

UNDERSTANDING SHORT SALES

What is a Short Sale

Assume a property has declined in value. The owner's equity is eliminated because the current fair market value is now less than the outstanding debt. Due to an unanticipated economic hardship, the owner is no longer able to pay the monthly carrying costs. The primary options for such an owner are:

1. Discontinue paying the mortgage and ultimately lose the home through a foreclosure proceeding;
2. Seek relief from the debt by negotiating a short sale.

Short sales (a/k/a discounted payoffs) occur when (i) the sales proceeds of the sale of the property are insufficient to pay off the mortgage **and** (ii) the lender consents to accept less than the outstanding mortgage balance, including penalties and interest, to release the lien. The benefit to both the lender and owner is the avoidance of foreclosure or bankruptcy.

Why Lenders Consent

Lenders are generally willing to consider short sales if the offer is at varying percentages below current fair market value. A lender's motivation is to avoid foreclosure because foreclosure is an expensive and time consuming process. The foreclosure process of retaking the property, finding a buyer and selling the property will likely exceed a year and can be considerably longer if the owner vigorously defends themselves in court.

Reason # 1 The bank suffers the risk of the price falling during the foreclosure process.

Reason # 2 Lenders set aside loss reserves, from the date the loan becomes non-performing through the date of resale. The loss reserve is considerably more than the current debt outstanding, which consists of:

- outstanding principle and interest
- accruing interest
- attorney fees (for foreclosure and resale)
- real estate taxes
- property insurance
- maintenance fees or common charges
- closing costs upon sale (broker commission, transfer taxes and building fees)

The funding of a bank's loss reserve during the foreclosure process prevents those funds from otherwise being loaned. The aggregate consequence of millions of foreclosures limits the banks ability to lend.

Reason # 3 Different state laws govern the recourse a lender has to pursue the owner for any shortfall which occurs if the foreclosure proceeds fail to equal the outstanding indebtedness. The lender's motivation to consent to a short sale is influenced by its ability to pursue the owner after a foreclosure for remaining indebtedness.

- Non-Recourse Loan: Lender is limited to the amount realized from the foreclosure and is not able to pursue buyer for any shortfall.
- Recourse Loan: Lender pursues owner for the shortfall after the foreclosure. The lender will likely demand that the former owner to make payments over time.
- **ONE ACT RULE - ELECTION OF REMEDIES UNDER NYS LAW RENDERS DEFICIENCY JUDGMENTS DIFFICULT TO OBTAIN ON FIRST MORTGAGE LOANS SECURED BY A PRIMARY RESIDENCE.**
- Second loans or home equity lines of credit are recourse loans.

Reason # 4 Lender avoids potential of owner filing bankruptcy and seeking principle reduction or "cram down" by a bankruptcy court judge.

Lender Acceptance and Terms

A lender's consent to a short sale has nothing to do with the amount of the outstanding indebtedness. Instead, the bank compares the offer being made by a buyer for the property to the amount that is likely to be realized from a foreclosure. A lender consenting to a short sale is making a business decision to mitigate its loss on a non-performing loan.

When lenders consent to short sale terms, they will demand control of the transaction. Lender control requires approval of all transaction fees paid from sale proceeds and approval of the HUD statement in advance of closing. If the bank refuses the short sale offer, the lien will not be released by the lender and a foreclosure proceeding will likely occur. Lenders are not required to release a lien and provide clear title when the mortgage is not paid in full.

Lender's acceptance of short sale terms relies upon:

- (i) owner realizing **zero proceeds** from sale, **there are no exceptions**;
- (ii) an offer price bearing some relationship to current fair market value, although that relationship will vary from bank to bank;
- (iii) persistent, often frustrating, discussions with the lender's loss mitigation / work out group to negotiate debt forgiveness and short sale terms.

Owner Concerns

Owners that cannot afford to repay their loan will ultimately end up in foreclosure. A short sale transaction is the lesser of two evils. Whatever circumstances brought the owners to the situation they are in, it is important to understand that foreclosure should be avoided. Short sales offer the following advantages to foreclosures:

Credit Implications

The FICO scoring model counts foreclosure as a long-standing and severe event, nearly comparable with bankruptcy, which remains on a credit report for seven years. How a short sale settlement is reported to credit agencies is part of the negotiation. As lenders control what is reported to credit bureaus, the skill of the negotiator dictates if the short sale settlement will be reported as either:

- “paid-unrated” - no negative effect on credit score;
- “paid - settled for less than outstanding” - considerably less negative effect than a foreclosure.

The owner should retain counsel and begin negotiations once they anticipate they will not be able to continue monthly payments. There is no need to be delinquent to begin the process. Missed or late payments are negatively reflected on credit reports. The best way to preserve credit is to negotiate a short sale while having never missed a monthly payment. Nonetheless, there is still time to negotiate a short sale until a foreclosure auction date is scheduled.

Peace of Mind

A short sale is a private proceeding. Foreclosure is a matter of public record. A foreclosure is a very stressful and aggravating experience. A short sale negotiation introduces a buffer, the attorney, between the owner and the continuous series of unpleasant phone calls and mailings.

Documentation Required

- A **hardship** letter describing the circumstances which now prevent the borrower from making continued payment is required. The hardship letter should be accompanied with supporting documentation, such as a termination letter, disability letter, medical bills, etc.;
- Proof of owner assets, debts & income;
- Statement that owner has insufficient assets beyond the property to pay the shortfall. This applies to recourse loans;
- Latest loan statements for all loans on the property;
- Most recent pay stubs, if applicable;

- All owner's bank and brokerage statements for last two months;
- Last two years of tax returns and W-2 Form;
- Copy of broker exclusive listing agreement.

Tax Consequences

Ordinarily, there is a tax liability on a forgiven debt, which is reported under Form 1099-C ("Cancellation of Debt Form"). The Mortgage Forgiveness Debt Relief Act of 2007 eliminates the owner/seller from having to pay tax on the forgiven debt if:

- 1) The property served as a qualified personal residence (not a vacation home) of the owner/seller for two of the last five years.
- 2) The debt forgiveness is less than \$2,000,000.
- 3) Loan related to acquisition, construction or improvement of primary residence.

Overview of Process

When to Begin

Delinquency is not a prerequisite to begin the process of negotiating a short sale. Ideally the owner should retain counsel as soon as they anticipate an inability to make payments. Most owners begin a short sale negotiation after some payments have been missed or foreclosure proceedings have begun.

Unfortunately, a foreclosure proceeding will not be halted until after a short sale has been successfully negotiated and closed. Lenders will continue to seek repossession of the property while the owner is seeking a short sale.

Time Frame for Approval

A short sale is a longer process than a typical real estate transaction. Loss mitigation / workout groups are currently overwhelmed. Not surprisingly, it takes considerable time for a lender to agree to settle for less than the amount owed. The time frame for a lender to approve a deal can take, on average, five to six months.

Additional time is added as lenders will not begin negotiations until a signed contract exists. Waiting until after a contract is signed to begin a five or six month process is disastrous to an owner that cannot afford to make payments. The additional time frame also antagonizes purchasers seeking to obtain rate locks.

Contingencies

The contract will be made subject to the lender's approval to the short sale. In the event the lender does not approve the transaction, the transaction is rescinded and the down payment is returned to the purchaser.

The outcome of a short sale negotiation is not known when a contract is signed. The contract of sale will include a contingency protecting the owner. The owner will have an absolute right to cancel the contract on at any time. If the lender pursues the deficiency or short fall on a recourse loan, the owner can cancel or negotiate. The owner's leverage to negotiate for forgiveness or reduction of the deficiency relating to recourse loans does not exist with a foreclosure.

Purchaser's counsel will most likely require an additional contingency allowing for the purchaser to back out of the contract with their entire deposit if lender does not provide consent by a specific date. Such date, if financing, should be coordinated around the rate lock expiration.

Agent Commission

A lender consenting to a short sale is accepting substantially less than what is due. Such lenders will seek to reduce attorney fees and brokerage commissions. Reduction does not mean elimination. Most often commissions are reduced from 6.0% to either 4.5 to 5.0%. **It is critical for agents/brokers to structure commission agreements with the anticipation of lenders demanding a haircut.**

Buyer Benefits & Contract Considerations

The benefits for short sale buyers are considerable. Anyone can purchase a property at fair market value without the additional burdens endured in short sales. Consequently, short sales often get approved at some percentage of appraised value.

Education of prospective buyers at the beginning of the transaction is critical to managing expectations. How the inherent risk associated with short sales, lender approval, impacts the transaction is critical for the buyer to understand along with the additional contingencies, approvals and time frames.

Lender approval of a short sale is absolute. The lender will require HUD form approval, which lists all payments provided at closing. Lender will seek to diminish most expenses paid from the sale proceeds. Real estate agents should structure transactions so that traditional seller expenses (flip taxes, transfer taxes and managing agent fees) are paid by the purchaser. Purchaser would adjust their offer price accordingly.

Contracts should be negotiated to incorporate the following terms:

- As-is contract;
- No contingencies for inspection;
- No seller concessions;
- No working order representations;
- No closing credits granted for repairs.

Investment Property

Short sales are not limited to principal residences. Short sales can be negotiated for investment property. Lenders are typically more aggressive in pursuing deficiency judgment on investment property.

Attorney Consideration

This office provides free one-hour consultations on a case by case basis to best advise clients. All negotiations are handled by myself or my colleagues, Howard Balsam, Esq. and Andrew M. Jacobs, Esq. We are a team of attorneys with the professional experience gathered from dozens of successful short sale negotiations with multiple lenders.

There are currently 8.5 million homes in the United States with mortgages in excess of the current fair market value. As property values decline, short sales will become increasingly frequent. Please instruct your clients needing to get out from their mortgages to call my office for a free consultation.