

A Primer on Short Sales

By
Phillip C. Querin, Legal Counsel for OREF

Generally - For any Realtor® watching the monthly statistics, it is common knowledge that we are experiencing a build-up in new and existing home inventory, nationally and locally. Fortunately, for the Portland metro area, the problem is not nearly as acute as elsewhere. In fact, a recent Oregonian article touted the fact that Portland and Seattle were two of the five areas of the country that defied the national slowdown in housing prices.¹ However, today, with a build-up of housing inventory, and a slowing of closed sales, we are seeing a flattening of home prices, which means there is less market value appreciation today than in the past. It was this appreciation over the last several years that kept sales so robust, since there always seemed to be enough money generated from a house sale to pay off the existing mortgage and closing costs, and move the remaining equity into another home.

However, today, many homeowners who bought homes in the last few years did so at the top of the market, paying prices that appeared to be going nowhere but up. With cheap money and relaxed (some might say “nonexistent”) loan underwriting standards, almost anyone could qualify for a mortgage and buy a home. Many purchasers took out adjustable rate mortgages and HELOCs², at low – but temporary - “teaser” rates that allowed them to purchase more home than they could otherwise afford if required to pay actual market interest rates. Additionally, the lower interest rates ushered in a refinancing boom, which permitted existing owners to tap their home equity for college education, vacations, cars, investments and other personal reasons. After the dot-com collapse in 2000 and beyond, real estate was “the place” to invest money, and many people obliged.

With the flattening of market values, some sellers are now finding that their existing equity is insufficient to pay off their mortgages, when coupled with the rest of the closing costs. For those owners who, because of timing issues, cannot afford to wait for the market to improve, a “short sale” is an option that is receiving increasing attention today. A “short sale” is a real estate transaction in which the gross proceeds generated from the sale are not sufficient to pay the seller’s mortgage(s), liens, and/or other closing costs. In other words, without a negotiated reduction in the mortgage indebtedness and/or other costs, the seller cannot complete the transaction and convey marketable title.

The Issue for Realtors®. The first order of business for a listing agent is to be able to recognize that the seller may need to do a short sale in order to close the transaction. This should become readily apparent if the Realtor’s® CMA suggests that the value of the home is less than the estimated cost to close. There is no reason to ignore this situation; Realtors® must thoroughly vet the issue with their seller *before* putting the home on the market. This means making sure that the seller verifies exactly how much is owed on *all* mortgages that would need to be paid off at closing in order to convey marketable title to the buyer. Not asking the right questions at the commencement of the listing merely means they will have to be addressed later. No Realtor® should want to be dealing with this issue at the closing table, when the lender’s payoff letter shows a principal balance, with interest and penalties, that far exceed the seller’s gross sale proceeds.

The short sale process can be fraught with problems: one party, the seller – is not negotiating from a position of strength; the other party – the buyer – may be attempting to acquire the property at a discounted price. Compounding all of this is the fact that the seller’s creditors, usually lienholders, are trying to protect their own interest by making sure they do not write off any more money than necessary to accommodate the sale. As a result of these competing dynamics, Realtors® are thrust into a relatively foreign situation, where there are multiple parties with very differing interests that are not necessarily aligned. These dynamics can be more akin to a divorce than a marriage.

The Need for Professional Assistance. In short sale situations there are multiple issues that do not normally arise in the conventional home sale transaction where both parties are typically ready, willing and able to close. For example: (1) If the lender agrees to reduce the indebtedness sufficient to close the transaction, will this “debt relief” be taxable to the seller?³ (2) If the lender agrees to remove their lien, will they pursue the seller for recovery of the unpaid indebtedness? (3) How will any negotiated reduction of the mortgage indebtedness impact the seller’s credit? (4) Rather than doing a short sale, is there any

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advantage for the seller to execute and deliver a “Deed in Lieu of Foreclosure” to the lender?⁴ (5) Is there any advantage for the lender to foreclose, rather than consent to a short sale? (6) Has the seller considered whether a bankruptcy might be more appropriate under the circumstances? (7) Does the seller have alternative sources of funds, thus eliminating the need for a short sale? (8) Should the seller consider not even selling the property, and either continuing to occupy or renting it out? These questions, some of which require familiarity with legal, tax and consumer credit issues, are best addressed by someone other than the Realtors® themselves. The sooner the parties, especially the seller, secure professional assistance in addressing these issues, the better.

Role of the Creditors. Once the parties enter into a short sale transaction, they – and their Realtors® - will quickly learn that it is the creditors who will be making most of the major decisions about the transaction, since without the creditors' consent, clear title cannot be conveyed and there will be no closing. The result will be that all time frames set forth in the Sale Agreement will hold little, if any, importance to the seller's creditors. In fact, prompt consent by a creditor to a short sale will be the exception rather than the rule. The reason for this is clear: If a creditor is being asked to reduce the indebtedness owed to them, they will need to evaluate multiple issues, which will take time to answer: (1) How does the proposed short sale price compare to the current fair market value? This may entail an appraisal. (2) Is this short sale the buyer's “last and best” offer, or is he/she prepared to increase their offer? (3) Are there any other prospective buyers out there who might offer a better price for the home (which would mean less of a loss to the lender)? (4) Does the seller have any other possible sources of funds besides the buyer's purchase money, with which to pay off the loan? (5) Would a straight foreclosure of the property (or Deed in Lieu of Foreclosure), be a better alternative? (6) Are there any other creditors being paid from closing (including the Realtors® themselves) who will reduce their claims in order to facilitate the closing?

Answers to all of these questions, and perhaps others unique to the particular transaction, mean that in a short sale transaction, nothing happens overnight. Increasing everyone's frustration with the process is the fact that some lenders may be completely unwilling to sign any written agreements actually committing to the short sale until the very last minute – if at all. The first time the parties learn of the lender's commitment to remove their lien may come when escrow receives the signed satisfaction of mortgage⁵ for recording. Patience is not only a virtue in short sales, it is a necessity.

Use of an Addendum. While each brokerage company's policy may be different, it is likely that if a transaction is going to be short sale, a separate addendum is in order. Given the fact that this entire process is not widely understood by the Oregon real estate industry, we are seeing different approaches by different Realtors®; some are drafting their own addenda while some are using company-developed forms. Currently, Oregon Real Estate Forms LLC, the statewide forms provider for Realtors®, is developing a Short Sale Addendum form that should be available shortly.⁶ Regardless of what form is used, here are some concepts that merit consideration in a short sale:

1. The seller should be entitled to consider *all* offers of purchase rather than taking the property off the market immediately after a short sale is accepted.⁷ There are two primary reasons for this approach: (1) The lenders will require it anyway; (2) By reviewing other possible offers, the seller may be able to avoid the short sale entirely.
2. While the seller will be primarily responsible for securing creditor consent to the short sale, the buyer may want to independently verify that it will be given. This may require written authorization by the seller permitting buyer contact with the lender(s). However, the seller should be alert to the risk of back-channel communications between the buyer and the seller's lenders, trying to cut a deal, perhaps following a foreclosure of the seller's property.
3. Securing creditor consent to the short sale should preferably be written as a contingency between seller and buyer, so that neither will be bound to the transaction if consent cannot be obtained.

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4. During the contingency period, attention should be given to possibly suspending all of the applicable time and performance deadlines, such as the closing date, financing, title, inspection, property disclosure and lead based paint. Until creditor consent is obtained – or appears highly likely – it may be premature for the buyer to expend significant time or money on the transaction. Conversely, the parties should be aware that if and when creditor consent does occur, there may be insufficient time for the buyer to complete all due diligence before closing.
5. Both parties should be prepared for one or more of the creditors to condition their consent upon a change in the price or terms previously agreed upon.
6. The brokers should be prepared for one or more of the creditors to try to negotiate a reduction in the commissions. In view of the offer of compensation rules in the RMLS™, this issue needs to be addressed between listing and selling broker early in the short sale transaction.
7. Both Realtors® must make sure they adequately explain to their clients the risks associated with short sales and strongly encourage them to secure professional assistance for the legal, tax, and consumer credit issues.

Conclusion. Most sellers are not familiar with the short sale concept, and most buyers, other than investors, are similarly unfamiliar with it. And for the last few years, with the rapid increase in home values, most Realtors® have never seen a transaction in which the sale price was insufficient to pay off the liens and closing costs. Accordingly, companies and principal brokers need to be proactive in developing training, office policies, and close supervision of their agents to make sure that the risks inherent in this newly developing area are recognized and dealt with early in the transaction.

FOOTNOTES

¹ “Portland, Seattle, Defy Housing Price Slump” AP, November 27, 2007. See, <http://www.oregonlive.com/news/index.ssf/2007/11/27/>.

² Home Equity Line Of Credit.

³ Under some circumstances, relief of mortgage indebtedness may be treated as receipt of income, in which case the amount of debt relief will be taxed at ordinary income tax rates. Currently, there is a bill pending before Congress to eliminate this result. It has passed the House of Representatives and is before the Senate. According to the National Association of REALTORS®, there is “momentum” to get the bill passed this year.

⁴ This would entail the seller voluntarily giving a deed to the lender “in lieu of” a foreclosure. If the seller has no real equity in the home and needs to relocate for personal or business reasons, a “deed in lieu” is obviously quicker and less painful than going through a foreclosure. It is debatable whether a short sale actually has *less* impact on the seller’s future credit than a Deed in Lieu of Foreclosure. Both will likely show as blemishes on one’s credit history and will have to be disclosed on future loan applications. Some lenders may prefer a short sale at market value to a Deed in Lieu of Foreclosure, since it eliminates the lender’s time and cost of reselling the home through their REO department.

⁵ In Oregon, we generally use trust deeds rather than mortgages. For purposes of this article there is no substantive difference, except for terminology. In trust deed nomenclature, a “satisfaction of mortgage” is called a “deed of reconveyance.”

⁶ Because of the complexity and importance of the issues, drafts will be reviewed at a variety of industry levels, including a PMAR Risk Management workgroup, OAR and the Eugene Board of Realtors®.

⁷ In view of the short sale situation, RMLS™ is evaluating its current rules, since acceptance of an offer today requires that the property be shown as “pending.”