

WHAT HAPPENS TO A HELOC IN CASE OF DEFAULT OR FORECLOSURE?

If you can no longer pay your first mortgage, your HELOC lender may be able to recoup some of their money via short sale or foreclosure. However, it's rarely as simple as "turning in the keys."

HELOC Subordination and Recourse

There are two factors to consider when facing foreclosure:

First, HELOCs are subordinate to primary home loans. This means that the HELOC lender has claim to any money generated by a foreclosure, only after the primary mortgage lender recoups their full loss. The primary mortgage lender will also use up thousands of dollars to sell the foreclosure home. In many cases, this means that the HELOC lender will not see any money when a property is foreclosed upon.

Second, almost all HELOCs are considered "recourse loans." The borrower is personally responsible for paying recourse loans in full, regardless of their property's value. If the lender doesn't recoup the full cost of the loan during foreclosure, they can sue the borrower for the remaining money owed. The lender may be able to recoup its loss by garnishing the borrower's wages or even placing a lien on a future property. Collections can continue for up to 20 years. (Note that in some states legal statutes require that all first mortgages are non-recourse. See: [List of Non-Recourse States](#).)

If a HELOC lender forgives a recourse loan, the borrower is generally required to include the forgiven amount in his taxable income. Based on the [Mortgage Forgiveness Debt Relief Act of 2007](#), you may be able to avoid paying taxes on the forgiven amount if you can prove the HELOC money was used to fund home improvements. (The act applies to those paying taxes in 2007, 2008, and 2009).

Recourse laws vary widely between states – check with a local finance professional to determine how these laws will affect you.

HELOC Foreclosure Options

Considering the issues above, there are a few ways that a HELOC foreclosure or short sale can play out. Here are the most common scenarios:

Option 1: Straight-Up Short Sale – The only way to hold a short sale on your property is if both the primary lender and the HELOC lender agree. As a part of the short sale agreement, you will probably be required to pay a certain amount to both lenders in order for your account to be considered closed. This is addition to the money recouped by the sale. Your credit report will note that the account was settled but that the full amount was not paid. However, the damage to your credit will be significantly less than the damage caused by a foreclosure. Keep in mind that only a small percentage of short sales actually go through; most end up in foreclosure.

Option 2: Short Sale with Incentive to HELOC Lender – It can be difficult to get a HELOC lender to agree to a short sale; chances are the lender will not receive any money from it. Instead, many HELOC lenders prefer to keep collecting monthly payments for as long as possible. If the primary lender wants to push a short sale, it may offer the HELOC lender an incentive. Sometimes the HELOC lender is paid between \$1,000 and \$4,000 to sign off on the sale.

Option 3: Primary Lender Forces Foreclosure – If your property is foreclosed upon, your primary lender will be paid everything it is owed with the money it takes from the sale. It may also use some of the money for expenses related to the sale of the home. Since the HELOC loan is subordinate to the first mortgage, the HELOC lender will be paid with any remaining money. If the HELOC lender is not paid the full amount owed on the line, the HELOC becomes an unsecured lien collectable via a deficiency judgment. The lien is no longer on the property; instead,

the borrower is liable for everything owed. Through the deficiency judgment, the HELOC lender may be able to recoup the money from you by garnishing your wages or even putting a lien on any property you buy in the future. A foreclosure will also show up on your credit report, making it extremely difficult for you to get credit for the next 7 years.

Option 4: HELOC Lender Forces Foreclosure – Some borrowers stop paying their HELOC bills while continuing to pay their primary mortgage. In this case, the HELOC lender may decide to force foreclosure. In trust deed states, such as California, HELOC lenders who force foreclosure can seek no additional recourse in addition to any money the foreclosure brings. Basically, once a HELOC lender forecloses, he can't get a deficiency judgment to recoup additional money from the borrower. Because the primary mortgage lender will receive the lion's share of the foreclosure money, HELOC lenders often choose to wait it out rather than forcing foreclosure themselves. A foreclosure forced by the HELOC lender will have the same effect on your credit as one forced by your primary lender.

Option 5: HELOC Lender Purchases Primary Loan – If you stop paying your HELOC while still making primary mortgage payments, the HELOC lender may try to purchase your first mortgage in order to initiate foreclosure proceedings. As the holder of both the first and second loans, the lender will be able to recoup the maximum amount possible. In this case, the lender will probably initiate foreclosure as the holder of the first mortgage. By doing so, it can still sue you for a deficiency judgment to collect any additional money owed on the HELOC.

Keep in mind that the above information is a general overview of how HELOC foreclosures and short sales work. Specific information varies from state to state. Before making any decision, you should seek professional legal counsel and financial advice in your state.

If you need more information about your specific situation, please feel free to contact our offices for help.