SPECIAL FEATURE

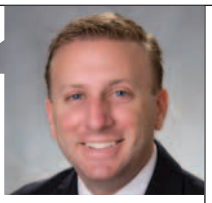
Living on the Edge

Short sales are financially tempting, but legally precarious.

Short sales still play a dominant role in today's real estate market (ORRA stats show they have accounted for one-third of all Orlando sales this year), and there are many legal considerations that a real estate licensee must be aware of when handling such a transaction. To name just a couple, licensees must be cautious not to advise homeowners in a manner that creates liability for the unlicensed practice of law, and there's always the potential for a short-sale lender to file a lawsuit to pursue a deficiency decree.

Let's hit the basics and discuss some of the legal implications that are important to real estate licensees and to the troubled homeowners they serve. >>

by ANDREW M. FISHER, ESQ.



Section 501.1377(1), Florida Statutes

When homeowners are in default on their mortgages, in foreclosure, or at risk of losing their homes, there needs to be protection from fraud, deception, and unfair dealings with foreclosure-rescue consultants or equity purchasers. Section 501.1377(1) of the Florida Statutes provides for guidelines, procedures, and requirements regarding who may negotiate with a lender on behalf of the homeowner for a fee.

Florida Statutes does not provide a specific exemption for a real estate licensee. However, an opinion from the Office of Financial Regulation provides that a real estate licensee may negotiate a short sale with a lender (i.e. enter into dialogue with the lender to see if the short sale would be acceptable, thereby avoiding a possible foreclosure situation), provided the real estate licensee only receives remuneration in the form of the commission on the sale. In a practical application, if a real estate licensee enters into dialogue with the lender on behalf of the homeowner as part of their permitted Chapter 475 duties, such real estate licensee cannot charge an upfront or any other fee for the negotiating service (other than the standard real estate commission on the sale).

Deficiency decree

In most suits for the foreclosure of mortgages, the mortgagee may sue for a deficiency decree. This amount is generally the amount owed by the seller minus the amount received at the foreclosure sale, plus interest and certain fees and costs related to the foreclosure (Section 702.06, Florida Statutes).

The deficiency decree is an important aspect of the short-sale negotiation process, and a critical aspect for the seller. A seller's negotiator should attempt to convince the lender to accept the short sale in lieu of foreclosure or stopping the foreclosure process; to have the lender receive a portion of the indebtedness now; and to release the right to sue for any deficiency. If the lender provides the release, the seller knows that once the short sale is closed, the seller is completely done with all financial liability to the lender.

Lenders today, more than ever, are willing to provide a waiver of pursuing the deficiency in order to make the sale happen and to recoup some of its loss immediately with a short sale. Lenders have come to recognize that they (usually) realize significantly less proceeds if they try to sue a seller for the deficiency after a drawn-out foreclosure process. Even if the lender will not specifically waive the right to pursue a deficiency, there are other negotiation tactics that an experienced short-sale negotiator can use to get this important language included in the short-sale approval letter.

Arm's length transaction

The short sale must be an arm's length transaction. In an arm's length transaction, the seller is not selling to an investor, relative, friend, etc., under the guise that the seller will somehow regain ownership of the property at a price less than owed.

Most lenders require the seller, buyer, seller's real estate licensee, buyer's real estate licensee, and sometimes even the settlement agent to sign an affidavit of arm's length transaction. The affidavit typically includes (but is not limited to) language specifying that:

- The sale was negotiated by unrelated parties, each of whom is acting in his or her own self interest and that the sale is based on the fair market value of the property;
- There are no agreements between the parties that the seller will remain in the property as a tenant or later obtain ownership of the property;
- No parties will receive any funds or commissions, except as allowed by the short-sale approval letter and disclosed on the HUD;
- There are no agreements relating to the current sale or subsequent sale of the property that have not been disclosed to the short-sale lender; and
- None of the parties have knowledge of any offer to purchase the property for a higher purchase price.

Note that a real estate licensee will be opening themselves up to serious consequences if they knowingly sign an affidavit of arm's length transaction, when in fact they know that is not the case.

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Tax Implications of a Short Sale

There are many tax implications associated with a short sale. Two key implications deal with federal tax income on the debt cancellation afforded by the lender and the amount of documentary stamp taxes required by Florida law to be paid on the recordation of the deed.

Until the end of 2012 (as of the writing of this article), for federal tax purposes, The Mortgage Forgiveness Debt Relief Act of 2007 generally allows taxpayers (depending on the time of purchase or refinance) to exclude income (up to specific dollar amounts) from the discharge of debt on their principal residence. For debt cancellation on houses not considered the primary residence, the amount of the debt cancellation is taxable as income based on the tax bracket of the seller.

Generally, documentary stamp taxes are levied on all recordable instruments, including deeds, prior to recordation (Section 201.01, Florida Statutes). Regarding the sale of real property, the deed is taxed (payable by either the buyer or seller pursuant to the contract) on the consideration paid for the house, which includes, but is not limited to:

- The money paid or agreed to be paid;
- The discharge of an obligation; and
- The amount of any mortgage, purchase money mortgage lien, or other encumbrance, whether or not the underlying indebtedness is assumed.

However, the taxable consideration for a short sale transfer does not include unpaid indebtedness that is forgiven by the lender.

The moral of the story is that unless you are a tax attorney, CPA, or accountant, you should advise sellers who are contemplating a short sale that they consult with the proper professional(s).

Rider G.

The Comprehensive Riders to the Residential Contract for Sale and Purchase, approved in 2010 by Florida REALTORS® and the Florida Bar, contain Rider G. Short Sale Approval Contingency. I recommend that all real estate licensees review Rider G. and consider attaching it to all short-sale contracts. Rider G. is fair and protective of both the seller and buyer.

One of the key components of Rider G. is the specific definition of "short-sale approval" occurring when the short sale lender(s):

- Approves the purchase price, terms of the sale and purchase contract, and the HUD;
- Agrees to accept a payoff that is less than the balance due on the loan or other indebtedness; and
- Agrees to release and provide a satisfaction of the mortgage(s) and/or other lien(s) encumbering the property upon receipt of reduced payoff amount(s).

However, under Rider G., an approval from a short-sale lender that does not provide a waiver and complete release of any claim(s) for a deficiency against the seller, or that requires additional terms or obligations affecting either party, shall not be deemed "short-sale approval" unless the party affected accepts those additional terms or obligations in writing.

This definition is important, because without it the parties may be legally bound to follow through with the sale and purchase, even if the short-sale lender includes additional terms (i.e. terms that were not included or contemplated in the contract), even if such terms would be detrimental to one of the parties. For example without this definition of "short-sale approval," if the lender's approval letter requires the seller to bring money to closing and does not permit the buyer to sell (or flip) the property for a certain amount of time, these terms may lead to dire consequences if the seller does not have the money or if the buyer intends to resell the property, both of which were not contemplated when the contract was executed.

Carefully review Rider G. regarding how deadlines are computed in the contract (i.e. contract termination, making deposits, inspection periods, financing time periods,

closing date, etc.) and how back-up offers are accepted.

"AS IS" Contract

Most, if not all, short-sale lenders require the sale and purchase of the property to be "as is." Therefore, I recommend you consider using the "AS IS" Residential Contract For Sale and Purchase approved by the Florida REALTORS® and the Florida Bar in 2010. This contract specifies that during the inspection period, the buyer, in buyer's sole discretion, may terminate the contract if the property is not acceptable to the buyer.

Essentially, the use of this contract amounts to a free look period for the buyer. It is something to consider when a buyer, for whatever reason, desires to cancel the contract during the short-sale lender review time period. Generally, this means that the buyer is contractually obligated to perform under a properly written and executed "AS IS" contract. Therefore, even if the buyer wants out of the deal, the buyer may not terminate the contract unless short-sale approval is not provided, or the time periods under Rider G. expire. However, if the buyer wants out, they will be able to use the free look time frame in the inspection period to terminate the contract. Therefore, it may be in the seller's best interest to release the buyer from the contract when asked and to find another buyer as quickly as possible.

REALTOR® Code of Ethics

I definitely do not advocate buyers entering into several contracts dealing with short-sale scenarios, and then closing on the one that receives short-sale approval first. A REALTOR® who aids their buyer with the practice of executing multiple short-sale contracts will likely be found to be in breach of several articles of the REALTOR® Code of Ethics.

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