

Short Sales 2009

By AAR General Counsel Michelle Lind

The current housing market has resulted in a seemingly ever-increasing number of homeowners in default on their home loans. These homeowners often seek guidance from their REALTOR®. One of the many possible options to a homeowner in default on their loan is to attempt a short sale.

A short sale is a real estate transaction in which the sales price is insufficient to pay the liens encumbering the property and sale costs, but the seller is unable or unwilling to pay the difference. Managing a short sale transaction takes experience and involves inherent legal and financial risks. Therefore, REALTORS® must become educated about the short sale process and always advise their clients in writing to obtain legal and tax advice before proceeding with a short sale. Unless you are confident in your ability to handle such a transaction alone, consult with your broker or manager for advice and guidance.

Seller Considerations

When considering a short sale, the seller must first determine how much is owed on the property. For example, in addition to the delinquent loan, there may be a home equity loan, past due homeowner's association fees or unpaid property taxes. Then, the seller must add the costs of a sale, such as closing costs, escrow fees and brokerage commissions. All of the seller's debt and costs must be factored in before determining whether a short sale is feasible.

The seller should also be aware of the downsides to a short sale. A short sale could affect the seller's credit score. A short sale may appear on the seller's credit report as "pre-foreclosure redemption," "paid in full for less than full balance" or other similar term. Further, even if a lender agrees to a short sale, the lender, the VA, or the FHA may not agree to forgive the debt entirely, and may require the seller to pay the difference as a personal obligation. This outstanding personal obligation could result in a subsequent collection action. For example, a lender may accept the short sale purchase price to "release the lien" on the property as opposed to agreeing to accept the purchase price as "full and final settlement of the debt" on the property. Therefore, the seller should be certain of the terms of any short sale before making a decision and obtain any debt forgiveness agreements with the lender in writing.

Also, a short sale in which the debt is forgiven is a relief of debt and may be treated as income for tax purposes. The Mortgage Forgiveness Debt Relief Act of 2007 created a three-year window for homeowners to pay no taxes on any debt forgiveness they receive; however, only cancelled debt used to buy, build or improve a principal residence or refinance debt incurred for those purposes qualifies for this tax exemption under the Act.

A short sale may involve more documentation than the original loan application since the seller must "reverse qualify" and prove that the seller is financially incapable of paying the loan. The seller must convince the lender that it will fare better by agreeing to a sale for less than the outstanding loan amount.

The AAR Short Sale Addendum to the Listing Contract will assist brokers in educating their sellers about these issues and help prepare them for this process. This Addendum addresses the major issues of concern to a seller and advises the seller to obtain professional tax advice and independent legal counsel regarding the advisability of entering into a short sale agreement.

Purchase Contract Considerations

The purchase contract in a short sale should be contingent upon a short sale agreement acceptable to both the lender and the seller. The AAR Short Sale Addendum to the Residential Resale Purchase Contract provides that the contract will be contingent on an acceptable short sale agreement. This contingency is similar to the buyer's financing contingency. However, both parties acknowledge that it may take weeks or months to fulfill the contingency by obtaining the lender's approval of the short sale.

The Addendum also obligates the seller to immediately deliver notice to the buyer that the seller and the lender have entered into a short sale agreement. This notice is defined in the Addendum form as the Short Sale "Agreement Notice." The date of seller's delivery of the Short Sale Agreement Notice to the buyer is deemed the date of contract acceptance for purposes of all applicable contract time periods. In other words, although the parties have entered into an enforceable contract, the time periods do not begin to run until the seller has delivered the Agreement Notice. In the event that the seller and lender are unable to reach an acceptable short sale agreement, the seller must notify the buyer and the contract is cancelled due to the unfulfilled short sale contingency.

Brokerage Commission Considerations

Because the lender is accepting less than the full obligation, the lender may demand that the brokers in the transaction reduce their commission as a condition to any short sale agreement. The NATIONAL ASSOCIATION OF REALTORS® (NAR) Code of Ethics Standard of Practice 3-2 requires the listing broker to communicate any changes in offers of compensation before an offer to purchase is produced. Therefore, some listing brokers request that the buyer's broker address any potential commission reduction issues with them before submitting an offer. The NAR Model MLS Rules and Regulations and Multiple Listing Policy Statement 7.23 were amended to attempt to address some of these issues. The MLS policy changes, which are optional, may be reviewed on the NAR website.

Of course, the brokers involved in a short sale have no obligation to reduce the agreed upon commission. The Commissioner's Rules do not "obligate a licensee to agree to alter the terms of any employment or compensation agreement or to relinquish the right to maintain an action to resolve a controversy." See, A.A.C. R4-28-1101(D). Therefore, even if the transaction will not close unless the brokers agree to reduce their commission, the brokers have no duty to do so.

Requests to lower commissions should be handled professionally in all cases and any agreement to alter the previously agreed upon commission structure should be reduced to writing to avoid any misunderstandings or disputes after close of escrow. If the listing broker agrees to reduce the listing commission, the buyer's broker's commission is not affected unless the buyer's broker also agrees. If a buyer's broker agrees to accept a reduced commission amount, the buyer's broker is bound by that agreement.

Steps to a Successful Short Sale Transaction

Many brokers report that short sale transactions are often difficult and often fail to close escrow. Documentation and eligibility criteria for short sales vary depending on specific lender and investor guidelines. Further complicating the issue, many lenders are struggling with staff that has a lack of experience with short sales. Additionally, different lenders have different short sale department names, so contacting the person who has the authority to authorize a short sale on behalf of the lender may require some tenacity. The appropriate department may be called loss mitigation, work-out, foreclosure, loan modification or loan reinstatement department.

A well-prepared listing broker can increase the chance of a successful short sale transaction. First, remember that generally speaking, the lender seeks to obtain fair market value for the property. Second, be aware that most lenders will not agree to a short sale unless the seller is insolvent or will either agree to make a cash payment or execute a promissory note at closing. To successfully handle a short sale, a listing broker should be prepared to:

- Obtain all pertinent information from the seller (pay off statements, liabilities, liens, trustee's sale date, etc.)
 - Perform a broker price opinion (BPO) or comparative market analysis (CMA) to determine the property's fair market value (Freddie Mac also requires that the BPO contain a 90 day "as is" marketing timeframe)
 - Calculate all costs of sale
 - Advise the seller to explore other workout options other than a short sale (retain the property, loan modification, deed in lieu of foreclosure, foreclosure, bankruptcy)
 - Advise the seller in writing to obtain legal and tax advice
 - Incorporate the AAR Short Sale Addendum to the Listing Contract in the listing agreement
 - Obtain written authorization from the seller to contact the lender(s) if the language in the Addendum is not deemed sufficient and immediately contact the lender for short sale package instructions
 - Communicate with junior lienholders and determine their payoff requirements
 - Check the MLS rules regarding short sale disclosure requirements
 - Ensure that the AAR Short Sale Addendum to the Residential Resale Purchase Contract is incorporated into the contract when an offer is received
 - Gather the documents necessary for a short sale for delivery to the lender, such as:
 - Seller's hardship letter
 - Seller's financial statement
 - Recent pay stubs
 - Executed purchase contract
 - Estimated seller's closing costs or estimated HUD-1
 - Buyer pre-approval letter
 - Bank statements
 - Credit report
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- Ensure that the escrow agent is aware that the transaction is a short sale
 - Communicate and follow-up on details frequently — a short sale approval from the lender may be limited in time