

Troubled owners: 3 warnings about short sales

Many struggling homeowners are considering short sales as a way to avoid foreclosure on their homes, but there are a few things they should know before taking the plunge.

By Aleksandra Todorova of [SmartMoney](#)



Dealing with the burden of owning a home that's underwater, or worth less than the underlying mortgage, can be financially devastating. Go into foreclosure and the blemish will stay on your credit report for the next seven years. Try to eke by and you put the rest of your finances in danger.

One solution some struggling homeowners turn to in hopes of limiting the financial damage is a short sale. In real estate, that term has a different meaning than the stock transaction in which an investor seeks to profit from a drop in price. A real-estate short sale entails selling the home at a loss under an agreement with the lender. Even though lenders often frown upon short sales, the U.S. government is trying to make them more amenable to such transactions. But the government may not be doing homeowners much of a favor.

In May, the Obama administration said it would expand its [Making Home Affordable](#) program by offering lenders and loan servicers an incentive of up to \$1,000 for each completed short sale and up to \$1,000 more to share the cost of paying any second-mortgage lenders to release their claim on the property. (If a home has a home-equity loan or home-equity line of credit, in other words, the investors who own the primary mortgage may pay those who hold the second mortgage a certain amount to settle that loan. The government will match \$1 for every \$2 paid by the investors, up to \$1,000.) Homeowners also benefit: They can get up to \$1,500 for relocation

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expenses.

But while a short sale may seem like a great way to avoid the financial fallout of foreclosure, it's not always the smartest move. In certain states, for example, a homeowner may have better legal protections by going the foreclosure route. And the damage to your credit score is the same whether you carry out a short sale or foreclose on the home.

What's your home worth?

Here's what you should know about short sales before taking the leap.

1. Your credit score will tank just the same

Contrary to what many homeowners believe, a short sale can have the same devastating impact on a credit score as a foreclosure. "If someone is unable to repay their mortgage, regardless of how that turns out, that failure to repay the mortgage is highly predictive of future risk," says Craig Watts, a spokesman for Fair Isaac, the company that calculates the FICO score, the score most commonly used by lenders. A short sale, a foreclosure and a deed-in-lieu, which lets the borrower transfer the property deed to the lender and walk away from his home, have the same impact on your score because they are all regarded as serious delinquencies. "When an account goes to foreclosure or a short sale, that's as severe as it can get," Watts says.

The impact on your score will depend on what shape it was in before the short sale or foreclosure. If your credit was good — say you had no late payments before the short sale and your score was in the 700s — your score could drop by 200 points, Watts says. Your score will begin to recover after a year or two, but how soon it gets to its previous level is going to depend on how you handle your credit in the meantime.

The drop will be less severe if your score was already low because of late payments or other negative marks on your credit. So if you persuade your lender to do a short sale without having a late payment on record, your credit score will tank a lot further than if you've been missing mortgage payments for months, as typically happens with a foreclosure.

2. The lender may come after you for the difference

Depending on the state you live in, you may have more protections from your lender with a foreclosure than with a short sale.

This is particularly true in states that ban deficiency judgments in foreclosure, such as California, Minnesota and Alaska, says Mark Ireland, supervising attorney at the Foreclosure Relief Law Project, a St. Paul, Minn.-based nonprofit that represents homeowners and neighborhoods affected by the foreclosure crisis. Deficiency judgments empower lenders to sue borrowers if the home they lost in foreclosure is sold for less than what they owe, he says.

When a short sale occurs, meanwhile, the bank will almost always try to get the homeowner to sign a promissory note agreeing to pay back the difference between the amount they owe and the final sale price, says Robert Lattas, a real-estate attorney in Chicago who specializes in foreclosure and short sales. It's up to the homeowner or the homeowner's attorney to try to get the clause removed and the lender to agree not to pursue any further payment by the homeowner.

Home affordability calculator

3. You'll have less time to recover financially

In most states, a foreclosure takes at least several months — a time when homeowners don't make house payments and can create a cash cushion that will let them move on with their lives after they leave the property, Ireland says. In states that have a nonjudicial process — meaning the lender doesn't have to take you to court to foreclose and the process is much faster — the homeowner gets a redemption period that can be as long as 12 months. (Click [here](#) for a

list of states and information on redemption periods, compiled by foreclosure listing company RealtyTrac.) "The redemption period is an opportunity for a soft landing," Ireland says. "You give that up with a short sale."

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