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Legal Update

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Please Route to:

Inside This Issue

2

Facing Reality

**When REALTORS® List
Short Sales**

7

**When REALTORS® Help
Buy Short Sales**

8

**Legal Hotline Short Sale
Questions and Answers**

11

Resources

Short Sales – A Risky Business

In a “short sale,” the lender and the owner of a home agree that the lender will accept less than is owed to pay off the mortgage loan on the house. The seller is “upside down” in most cases, and owes more on the house than they can sell it for. As envisioned from the real estate industry’s perspective, a short sale means that the proceeds from the sale will not be enough to satisfy all of the liens on the property and to pay all of the closing expenses, possibly including the broker’s commission. The seller lacks sufficient equity to close the sale, so the seller must contribute additional funds or ask the lender to accept a reduced payment, which is less than the full loan balance, as payment in full on the mortgage loan.

There are plenty of risks when brokers work with homeowners in jeopardy – sellers who cannot afford to sell their homes and pay off their mortgages. A knowledgeable broker can earn a commission when listing a short sale property and help minimize the damage to the seller’s credit. Brokers can effectively work with buyers and help them find a good value in a short sale situation, but it is important to know what is really a good bargain versus a market adjustment bringing prices that had been inflated back down to reality.

This *Legal Update* overviews some of the traps that a broker working in a short sale situation must be careful to avoid. The discussion includes ways to identify a short sale and pointers for brokers listing or assisting in the purchase of a short sale. Listing brokers must be concerned with listing contract addenda for short sales, obtaining

authorization to communicate with the lender’s loss mitigation decision maker on behalf of the home seller, cautioning the seller about potential tax and credit status consequences, commissions, and making appropriate disclosures. Brokers working with buyers must be cautious with respect to the lender approval contingency, timing issues involved with the offer, verbal approvals and multiple offers. The *Update* concludes with a section of Hotline questions and answers.

Short Sales

A short sale is not the same thing as a sale under market value because homeowners may decide to sell at a lower price for many different reasons which do not involve the seller not having enough money to pay off the mortgage balance. In a short sale somebody is getting “stiffed” or “shorted” and it is usually the lender on the short end.

These transactions may involve scenarios where the seller is filing bankruptcy or where the mortgagee is foreclosing on the property. Other times the total of all of the liens on the property exceeds the value of the property or what the property can bring on the market. When there are many liens on the property, the different lien holders sometimes will negotiate with the owner and agree to take an amount less than the full amount owed rather than suffer the expense and delay of a foreclosure or other litigation. When there is no more room to negotiate with lien holders, either the seller must bring cash to the table or ask others, like the real estate brokers, to accept reduced compensation for their services.

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Most sellers in this situation want to try to sell. Assuming a six percent commission and two percent for title work, transfer fees and other additional closing costs, the sellers of a \$200,000 property would have to come up with \$16,000 in closing costs. If these homeowners were unable to come up with a down payment when the property was purchased, the odds are extremely high that they will be unable to come up with enough money to close the sale.

Facing Reality

Brokers can help a sellers in distress sell their homes and help buyers find a good buy, but they should realize that there are limits to what can usually be accomplished. Brokers can lend a helping hand and offer some relief, but should never lose touch with reality or allow their clients to become overly optimistic. Brokers are not white knights coming to the rescue, because miracles will rarely result from short sales. If the broker's mindset is to help people and make sure they understand the process and the potential consequences, the broker may enjoy success with short sales, receive a commission, and have the satisfaction of assisting a homeowner in a bad situation.

The most critical thing a broker working in a short sale situation must be prepared to do is to educate the party and make sure they understand upfront all of the delays and difficulties that likely await them. If the broker does not and the party is frustrated with the outcome, the party will invariably blame the broker and may even sue him. Brokers will be accused of not submitting the offer, not following up properly, lying about whether the offer was accepted, wasting the party's time and money on nothing or causing the buyer to miss defects when inspections were rushed or skipped due to the time crunch.

Short sales are frustrating, unpredictable transactions where the outcome may ultimately depend more on luck or the whim of a lender, despite thorough and diligent preparation by the broker. Brokers can easily become discouraged and parties can become angry – and the broker is often the easy target of that anger. Brokers can best avoid that unhappy result by teaching the party about what may happen in the short sale process and making sure that key points are delivered in writing. Brokers should be sure to not over-promise or make commitments in the MLS or elsewhere that they cannot keep. Education, disclosure and caution must be the primary themes in a short sale.

When REALTORS® List Short Sales

The seller in a short sale transaction should be made aware of all of the difficulties that may be encountered, including the extra work and loss of control. Sellers facing a short sale will be very emotional and they need to have everything laid out for them so they know what to expect. While face-to-face discussions help the broker gauge if the seller is tracking the explanation of the process, the broker should have at least the key points put into writing in a document requiring the seller's signature. Having a short sale addendum to the listing contract is one effective way to achieve this measure, which provides a resource that the seller can refer to and which protects the broker from future backlash if things do not turn out as the seller had envisioned. Key points that should be covered include all of the personal financial information and additional paperwork involved, the maddening delays, the seemingly discretionary and arbitrary control that the lenders have, the tax repercussions of a short sale, the impact on the seller's credit status and the residual obligations that lend-

ers seem to create at the last minute for seller payment of any deficiency.

Identifying a Short Sale

When meeting with the prospective seller client, the best thing that REALTORS® can do for the sake of the sellers and themselves when facing a listing where the numbers may be tight – a possible short sale – is to take the time to do their homework regarding the homeowner, the mortgage and title to the property before the listing contract is signed. This will help the REALTOR® and the homeowner choose the best course of action and help save them from unpleasant surprises and from wasting their time and energy on fruitless strategies.

Brokers should make preparation of a net sheet showing the seller's estimated proceeds and a CMA routine steps in the listing presentation. In order to complete these tasks, the broker must gather information about the liens and encumbrances that will be involved at a future closing.

It is critical to know what liens are outstanding and how much money will be needed to clear those liens from title. To this end, listing brokers may wish to use the "Listing Questionnaire Regarding Title Issues" (revised 12/07) when listing properties to prompt the seller to identify potential title issues that would not be evident from simply examining recorded documents, including whether they are behind with mortgage payments. This questionnaire appears on page 13 of *Legal Update* 03.09, "Warranties in the Offer to Purchase," online at www.wra.org/LU0309, and on ZipForm.

In addition, the listing broker may also want to order a search and hold from the title company to see what liens appear of record. While this certainly is not within a real estate broker's job description, it is better to try to get a full picture of what the broker

is dealing with up front and try to head off disaster down the line. While the "Listing Questionnaire Regarding Title Issues" and the title search may come up with the same list of liens, sometimes they may be very different. Sellers in financial straits may not reveal or remember all that is going on and thus may overlook disclosing one or more liens. The seller also may be unaware of some items in the title report like procedural glitches in court proceedings affecting title or information appearing on an official map.

The seller should review the seller's mortgage and examine the due-on-sale clauses and prepayment penalty provisions to make sure that the procedures for obtaining lender consent to the sale are being followed and that there is not any prepayment penalty that will need to be included when calculating the amount the seller must pay to release the mortgage lien.

Listing Contract Addendum for Short Sales

Once the transaction has been identified as a short sale, the broker can proceed with the listing contract, to which the prudent listing broker will attach a short sale addendum. An addendum gives the broker an opportunity to drive home to sellers the main points that should have already been covered in their discussion of short sales and to obtain the sellers' signatures on a document that acknowledges that the sellers have been cautioned about the potential outcome and consequences of a short sale.

What Does a Short Sale Mean for a Seller?

The addendum should identify that the sale of the listed property will likely be a short sale. That means that if sales price is not sufficient to pay the mortgage(s), other liens and other expenses at closing that either the seller will have to pay additional money to cover the shortage

or negotiate an agreement with the lender whereby the lender accepts less than the full amount owed. It should be made clear to the seller that there is no guarantee that the lender will approve a short sale and that if they do approve, they will likely impose additional requirements upon the seller including arrangements for the seller's payment of the remaining balance owed outside of the real estate transaction. This latter point is important because some sellers find it hard to comprehend that they still are responsible for the deficiency remaining after the short sale closes.

Potential Tax Consequences

The addendum should make it clear that if the lender does forgive the deficiency, this debt forgiveness may result in taxable income for the seller. This will be less significant to the extent that the three-year window created by the Mortgage Forgiveness Debt Relief Act of 2007 negates the requirement that the homeowner pay tax on any debt forgiveness they receive prior to January 1, 2010. That does not mean that the provision should not be included – it will guard against the possibility that the homeowner does not qualify for this protection, which will expire in three years. The tax disclosure provision should also raise the possibility that the short sale may result in capital gains, as with a property with a low basis recently refinanced at a high value which is now above market value. The difference between the original basis and high values in the market, even if now below the refinance value, will produce capital gains.

Credit Rating Consequences

The addendum should advise the seller that there may be adverse consequences to the seller's credit rating if the lender forgives part of the amount owed. This is somewhat dependent upon what the lender chooses to report to the credit bureau. The

characterization selected may impact the severity of the credit status bite.

Lender Approval is Lender's Discretionary Decision

The addendum needs to make clear that the securing of lender approval of a short sale is purely at the discretion of the lender, who may require the seller to jump through numerous hoops to win lender approval. This provision should summarize the documentation required for the short sale application to the lender. Most important, this provision should clearly state that the decision to approve a short sale and impose additional requirements or change requirements at the last minute are all decisions made solely by the lender and that the broker has no control over this outcome. The seller should understand that the lender may seek to restructure the transaction and when all is said and done, the lender may not agree to a short sale.

Seller Authorization for Broker Dialog with Lender

It may be best that the addendum contain the seller's agreement to provide authorization letters to the broker as needed so that the broker may communicate with the lender to determine the lender's requirements for approval of short sales and to provide such documentation and information from the seller as the lender requires. The broker can find out what is needed from the seller and ensure that all required information is submitted, but it isn't necessarily the job of the broker to negotiate with the lenders. The broker's forte is to provide market information to the lender about current values, but actual negotiations bargaining over dollar amounts and short sale terms and conditions should be handled by the seller or the seller's attorney.

Home to be Advertised as a Potential Short Sale

The addendum may authorize the broker to advertise that the transaction will be a short sale by indicating that the sale, sales price and commissions are subject to lender approval, or by using other language agreed to by the seller and broker. General statements of fact are fine, but brokers should avoid any mention of specifics because the lender's discretion knows no bounds. The comments section of the MLS may be a good place to indicate that it is a short sale or is subject to lender approval.

Attorneys Give Legal Advice; Tax Advisors Give Tax Advice

Although it appears in the offer to purchase, this is an excellent place to repeat the warnings found in lines 142-144 of the 2008 WB-1 Residential Listing Contract that the broker cannot give the seller legal or tax advice and that the seller should contact an attorney and tax advisor before entering into a short sale listing. This is for the seller's own good – they should be sure that this is the best solution for them – and it also protects the broker who must tread carefully in

explaining the different procedures and mechanisms of a short sale. The broker cannot give tax or legal advice. The broker can explain the options, caution about the pitfalls and help implement the seller's decisions, but those should be decisions made upon the advice of the seller's attorney and tax advisor, not based upon a real estate broker's recommendation.

Obtain Authorization from the Seller to Communicate with the Lender

The listing broker/agent should request authorization letters from the seller for each lender or lien holder that may be involved in the short sale negotiation. Written authorization is required by post 9/11 privacy laws. The broker should be authorized to communicate on behalf of the seller.

Identify the Proper Loss Mitigation Decision Maker

Once the broker has the proper authority, the broker can contact the lender and start the search for the proper person with the ultimate authority to approve a short sale. In today's world, where mortgages are bought and sold

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on the secondary market and shifted about the country in multiple assignments, it may be challenging to find out who actually has the authority to say yes or no to a short sale. The broker should always ask – repeatedly, if necessary – for the loss mitigation department. Working with a person in the collections department, for instance, may not produce optimal results because collections department staff are intent on maximizing collections, as the name implies.

Some commentators have suggested that some lender collection personnel will lie and misrepresent seller short sale requirements to try to push the seller as far as possible into handing over every dollar in sight at the expense of anyone and everyone.

Prepare the Seller to Apply for a Short Sale

Right out of the gate the wise listing broker will prepare the seller to apply to the lender for a short sale and have the seller immediately begin compiling the documentation that will be needed. Once the broker has made contact with the proper loss mitigation person, the broker can find out exactly what that lender requires for a short sale application.

Much of the documentation that most lender loss mitigation departments will require is financial information. This may be emotional and embarrassing for the seller, so it is helpful to try to be sympathetic and kind yet firm when explaining the data that they must gather. This generally will include a statement of need or hardship accompanied by supporting documentation; employment verification along with paycheck stubs and W-2s or verification of a lost job; personal financial statements, the last couple of tax returns; cash flow analysis, an appraisal or CMA; and the listing contract, complete with a short sale addendum.

The broker should stand ready to show the lender whether the market is increasing or decreasing, the current inventory of homes on the market, and whether home prices are going up, staying flat or declining. When there is a decline, the lender will probably get even less for the property by waiting for the sheriff's sale instead of agreeing to an immediate short sale. The broker can emphasize the benefits of accepting a known quantity versus taking their chances with an uncertain and arguably risky future market. This same information may also be useful when trying to convince the lender to allow payment of commission.

Dialog with the Lender's Loss Mitigation Department

Once the person in authority has been identified and the seller has the required information compiled, the seller or broker submits the hardship letter and financial information. Most lenders require a preliminary evaluation of the seller's circumstances before an offer will be reviewed for approval.

The seller's situation is one of countless others under consideration at any given time. In essence, the seller is just a number to the lender and any decision, whether preliminary or otherwise, may take several weeks. The broker's role, however, is to follow up and make sure that all needed information was received. Some brokers may try to follow up every day. Others recommend trying to keep conversations with the loss mitigation person as friendly and cordial as possible.

Passing the preliminary review guarantees nothing. The lender can still reject any offer. Once an offer is submitted, the seller and broker must be prepared for the possibility that the offer may be rejected. Most often the offer is countered as the lender begins to inject its particular requirements and conditions into the parties' offer.

Seller's Mortgage Payments

While homeowners are encouraged to not miss any mortgage payments to preserve their ability to structure a work-out arrangement or loan modification with the lender, if all other options have failed and a short sale is the only remaining viable alternative, then it may be necessary for the seller to stop making mortgage payments. Unfortunately, many lenders may not consider a short sale unless the seller is delinquent. Stopping payments will have a negative affect on the homeowner's credit rating, but it may be necessary to preserve the opportunity for a short sale. However, not all lenders may require a payment default and may permit a short sale based upon market conditions combined with other hardship situations. Be sure that this has been discussed with the lender's loss mitigation department. Licensees should encourage sellers to consult with their legal, tax and other advisors before taking this step. In no case should the broker or agent be the one to advise a seller to stop making their mortgage payments because payment defaults are extremely harmful to a seller's credit status – no one should ever voluntarily stop making their mortgage payments unless they and their advisors are positive that this is necessary.

Tax Consequences of a Short Sale

On December 20, 2007, President Bush signed the Mortgage Forgiveness Debt Relief Act of 2007, which will help Americans avoid foreclosure by protecting families from higher taxes when they refinance their home mortgages. The Act amends the Internal Revenue Code to exclude from gross income amounts attributable to a discharge, prior to January 1, 2010, of indebtedness incurred to acquire a principal residence. The Act sets a \$2 million limit on the excludable amount of such indebtedness. In addition, the basis of a principal

residence is reduced by the amount of discharged indebtedness excluded from gross income. The Act disallows an exclusion for a discharge of indebtedness on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the homeowner. Rules will be established for determining the allowable amount of the exclusion for taxpayers with non-qualifying indebtedness and taxpayers who are insolvent.

In the event that the lender does forgive debt, the lender will report this amount on a form 1099. Sellers should forward any 1099s they receive to their tax advisors who can evaluate what needs to be done: the basis of the residence may be reduced by an equal amount if this falls under the Mortgage Forgiveness Debt Relief Act of 2007 or it may have to be reported as taxable income if it does not fall under the Act.

Credit Hit

In a short sale the lender will release the mortgage and allow the homeowner to sell the property, but that is not necessarily the end of it for the seller. On the contrary, most sellers will be required to sign a promissory note for the remaining balance and the lender may pursue collections or legal action if that is not paid in a timely manner. This arrangement may include a lump sum payment or installments.

The credit hit comes from what the lender chooses to report to the credit bureau. It may be reported as a "charge off," a collection or a judgment. These are all seen as very bad situations in the credit bureau industry and may have a crippling effect on the homeowner's credit. It may be worthwhile to suggest to the seller that they sign an apartment lease and get that approved before the short sale closes. The same would

also go for any other credit-based transactions they may contemplate.

Disclosure Obligations

Wis. Admin. Code § RL 24.07(2) requires brokers to promptly disclose material adverse facts in writing to all parties to the transaction, even if the broker's client would direct the broker not to disclose. Failing to disclose these circumstances may lead to broker liability. The fact that a transaction on a property may be a short sale, however, may fall more squarely under § RL 24.07(3), which provides:

DISCLOSURE OF INFORMATION SUGGESTING MATERIAL ADVERSE FACTS. A licensee, when engaging in real estate practice, who becomes aware of information suggesting the possibility of material adverse facts to the transaction, shall be practicing competently if the licensee discloses to the parties the information suggesting the possibility of material adverse facts to the transaction in writing and in a timely fashion, recommends the parties obtain expert assistance to inspect or investigate for possible material adverse facts to the transaction, and, if directed by the parties, drafts appropriate inspection or investigation contingencies. This provision is not limited to the condition of the property, but includes other material adverse facts to the transaction, including but not limited to defects and conditions included within the report form under s. 709.03, Stats. A licensee is not required to retain third party inspectors or investigators to perform investigations of information suggesting the possibility of a material adverse fact to the transaction.

The fact that the transaction is subject to lender approval and will not apparently be able to close without approval of a short sale falls within the category of information that may be stated factually to buyers, coupled with the offer to draft offer language

to address the situation. If the MLS listing notes that it will be a short sale or the transaction will be subject to lender approval, the agent working with the buyer can educate the buyer and include provisions in the buyer's offer to purchase to permit appropriate buyer investigations and protections.

National Association of REALTORS® attorneys say that simply advertising a property that's upside-down isn't inherently misleading, even though it's possible that the seller and the lender won't be able to work things out. Advertising does little more than invite further interest in the property; it shouldn't be deemed misleading if it doesn't expressly disclose the seller's equity status. A short sale should be disclosed before a buyer makes an offer.

Commissions

Dealing with short sale situations is precarious because there are many pitfalls that may result in no closing or a closing that does not include the payment of the real estate commission. If the seller or seller's attorney cannot negotiate reduced payoffs with lien holders, the lenders or parties may ask the real estate brokers to reduce or postpone their commissions in order to reduce the seller's shortage.

REALTORS® cannot allow the fact that their commissions are not being paid in full to stop a transfer or closing. When working with the lender's loss mitigation contact, it is perhaps a good idea to treat this person in a friendly, personable manner as if they were a client, because there is little that can stop a lender from insisting that the brokers get 0 percent commission. Impressing them with a broker's hard work and charm cannot hurt. If the listing broker were to receive 0 percent per the lender's approval of a short sale, MLS policy says the listing broker does not have to pay co-broke if the listing broker cannot obtain the commission through good efforts. This is a tough

result because short sales take a lot of work, marketing and cost that is not intended to be performed for free.

Some MLSs may have policies in place regarding commissions subject to reduction as a result of a court order or lender decision. In the 2008 MLS Handbook from NAR, in Part Two: Policies, G. Commission/Cooperative Compensation Offers, Section 1, it states, **“Multiple listing services, at their discretion, may adopt rules and procedures enabling listing brokers to communicate to potential cooperating brokers that gross commissions established in listing contracts are subject to court approval or to lender approval; and that compensation payable to cooperating brokers may be reduced if the gross commission established in the listing contract is reduced by a court or by a lender. In such instances, the fact that the gross commission is subject to court or to lender approval and either the potential reduction in compensation payable to cooperating brokers or the method by which the potential reduction in compensation will be calculated must be clearly communicated to potential cooperating brokers prior to the time they produce an offer that ultimately results in a successful transaction. (Adopted 11/98)”**

Such a MLS policy may be helpful because it forces disclosure of the fact that the commission is potentially subject to the lender’s approval, but the listing broker has little if any means by which he or she can predict the potential reduction or the method by which the lender reaches its decision.

When REALTORS® Help Buy Short Sales

When brokers assist buyers making an offer to purchase on a short sale property, first and foremost the broker should impress upon the buyer that the timeframes and rhythms nor-

mally experienced during a real estate transaction will be out the window in a short sale. Instead, the buyer should expect a lot of waiting – for weeks and weeks – followed by a hurry and respond before we change our minds, followed again by an extensive waiting period, and so on. The buyer must have enough interest and patience to be willing to wait many weeks and enough flexibility to jump up and close upon minimal notice.

Drafting the Offer to Purchase

The offer can be drafted in the normal fashion, with the following possible exceptions:

Short Sale Statement

Include a statement that the transaction will be a short sale. The price in the offer is not enough to pay off the liens and encumbrances and provide clear title to the buyer. The lender must approve a short sale wherein the lender will release the mortgage lien for an amount less than the balance due from the seller.

The Lender Approval Contingency

The listing broker may have already checked with the lender’s loss mitigation department to see if they have preferred language for the lender approval contingency that will be used in the offer. The broker working with the buyer should ask the listing broker if such a specific provision will be required. If the lender has favored language then the buyer would be foolish to not place that provision in the offer.

Features of a lender approval contingency that should be considered include:

- The offer is contingent upon lender approval of the sale.
- The contingency optimally will specify how and to whom the lender’s approval will be given.
- The seller may promise to promptly submit the accepted offer and any other documentation required by the lender which has not yet been

forwarded for submission. In some cases the financial information will have already been submitted, but in some cases it may not have been done yet.

- The buyer may want to include a deadline for obtaining lender approval. If no approval is received by the deadline, the buyer may wish to reserve the right to unilaterally cancel the transaction and receive his or her earnest money back.
- The lender’s approval of the sale may be conditioned upon the parties’ agreement to modify certain terms and conditions of the offer. That agreement may be embodied in an amendment to the offer. Most of the terms and conditions will affect the seller and few will impact the buyer; broker commissions will likely be reduced.
- The contingency provision should specify when the sale is considered approved by the lender: when the document specifying the lender approval is received by the seller or when the offer has been successfully amended to incorporate the terms required by the lender as a prerequisite or condition of the lender’s approval.

What types of terms and conditions might a lender require in order to approve a short sale?

One lender required that:

1. The seller pay the shortfall deficiency
2. The property be sold “as is”
3. A minimum purchase price and amount to be received by the lender were set
4. The lender was entitled to all proceeds from the transaction except those necessary to pay off senior liens and customary seller’s closing costs
5. A maximum brokers’ total commission amount was set
6. The seller cannot receive any proceeds from the sale

Another lender required that:

1. That the seller receive no proceeds (\$0) from the sale
2. All escrow funds to be a credit on the payoff and no funds may be returned to the seller
3. A certified or signed HUD1 settlement statement
4. All liens must be released or the offer is null and void
5. The property is sold "as is"
6. The total commissions were set at a specific dollar amount
7. The closing costs were set at a specific dollar amount

"As Is"

The transaction will invariably have to be an "as is" transaction as part of the conditions required for lender approval. The buyer may draft the contract "as is" and ensure that the buyer will still have the necessary opportunities to inspect and withdraw from the transaction or make it null and void if the property has serious defects or is not as was represented.

Deadlines Run From Lender Approval, Not Acceptance

The buyer may wish to provide that contract deadlines such as the time-frame for the inspection contingency run from the time the lender approves the sale instead of acceptance of the offer. This may be a sort of catch 22. If the buyer proceeds with inspections and spends time and money only to have the lender fail to approve the sale or approve the sale only upon conditions that are objectionable to one or both of the parties, the buyer will be upset and will blame the agent who drafted the offer.

If the clock for the deadlines does not begin to run until the lender approval has been received, there may be little time to complete the inspections in the long wait, quick closing environment of short sales. The buyer

may not be able to finish all of the inspections that he or she had wanted and be forced to rush to closing. The buyer will blame the agent for creating this frenzied timetable, and, worse still, will certainly blame the broker if property defects pop up later that were missed in the hasty inspections or undiscovered because the inspection or portions thereof were skipped altogether for a lack of time.

There is not a right or wrong answer. It is an issue that should be carefully considered by the buyer and the broker writing the offer.

Verbal Approvals and Multiple Offers

There are certain features in the arbitrary world of short sales and lender approvals that the buyer may not be able to control or influence, yet which may leave the buyer out in the cold after weeks of waiting and doing everything a good buyer should.

Sellers generally are free to accept multiple offers – under the current WB-11 the seller may accept a pool of secondary offers. Each secondary offer may be submitted to the lender so the primary buyer may find him or herself passed over if the lender chooses to approve one of the secondary offers. While the buyer and seller are the parties to the offer, the lender assumes a powerful role in a short sale because the factor determining who successfully purchases the property is which offer is approved by the lender for a short sale. It may seem to buyers like the lender is calling the shots and is really acting as the seller, and those buyers would be substantially correct. The lender does call the shots because no offer will go to closing without lender approval – the seller will be unable to provide clear title without that approval.

Unfortunately, many of the lenders involved in short sales tend to operate in the same manner as relocation companies did in the late 1990s –

they will provide only a verbal or e-mail approval and the seller's hope of receiving a signed written approval is slim. In this world of short sales and loan approvals, these verbal and e-mailed approvals are considered non-binding. This works to the lender's advantage because if a better offer is received in the interim the lender feels free to hop on the better offer, leaving the primary buyer with nothing for all of the her time and effort.

Legal Hotline Short Sale Questions and Answers

Short Sales – Process

An agent has been asked by the personal representative of an estate to sell a property. Any sale will likely have to be a short sale. The property is mortgaged for \$157,000 and is worth \$145,000. One and one-half years' real estate taxes are outstanding. The agent has been in touch with the lender and the lender said the mortgage is more than 136 days delinquent. The property is slated for foreclosure, but the process has not yet started. The lender told the agent to list and sell the property. The estate does not have any money and the agent does not want the estate to have to come up with funds in shortfall.

Should any listing be subject to the lender's approval? Should any offer be subject to lender's approval? It almost appears it is in estate's best interest to walk away from the house and sign it back to the bank. If estate wants the property listed and the lender says to list the property, should the agent get something from the lender stating they will negotiate a short sale if an offer is procured and specifically not obligate the estate for the shortfall? What is the proper way to list and sell this property?

It may be prudent to make any offer received contingent upon the lender's approval of the short sale. Any acceptance should be contingent upon the lender's approval of the short

sale. It would also be tremendously beneficial to obtain the general terms and conditions under which the lender would consider a short sale.

The estate may wish to discuss any potential liability for a deficiency judgment and the potential benefits of a deed in lieu of foreclosure with the lender and with legal counsel.

The cooperating agent wrote an offer on a property subject to approval of the lender for a short sale (the offer has not been accepted yet). A foreclosure action was started and the sellers have filed for bankruptcy. The buyers have conditioned their offer on the sellers removing the above-ground pool. The pool has a lien on it from a credit card company. If the sellers have to wait until spring to remove the pool, would the buyers be liable to the credit card company?

Given all that is going on with respect to the sellers' financial circumstances, it is more important than ever that the buyers have legal representation in not only negotiating this transaction but in making certain that they receive clean and marketable title at the time of closing. At a minimum, the buyers need to determine if the lender will approve the short sale, whether the bankruptcy trustee or court will approve the sale, whether or not the seller can convey legal and marketable title to the property given the various liens that are against them and/or the property – such as the credit card lien on the pool, etc. It would be in the best interests of the buyers to make these determinations as soon as possible.

Short Sales – Offer to Purchase

Re: notice on a short sale contingency. How does a seller meet the contingency for the short sale? The offer was accepted and the sellers are divorcing. After acceptance it was disclosed to the buyer this was a short sale, and the buyer initiated an addendum regarding the short sale. The sell-

ers agreed to the addendum because the sellers needed short sale concessions from the lender. The parties agreed the offer would be contingent on the lender's reduction in the seller's mortgage balance or other debts and the sellers will not be required to obtain funds to close the transaction. The contingency gave the sellers 30 days to waive the contingency in writing. The sellers gave a notice with a copy of the lender's agreement to short sale saying they met the terms of the contingency. The buyer is demanding a "waiver" of the contingency and proof of funds. How to proceed? Also, can a notice be withdrawn?

The WB-11 Residential Offer to Purchase provides at lines 222-224 that once received, a notice cannot be withdrawn by the party delivering the notice without the consent of the other party and a party cannot unilaterally reinstate a contingency after a notice of a contingency waiver has been received by the other party. Whether the sellers' notice was effective to waive the contingency may be determined by legal counsel upon a review of the offer, the addendum, and the offered notice and attached documentation from the lender. Provided there is still time remaining in the contingency, the sellers could arguably issue an additional notice if the attorneys deem the first notice to be incomplete.

Whether there is an affirmative requirement for the sellers to show proof of funds for closing will be determined by the text of the contingency. Depending on the drafting, the sellers may only need to provide the agreement of short sale and not proof of funds. If a buyer wants additional proof of funds, a contingency should be drafted in such a manner that proof of funds are clearly required.

How much time does the buyer have to back out of a short sale? Is it a breach if the buyer has an accepted contract with the seller but not with the bank?

Once there is binding acceptance with the offer to purchase, the buyer may not back out unilaterally. The bank is not a party to the offer. Rather the bank is the party who must approve the short sale transaction in fulfillment of the lender approval contingency. The offer will not be enforceable against the buyer if the lender does not approve a short sale and the contingency thus fails.

The broker is writing an offer on a property. The transaction is going to be a short sale and the listing agent is putting out a document with a list of demands. The cooperating agent cannot call to see how the transaction is going and should not expect an immediate response – it could take six to seven weeks. The agent's concern is that he has a ready and willing buyer – are these restrictions allowed?

The listing agent may be working with an out-of-state lender that requires an offer before negotiating a short sale. Sometimes these lenders are very slow in communicating with the listing agent or seller, so that is most likely why the listing agent is requiring more time. A seller and a buyer can agree to a long period for acceptance, even six or seven weeks. Six to seven weeks seems high, even under those circumstances, but if both sides agree to it, there is nothing wrong with it.

The agent should make sure that the buyer understands the time frame involved. The fact that the listing agent does not want to be contacted seems counter-productive. That policy does not seem to be in the best interest of the seller as it would be difficult for a buyer to wait for the seller's signature if he or she is not kept in the loop regarding progress with the short sale.

Broker has a listing that is going to be a short sale. The seller and broker have chosen to disclose to the buyers that there will be a short sale and that the lender and seller will work out the details to avoid the seller having to

bring money to the closing. The seller accepted an offer with a contingency regarding the short sale. The seller has received another offer. The lender is telling the seller that the seller should accept the second offer that came in. The broker is concerned about the primary buyer: can the seller get out of the deal because of that short sale contingency? Also, can the lender dictate which offer the seller is to accept?

The offer to purchase includes a duty of good faith and due diligence for the parties to meet the terms of the contract. Once the primary offer has been accepted, the seller must proceed per her contractual obligations or risk breach of contract. Therefore, the seller should pursue the negotiation of the short sale per the terms of the offer.

Depending upon how the contingency is drafted, the seller may be able to terminate the primary offer if the short sale cannot be accomplished. Unless there is a CAMR between the seller and the primary buyer, the second offer should only be accepted in secondary position to avoid two primary offers.

Although the lender has the authority to negotiate the short sale with the seller, the lender is not a party to the offer to purchase and cannot terminate the primary offer once accepted. The broker may refer the seller to legal counsel to review the short sale contingency and advise her on her contractual rights.

Short Sales – Commission Issues

An agent showed a condominium unit listed by another agency. The listing agent called a few days later as the cooperating agent was writing the offer and told her that the property is in foreclosure and the bank has to do a short sale. The buyer wrote a full price offer. The seller countered, saying it is contingent on a short sale. The buyer countered back, agreeing that the offer is contingent on bank approval, but also requiring an answer for the

buyer by a certain date. The offer was accepted. Now the listing agent called and said that if the bank is going to agree to do this, the cooperating broker will need to reduce her commission. The cooperating agent feels the listing broker needs to take a cut, not the cooperating broker. Is that correct?

Once an offer to purchase is produced, a listing broker may not unilaterally reduce the cooperative commission offered in the MLS. The REALTOR® Code of Ethics, Standard of Practice 3-2, provides, "REALTORS® shall, with respect to offers of compensation to another REALTOR®, timely communicate any change of compensation for cooperative services to the other REALTOR® prior to the time such REALTOR® produces an offer to purchase/lease the property. (Amended 1/94)".

The listing broker will be obligated to pay the MLS offer of compensation regardless if the listing broker chose to negotiate a reduced commission with the seller. It is the listing broker's prerogative to reduce the listing commission, however the listing broker may not reduce the cooperating broker's commission without the consent of the cooperating broker. Note: a listing broker's obligation to compensate a cooperating broker who was the procuring cause of sale (or lease) may be excused if it is determined through arbitration that, through no fault of the listing broker and in the exercise of good faith and reasonable care, it was impossible or financially unfeasible for the listing broker to collect a commission pursuant to the listing agreement. See Handbook on Multiple Listing Policy 2006 Commission/Cooperative Compensation Offers Section 1 at www.realtor.org/2006mlshandbk.nsf/pages/InformationSpecifyin.

The bank wants the listing broker's commission reduced to 4 percent on a short sale before it will approve the offer. What should the listing broker do?

The listing broker may wish to amend the listing contract to provide that 4 percent will be paid at closing and the remaining 2 percent will be paid after closing. The listing broker may wish to require that the seller provide a promissory note for the 2 percent. This, however, might be a Wis. Admin. Code § RL 24.07(4) side deal that needs to be disclosed to the lender. There is a possible misrepresentation if the seller's agreement to pay the broker later is not disclosed to the lender.

An agent just listed a property that is a short sale. The price is \$309,900. The sellers purchased it a couple of years ago and there is an almost \$300,000 first mortgage and a second mortgage of over \$50,000. The sellers said they are negotiating with the banks and they said it would be no problem for the listing agent to be paid. How does the listing agent assure he will get paid?

The terms and conditions of the listing contract determine the contractual agreement for the seller to pay the broker's commission. The broker's expectation is based on the terms of the listing, a contract between the seller and the broker, not the broker and the lenders.

The broker may structure the listing contract in a short sale situation to include an advance fee, a flat fee, a promissory note or other security to guarantee payment of commission. The broker must also keep in mind the amount of cooperative commission that the broker may be obligated to pay. If there are not enough funds to close the transaction and pay the commission, the broker may need to make arrangements for payment after closing or sue the seller for commission. The broker may also refuse to enter into the listing if commission cannot be assured.

Short Sales – Disclosure Issues

The listed property is set to soon close. The listing broker had the title company do a search and hold and discovered

three mortgages. Two or three additional judgments have also been found, so the sale will require an additional \$8,000 to clear title. The listing broker has prepared an amendment to increase the sales price.

The listing broker will need to disclose to the buyers that the sellers may not be able to give clear title.

This is a material adverse fact that must be promptly disclosed in writing. The buyers can then decide whether they want to sign or not sign the amendment.

After taking a listing, the broker finds out that the seller is in foreclosure. Can the broker walk away from the transaction? What can be done if the closing is set and there are not enough funds to close the deal and pay commission?

Once the listing is entered into, the broker has a contractual and a fiduciary duty to the seller to provide brokerage services for the duration of the transaction. The listing broker should do whatever he or she can to help the seller meet the terms and conditions of the offer. If the seller has enough funds to meet the contract obligations and provide a clear title, the closing should proceed. If the funds fall short, the seller may work with legal counsel and try to borrow needed funds, convince lien holders to accept less than the full amount due and find other ways to meet the seller's closing obligations.

A broker cannot put his or her interest in commission ahead of the broker's duty to help the parties complete the transaction. Although the listing contract provides that the broker's commission is due at closing, the broker cannot stop the closing just because there is not enough money to pay the full commission at that time. The listing broker may consider renegotiating the commission, creating a payment plan for the seller, having the seller give a promissory note, taking a lien on other property owned by the seller or going to court to obtain a judgment for the commission.

Resources

NAR Field Guide to Short Sales: www.realtor.org/libweb.nsf/pages/fg335.

Seminar materials from "Short Sales and Other High-Risk Transactions in Today's Environment," prepared by Robert C. Kutschbach of Hondros College and Carleton Realty for the November 2007 REALTOR® Conference and Expo (these materials are outstanding!): [www.realtor.org/letterlw.nsf/23e5e39594c064ee852564ae004fa010/0d1ae74ab8ffdee28625736f0066cea2/\\$FILE/Scan001.pdf](http://www.realtor.org/letterlw.nsf/23e5e39594c064ee852564ae004fa010/0d1ae74ab8ffdee28625736f0066cea2/$FILE/Scan001.pdf)

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