, declaring bankruptcy immediately following a short sale can be a strategic move to rid themselves of any remaining mortgage debt or 1099 liability.

The best strategy for a distressed homeowner to minimize or even shed completely their debts, and get a clean start on life, depends on their personal situation: a careful analysis of both

their secured and unsecured debts and of their assets. The evaluation processes for a short sale and for bankruptcy are nearly identical anyway, so it is wise to consider both options before coming up with a final plan. Advice from experienced professionals in coming up with that plan can save distressed homeowners thousands of dollars - or more.

One challenge for distressed homeowners is that seeking reputable, affordable legal counsel can be overwhelming, both in terms of time involved and financially.

For brokers, the challenge has been how to assist homeowners without incurring legal liability or being accused of practicing law.





The Homeowner's Guide to Bankruptcy and Short Sales

Seattle Short Sales, Inc. has solved both of these challenges. All clients of Seattle Short Sales, Inc. receive legal and financial counseling at no charge.

The benefits to using our network of professionals include:

- ➔ brokers reduce their liability by ensuring that any advice given to their clients is by professionals working in their own fields
- ➔ brokers can provide their clients with all necessary support, tailored to each individual situation, to get the job done
- ➔ homeowners know they are receiving the best advice, specific to their own financial situation
- ➔ homeowners gain access to advanced strategies, which may allow them to eliminate deficiencies and to even shed some debts all together.

The more connected a homeowner is to a trusted network, the better their chances of implementing the best strategy for settling their accounts in the most favorable terms possible.



The Homeowner's Guide to Bankruptcy and Short Sales

ABOUT BANKRUPTCY

A lot of the stigma around bankruptcy comes from the fact that many people don't really understand what it means. Some people think declaring bankruptcy means that they will lose everything they own. Each person's situation is different, and it is important that anyone with financial troubles consult a qualified professional about their own personal situation. For many people, and especially for those whose debts include both secured loans (e.g. mortgages) and unsecured loans (e.g. credit card debt, medical bills) declaring bankruptcy may actually be the best option.

Declaring bankruptcy means assessing a current financial situation, and taking charge of it. In most cases, it does not mean losing anything. In fact, most people are able to exempt their assets and keep everything they own. In Chapter 7 bankruptcy, assets such as jewelry, tools of the trade, their car, and even their house may be exempted. Chapter 11 and Chapter 13 bankruptcy usually involve coming up with modified payment plans for assets such as home or car, rather than liquidating (selling) assets; however, both can be used to obtain more time in order to complete modifications or sales of these assets.



Many individuals who are in debt are honest people who only want to clear their name and get a fresh start. For some of them, the bankruptcy process in conjunction with a short sale is the quickest and cheapest way to do that.



The Homeowner’s Guide to Bankruptcy and Short Sales

WHAT BANKRUPTCY MEANS FOR HOME OWNERSHIP

Bankruptcy is an important option for distressed homeowners to consider before making any final decisions regarding either allowing foreclosure to proceed or choosing to do a short sale.

Bankruptcy can allow a homeowner to keep their house—at least for the period that the bankruptcy stay is in place. What happens afterward depends upon the debtor’s particular situation, and any agreements that were made with creditors while in the bankruptcy.

BANKRUPTCY CAN ALLOW A HOMEOWNER TO KEEP THEIR HOUSE—AT LEAST FOR THE PERIOD THAT THE BANKRUPTCY STAY IS IN PLACE. WHAT HAPPENS AFTERWARD DEPENDS UPON THE DEBTOR’S PARTICULAR SITUATION, AND ANY AGREEMENTS THAT WERE MADE WITH CREDITORS WHILE IN THE BANKRUPTCY.

In the state of Washington a debtor is allowed to keep a home with as much as \$125,000.00 in equity (otherwise known as homestead). So, if the equity is less than \$125,000 but they are current on their mortgage, then as long as they continue making their payments, they may remain as the owner of the home. If they are in arrears, then things get more complicated. They may set up a payment plan to get caught up, or the courts will usually allow them up to six months to try to negotiate a loan modification or conduct a short sale. Short sales or modifications are more desirable for most people than a foreclosure. If they are unable to pay back the arrears, or obtain a modification, or

conduct a short sale, then eventually they will be forced to surrender the home. However, a successful bankruptcy filing will ensure there is no deficiency balance owed, no income tax owing on forgiven debt (i.e. no 1099 form issued), and no debts related to the property remaining.





The Homeowner’s Guide to Bankruptcy and Short Sales

Stopping foreclosure through declaring bankruptcy

Declaring bankruptcy stops a foreclosure proceeding immediately. Filing for bankruptcy involves creation of an “estate,” which consists of the debtor’s property and assets (less all of the items that have been exempted). A “trustee” is usually appointed to look after this estate.

The moment a petition for bankruptcy is filed, the Bankruptcy Code imposes an “automatic stay,” which stops the commencement, enforcement or appeal of most actions or judgments against the debtor. It also prohibits any collection actions, such as a foreclosure, against the estate.

However, whether stopping the foreclosure is temporary, or what may happen next, depends upon a number of factors:

WHETHER STOPPING THE FORECLOSURE IS TEMPORARY, OR WHAT MAY HAPPEN NEXT, DEPENDS UPON A NUMBER OF FACTORS.

A lender may file to request relief from the automatic stay. In Chapter 7, if no defense exists for the debtor, the court will grant that relief and, at that point, the lender may continue foreclosure proceedings. Generally, Chapter 7 only provides a temporary stop to the foreclosure process. Even if the lender does not file the request for relief, usually the case will end, and the stay will also end, approximately 90 days from the date of filing.

However, Chapter 13 bankruptcy can stop the foreclosure for a longer period of time. The debtor must then come up with a payment plan, get a modification done, or short sell the home, usually within six months. If a repayment plan is approved, the duration is usually 60 months. Filing for Chapter 13 bankruptcy only protects the homeowner from foreclosure as long as they are adhering to the terms of the new payment plan. If they miss their payments, their lender may ask for relief from the automatic stay and resume foreclosure proceedings.



The Homeowner's Guide to Bankruptcy and Short Sales

Bankruptcy versus foreclosure

Declaring bankruptcy allows a homeowner to keep their home at least temporarily—while the bankruptcy procedure takes place—but, if a plan or modification can be achieved, they get to keep their home for the long-term, too.

Foreclosure on a home *necessarily* means that the homeowner loses the home. But even more, they also lose the opportunity to strategize and work out which solution suits them best: e.g. to consolidate, or eliminate, other debts (such as credit cards) through bankruptcy; to short sell their home; or to combine these strategies to their advantage.



Following foreclosure, the former homeowner may still be responsible for money owed on any junior liens, such as a second mortgage or HELOC (home equity line of credit). With bankruptcy, there is not only the possibility of them keeping their home, there is also the possibility of permanently ridding themselves of some debts. In an optimal situation, a person may be able to strip a second loan, modify the first, and discharge the second (along with any unsecured debts, such as credit cards). This can dramatically alter their financial situation.

A foreclosure may register far worse than a bankruptcy on credit scores. The credit bureau agencies are very tight-lipped about how they calculate credit scores, and other factors (such as whether the homeowner was delinquent on mortgage payments before the bankruptcy or foreclosure, and by how many months) will also impact credit scores. But some bankruptcy experts believe that the negative impact of a foreclosure may be up to three times higher than for a short sale or bankruptcy.

For most distressed homeowners, choosing a short sale and/or declaring bankruptcy are preferable options to foreclosure. There is a good chance



The Homeowner’s Guide to Bankruptcy and Short Sales

that the short sale approval letter will also wipe out the deficiencies for the first lien. Bankruptcy creates a plan for dealing with *all* debts, not just mortgage debt, and it also has the possibility of completely wiping out unsecured debts such as credit cards, and sometimes even second and third mortgages. Once all that there is left to pay is a first mortgage, keeping a home becomes more attainable. And many homeowners are finding that combining a short sale with bankruptcy is the best option for clearing all of their debts and moving directly on to a new financial start.

HOW BANKRUPTCY WORKS

Bankruptcy is a strategic financial move that individuals may choose to undertake.

There are three types of bankruptcy that individuals might choose to file under.

1. Chapter 7 bankruptcy, also known as “liquidation,” is the most common type of bankruptcy that individuals file for. It involves appointment of a trustee, and liquidation and sale of non-exempt property in order to pay off creditors. Since most property that is considered “essential” is actually exempted, debtors usually get to keep most or all of their property. In most cases, they do not actually lose any of their property at all; however, it is important that they understand that losing some possessions is a possibility when declaring Chapter 7 bankruptcy—this is why it is important to get professional advice.
2. Chapter 11 and Chapter 13 bankruptcy are both considered “reorganization.” Chapter 13 is for higher-income individuals who have no more than \$1,081,400 in secured debt, and involves making payment plans in order to be able to keep assets such as houses or cars.

BANKRUPTCY IS A STRATEGIC FINANCIAL MOVE THAT INDIVIDUALS MAY CHOOSE TO UNDERTAKE. CREDITORS MAY NOT IMPOSE BANKRUPTCY ON AN INDIVIDUAL DEBTOR (ALTHOUGH THEY MAY IF THE INDIVIDUAL IS ENGAGED IN BUSINESS).





The Homeowner’s Guide to Bankruptcy and Short Sales

- 3. Chapter 11 is intended more for companies but can also work for individuals, such as investors or developers, who have more than \$1,081,400 in secured debt and do not qualify for Chapter 7. It is more expensive to do, and is structured so that individuals or companies can continue to remain in business while coming up with a repayment plan for their creditors.

Choosing which type of bankruptcy to file for, and whether to combine moves such as conducting a short sale and then declaring bankruptcy, or filing for one type of bankruptcy and then making a strategic move to another type of bankruptcy, depends upon each individual’s current financial situation as well as on their expected future financial situation. Things to consider include:

- ➔ the individual’s past earnings
- ➔ how much unsecured debt they have
- ➔ whether or not their future income is likely to be higher than present (e.g. if their current financial hardship is due to a job loss, but they may reasonably expect to be re-employed in a high-income position within a few years)



- ➔ what their debt-to-income ratio is, and whether that is expected to change.

Coming up with the best strategy can make the difference as to whether key assets are retained or not, and in some cases it can result in the complete shedding of some debts, saving the client many thousands of dollars. It is important that qualified professionals who understand the system and all of the options review each case, before important decisions are made.



The Homeowner’s Guide to Bankruptcy and Short Sales

CHAPTER 7 BANKRUPTCY

To qualify for Chapter 7 bankruptcy, the debtor must have an income that is below the median for their state, calculated using their income for the six months prior to filing. In Washington state, this means less than \$49,124.00 for individuals with no dependents, and \$62,204.00 for couples with no dependents. (These thresholds go higher if there are dependents, and are subject to quarterly adjustments). If their income is above the median, they still may qualify for Chapter 7 through the Means Test, which calculates monthly disposable income.

They must not have received a discharge of their debts through Chapter 7 within the past eight years. They must not have more than \$125,000 equity in their home; if the equity is higher than \$125,000, the trustee will likely choose to sell the home to pay off the debts. There is no limit to how much unsecured debt they have (e.g. credit card debt, medical bills, personal loans, etc.).

TO QUALIFY FOR CHAPTER 7 BANKRUPTCY, THE DEBTOR MUST HAVE AN INCOME THAT IS BELOW THE MEDIAN FOR THEIR STATE, CALCULATED USING THEIR INCOME FOR THE SIX MONTHS PRIOR TO FILING.

Debtors file a schedule of their exempt property. This is a list of the possessions that they do not want to lose as a result of filing for bankruptcy, with a list of the values. It is important for debtors to understand that they can use what are known as “garage sale” values for the items - literally, the value that the items would likely sell for in a distress sale, and not what their purchase price was.

In Washington state, they can choose whether to use the federal list or the state list of exemptions. For example, federal exemptions allow up to \$43,250 of their home equity (State homestead exemption is \$125,000). In addition, individuals may exempt up to \$11,525 in household items (\$23,050 for a couple), \$1,450 in jewelry (\$2,900 for a couple), \$2,175 in “tools of the trade,” and \$3,450 of their car’s value. In addition, they have a “wild card” exemption of \$11,975 (\$23,950 for a couple) of unused homestead exemption that can be applied to other possessions, or towards additional value in the exemptions above, e.g. towards their jewelry or their car.





The Homeowner's Guide to Bankruptcy and Short Sales

Other than the homestead, Washington state exemptions tend to be lower than the federal ones in some categories. However, they do allow exemption of certain insurance payments, disability payments, and pensions. Debtors may choose which list of exemptions suits their personal situation better - but they may not mix and match between the lists.

Filing for Chapter 7 bankruptcy immediately stops all collection actions, including foreclosure—but only temporarily for secured debts. Under Chapter 7, creditors will likely request relief from the automatic stay, and once that stay is granted, or the case comes to an end (which is generally 90 days) foreclosure proceedings may resume.

The filing fee for Chapter 7 bankruptcy is about \$299, on top of any costs for legal fees. The debtor must take a credit counseling class which you can take on line. Fees for the classes vary, but generally range from \$35 to \$50 per person. After filing, the debtor must attend a meeting with the creditors, which is scheduled by the U.S. trustee or bankruptcy administrator. The creditors almost never actually show up. In the majority of Chapter 7 bankruptcy cases, all of the debtor's assets either fall under the exemptions (above) or are secured by liens (e.g. home or car). These are called "no asset" cases, because there is nothing to sell and distribute to creditors. If there are assets to sell, the trustee distributes the proceeds amongst the creditors according to a priority formula.

In the end, the debtor receives a discharge from remaining unsecured debts. This whole process usually takes about three months.

Chapter 7 bankruptcy is a very good option for homeowners who are considering a short sale due to a temporary unemployment or underemployment situation, but whose income is likely to go up in a few years when the economy recovers and they return back to full employment. This is because short sales may require the homeowner to sign an agreement to repay the deficiency. Many people sign the deficiency agreement in the hope that the lender will never attempt to collect the deficiency. Chapter 7 can completely clear them of any deficiency obligation.



The Homeowner's Guide to Bankruptcy and Short Sales



Specific example

A homeowner who is laid off from a \$90,000 job is unable to continue making mortgage payments and opts to short sale his home, signing an agreement to repay the \$80,000 deficiency on the loan. At the time of the short sale, the seller's income is very low and the idea of the lender ever being able to collect on the deficiency seems unlikely.

The lender may retain the loan or, more likely, they will sell it to a collector, who purchases it with the hope of being able to collect on it in the future. The lender has six years to sue for the deficiency.

Five or six years down the road, the loan collector moves to collect on the loan - which, at default interest rates, may now show more than \$100,000 owing. Meanwhile, the former homeowner has returned to full employment and is now making \$90,000 again. The homeowner can no longer move into Chapter 7 bankruptcy because their income is too high to qualify. They can move into Chapter 13 bankruptcy, but Chapter 13 still requires them to pay part or all of the loan over a five-year period. *If they had chosen Chapter 7 bankruptcy right after the short sale, they could have had their obligation wiped clean at that time, and moved forward in their life knowing that loan no longer exists, that there could never be any attempt to collect on it.*

Many distressed homeowners fear the short sale process because they are worried about the deficiency balance owing. Declaring Chapter 7 bankruptcy immediately after the short sale is one way that they can be relieved of any obligation to pay a deficiency balance; it is a strategy that can allow them to immediately move ahead with their life, without the specter of lenders possibly moving in later to collect on a long-past unpaid balance.



The Homeowner’s Guide to Bankruptcy and Short Sales

CHAPTER 13 BANKRUPTCY

Chapter 13 is the other type of bankruptcy that individuals commonly use. It is usually the best choice for individuals whose income is too high to qualify for Chapter 7.

Chapter 13 bankruptcy is for individuals, and not companies or partnerships. The individual must not have more than \$1,081,400* in secured debt. Secured debt means loans with liens registered on them: for example, an

CHAPTER 13 IS THE OTHER TYPE OF BANKRUPTCY THAT INDIVIDUALS COMMONLY USE. IT IS USUALLY THE BEST CHOICE FOR INDIVIDUALS WHOSE INCOME IS TOO HIGH TO QUALIFY FOR CHAPTER 7.

investor with several rental properties, where the value of loans totals more than \$1,081,400, would not be eligible for Chapter 13, and would have to consider Chapter 11. They also may not have more than \$360,475* in unsecured debt (e.g. credit card debt, medical bills, personal loans, etc). Even if the individual has been discharged through Chapter 7 in the past eight years, they still may apply for Chapter 13. (*These numbers are adjusted from time to time).

Like Chapter 7 bankruptcy, Chapter 13 also involves the appointment of a trustee. In Chapter 7, the aim is to sell unexempted assets to pay the creditors. In contrast, in Chapter 13, the trustee assists in coming up with a payment plan in order to repay creditors, usually structured over a five-year period.

The filing fees for Chapter 13 are about \$274. The debtor must attend a meeting with the creditors, which will be scheduled by the U.S. trustee or bankruptcy administrator. Again, the creditors almost never actually show up for these hearings. The debtor may be able to keep property that is collateral on secured loans, such as a car or a home, as long as the plan accounts for eventual paying of those loans. Loan payments may be at the original payment schedule, but any arrears owing must be paid in full by the end of the plan’s term (usually at 1/60th of the total arrearage per month, on top of the regular payments). If the debtor chooses to attempt to do a loan modification while in the Chapter 13, or will be short selling the





The Homeowner's Guide to Bankruptcy and Short Sales

property while in the Chapter 13, the court will generally allow them about six months to get either one accomplished.

Depending on the income of the debtor, and on what is called the liquidation analysis, there may be a portion of the payment that goes to unsecured creditors. They may get a small percentage of what they are owed over the term of the plan, or they may not get anything. This is determined on a case by case basis. Please contact a professional to address this issue. The repayment plan must be approved in court, and the trustee administers the plan, receiving payments from the debtor and distributing them to creditors.



Specific example: Stripping a junior lien

A client purchased a home three years ago for \$656,259 with an 80/20 loan. This means that the first mortgage is for 80% of the home's purchase price (\$525,000) and the second mortgage is for 20% of the purchase price (\$131,259). If the current appraisal comes in at \$500,000, then the first mortgage is undersecured, and the second mortgage is wholly unsecured and can be stripped off. The loan still exists and the money is still owed to the lender, but there is no longer a lien on the home to secure the debt. As unsecured debt, it is now in the same category as credit card debt or medical bills.

Junior mortgages cannot be stripped through Chapter 7 bankruptcy. However, once stripped through Chapter 13 (or Chapter 11), the bankruptcy can be transferred to Chapter 7. The junior mortgage is now like those other unsecured loans and, through Chapter 7, it may be wiped out. This is one example of the complex strategies a bankruptcy lawyer can help debtors with, to minimize losses and maximize benefits through the bankruptcy process.



The Homeowner's Guide to Bankruptcy and Short Sales



Specific example: Chapter 13 debt reorganization

A debtor has a \$235,000 first mortgage, a monthly payment of \$1,427.95 and is one year behind on mortgage payments - so owes \$17,135.40 in arrears, plus late charges and other costs.

Chapter 13 would allow the debtor to retain the home, provided that he continues making his regular monthly payments of \$1,427.95, plus makes up the arrears over a period of five years. The monthly arrears payment would be \$17,135.40 divided by 60 months, or \$285.59. There would also be a \$171.35 monthly charge for trustee's fees.

So the total monthly payment under Chapter 13 bankruptcy, under a five-year plan, would be \$1,884.89. By the end of the five years, the homeowner would be completely caught up on both regular mortgage payments and arrears, and would continue making only regular mortgage payments on their home.





The Homeowner’s Guide to Bankruptcy and Short Sales

CHAPTER 11 BANKRUPTCY

Chapter 11 bankruptcy is oriented more towards businesses, but may also be used for people who are in business or for individuals. It is useful, for example, for individuals who operate as businesses, e.g. real estate developers.

CHAPTER 11 BANKRUPTCY IS ORIENTED MORE TOWARDS BUSINESSES, BUT MAY ALSO BE USED FOR PEOPLE WHO ARE IN BUSINESS OR FOR INDIVIDUALS. IT IS USEFUL, FOR EXAMPLE, FOR INDIVIDUALS WHO OPERATE AS BUSINESSES, E.G. REAL ESTATE DEVELOPERS.

It is similar to Chapter 13 in that it involves making a repayment plan, but with the aim that the business operation can continue running while creditors are being paid. It is different in that there is usually no appointment of a trustee. Instead, the debtor becomes a “debtor in possession” until the reorganization/repayment plan is confirmed, or until the bankruptcy is converted to Chapter 7 or, in rare cases, a Chapter 11 trustee is appointed. The “debtor in possession” can continue to run the business while meeting the payment plan and paying off creditors over time.

Individual debtors must file for Chapter 11 if they have over \$1,081,400 in unsecured debt and do not qualify for Chapter 7. The filing fees are \$1,139.

Using bankruptcy as part of a strategic plan:

A distressed home owner has many options: actions they can take themselves, rather than simply waiting for their lender to take action through foreclosure. These options include: loan modification, using a debt settlement agency, three different bankruptcy options (Chapter 7, 11 or 13) and conducting a short sale.

Loan modifications work for some people, particularly if the lender is willing to reduce the principal balance owing on the loan. However, the most recent data show that nearly 50% of modified loans re-default within 12 months of their terms being modified. So, for nearly half of the homeowners who attempt a loan modification, all that the process does is delay foreclosure, rather than prevent it. For some, their deteriorated financial situation may mean that other options, such as a short sale, are no longer available to them.





The Homeowner's Guide to Bankruptcy and Short Sales

Debt settlement agencies are not a good option for most people. For a distressed homeowner, their unsecured debt (e.g. credit cards, medical bills) should be their lowest priority. But making payments on secured debts (i.e. loans secured with home, car etc.) is important, or they risk losing the collateral: the property that secures the debt. Debt settlement agencies often do not prioritize debts this way, and they may collect such high charges for their services that the earnest debtor, attempting to catch up on their payments through the credit repair company, ends up finding that most of their monthly payments have gone to the debt settlement company while their other debts continued to accumulate.

For most people, waiting for foreclosure is also a very poor option.

What is a strategic plan?

A strategic plan is one where the debtor, with the aid of experienced professionals, comes up with the plan that best suits their individual financial situation (e.g. debt to income ratio, assets they want to keep, current and expected future earnings). This evaluation process for a short sale is identical to that for bankruptcy, so it only makes sense to investigate bankruptcy at the same time.

The most important part of a strategic plan, though, is looking at how a distressed homeowner can use more than one of these options, and this is where the advice of a knowledgeable and experienced professional can be invaluable. For example, for some people, short-selling a home followed by Chapter 7 bankruptcy can result in shedding of any deficiency balances owing, along with all other unsecured debts, such as credit cards. For others, it would be more advantageous to first enter Chapter 13 and then short-sale the home. And for others, moving from Chapter 13 to Chapter 7 may provide a way to retain their home. Bankruptcy lawyers and other professionals can provide advice specific to each individual financial situation and to the homeowner's specific goals.



The Homeowner's Guide to Bankruptcy and Short Sales



Specific example 1: Short sale followed by Chapter 7 bankruptcy.

A homeowner can no longer make payments on her mortgage, and the current value of the home is less than the balance she owes on the mortgage. She decides to short sale the home, but must sign an agreement to repay the \$60,000 deficiency in order for the lender to approve the short sale.

The loan was a secured debt, but the deficiency agreement is an unsecured debt. She may choose to declare Chapter 7 bankruptcy, exempting most or all of her assets, and shedding debts to unsecured creditors. In other words, she rids herself of any obligation to ever pay back the deficiency; her slate is wiped clean.



Specific example 2: Starting with Chapter 13 bankruptcy and moving to Chapter 7.

A homeowner owes \$325,000 on his first mortgage and \$100,000 on his second mortgage—a total of \$425,000—as well as \$30,000 in credit card debt. However, due to collapsing home prices, his home is now appraised at only \$300,000. The first mortgage is undersecured, and the second mortgage is totally unsecured.

Through Chapter 13, the debtor's attorney serves the second lender with an adversary action stating that there is no security for the second mortgage. Unless there is reason to doubt the appraisal (and that is why it is important to get a genuine appraisal) the second lender has no grounds to contest the action. The second loan is stripped, which means now it is considered an unsecured debt for \$100,000.



The Homeowner's Guide to Bankruptcy and Short Sales

As long as the homeowner meets the eligibility criteria for Chapter 7, it would be strategic to then move him into Chapter 7. Now all unsecured debt—the \$100,000 second mortgage as well as the \$30,000 in credit card debt—can be wiped out. He now has only his first mortgage to pay, and as long as he makes payments on that he may keep his home and move forward with his life. He may even be able to do a modification on the first mortgage, to lower that payment as well!

Moving from Chapter 13 to Chapter 7 works well for people with two or more mortgages, whose home value is less than the money owing on the senior mortgage(s): through Chapter 13, the junior mortgages are stripped, i.e. become unsecured, and then through Chapter 7 they can be wiped out along with any other unsecured loans.

How to come up with the right plan

The examples above illustrate how distressed homeowners, by coming up with the appropriate plan, can save tens or even hundreds of thousands of dollars. Making a plan is far better than simply waiting for foreclosure—which means losing their house, and also does not deal with any of their unsecured debts.



Considering the large amounts of money that can be saved by coming up with the right plan, most people come out well ahead even after paying for professional advice. Experts such as bankruptcy attorneys will assess an individual's financial situation, and they also know exactly what is and is not allowed when combining strategies.

For example, eligibility criteria are different for each chapter of bankruptcy, and it is important to be sure that debtors meet



The Homeowner’s Guide to Bankruptcy and Short Sales

the eligibility criteria of the chapters they want to start with and that they might want to convert to.

The entire bankruptcy filing process usually takes about three months for Chapter 7, sometimes much longer for Chapter 11 or 13. In Chapter 7, that is the end of the process: everything is done, debts are discharged, and the homeowners are off to a new start. In Chapter 13 and Chapter 11, after the filing process and coming up with a payment plan, the plan itself is usually structured over either a three-year or five-year period. The costs to file for bankruptcy are the filing fees, which for Chapters 7 and 13 are under \$300 and for Chapter 11 are \$1,139, plus fees for lawyers or any other advisors. Working with an experienced bankruptcy lawyer, a client could expect to pay legal fees for a Chapter 7 of between \$1,000 and \$2,500 depending upon the complexity of the case. Fees for Chapter 13 are set by statute; in western Washington, that fee is \$3,500. Fees for Chapter 11 are negotiated.

HOW DECLARING BANKRUPTCY AFFECTS A CLIENT’S FUTURE

Credit score

The FICO credit score scale goes from 350 to 850. Scores above 700 are considered “good”, and scores above 800 are “excellent.”

THE FICO CREDIT SCORE SCALE GOES FROM 350 TO 850. SCORES ABOVE 700 ARE CONSIDERED “GOOD”, AND SCORES ABOVE 800 ARE “EXCELLENT.”

The credit bureaus are reluctant to release the exact formulas that they use for calculating credit scores. Their formulas are complicated, and there is not an exact number of points debtors would lose for a short sale, a bankruptcy or a foreclosure. The number of points they lose also depends upon what their credit score was to begin with (people with high scores lose more points for the same action than people with lower scores). It also depends on whether they were behind on mortgage payments before the short sale or bankruptcy or foreclosure.





The Homeowner's Guide to Bankruptcy and Short Sales

Some published reports indicate that the number of points lost for a short sale, bankruptcy or foreclosure is about the same, ranging from 85 to close to 300. The range comes from each seller's unique situation, e.g. other aspects of their credit, and whether not they were behind on mortgage payments before the short sale or bankruptcy. Late mortgage payments alone can cost up to 135 points. However, some industry insiders believe that the negative impact of foreclosure can be up to three times higher than for a short sale or bankruptcy, with bankruptcy or a short sale costing 100 points, whereas foreclosure can cost around 300 points. This view is supported in some online discussion forums, where forum posters have indicated that they lost between 50 and 150 points after completing a short sale.

Both a bankruptcy and foreclosure will remain on a personal credit report for up to ten years.



People who take their finances seriously and work at rebuilding their credit score can have reasonably good scores as soon as two years after having declared bankruptcy. Steps they can take to rebuild credit score include making house and car payments on time, improving debt-to-income ratios, and obtaining and using a secured credit card and making payments on time on it.

Future home purchases

Even with a significant hit to their credit score due to bankruptcy or a short sale, as a responsible borrower you can bring their credit score back up very quickly. For example, getting and using a secure credit card can help raise their credit score. As soon as two years following bankruptcy, it is possible for many borrowers to bring their credit score back up to 680 or higher, which is more than enough to get a mortgage. Guidelines are changing all the time, but at the current time, a person who has filed for bankruptcy or done a short sale may qualify for an FHA mortgage after two years, and for a conventional mortgage after three years. However, if a person has had a foreclosure, they probably will not qualify for any mortgage for up to ten years.



The Homeowner's Guide to Bankruptcy and Short Sales

HOW TO FIND MORE INFORMATION ABOUT BANKRUPTCY FOR YOUR CLIENTS

Everyone's financial situation is different. Deciding whether bankruptcy is the best option, choosing which type to file for, and looking at other options such as a short sale in conjunction with bankruptcy, are best done working with an experienced expert. The evaluation process for a short sale and for bankruptcy are identical, so it makes sense that anyone considering a short sale also looks into bankruptcy options at the same time. The more information they have about their options, the more likely they are to find the best possible solution to their individual situation.

Although it is legal to file for bankruptcy without a lawyer, for most people this is not advisable. Most people save many times what they pay for good advice, compared to if they tried to work through the process without advice.

Seattle Short Sales, Inc. has a support network of trusted real estate professionals. By becoming part of our professional network, real estate agents can build their own reputation as a trusted professional, as well as reduce their own liability by ensuring that advice provided to their clients is appropriate and accurate.

Contact Seattle Short Sales, Inc. for more information about combining short sales and bankruptcy, and to gain access to our network of professionals in the real estate industry.

<http://www.SeattleShortSales.com>

1-800-603-3525

JONATHAN SMITH

Attorney at Law

Advantage Legal Group

11100 NE 8th Street, Suite 340

Bellevue, WA 98004

425-452-9797

