



Legal Lines

FORECLOSURE & SHORT SALES, PART II

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This article is a continuation of last month's article on foreclosure and short sales. If you have not read the prior article, please read it before going further. Otherwise, some portions of this article may make no sense or, worse yet, lead you to an incorrect understanding of the process.

In this article we are picking up with that part of the foreclosure process where a REALTOR® has met with the seller whose property is in the foreclosure process; has gathered the information necessary to make an informed decision with respect to listing the seller's property; and has decided to proceed forward with the listing.

The REALTOR® has determined that in addition to the \$150,000 owed to Acme Bank, which is in the foreclosure process, Ace Bank holds a second mortgage securing debt of \$30,000 and Home Equity, Inc. holds a third mortgage securing debt of \$20,000. The REALTOR® has determined that during the five months remaining in the redemption period it is possible that the property could fetch a price of up to \$230,000, but it is more likely that it will be sold at a price closer to \$200,000. When deciding to proceed forward with a listing that could very well result in a short sale (*i.e.*, insufficient funds at closing to pay off all lenders, a cooperating REALTOR® and other closing costs), the REALTOR® has to determine how he is going to handle issues arising from three very important groups of people.

First, the REALTOR® needs to make certain that the seller understands that the marketing and sale of his

property could become a very nerve-racking process. Assuming that the sale will result in a short sale, a seller must understand that an offer must not only be approved by him, as seller, but also by at least one, if not three, lenders. In addition, it must be emphasized with the seller that completing a sale prior to the end of the redemption period is an all or nothing proposition. In other words, if an acceptable offer is obtained, but for whatever reason the sale is not closed prior to the expiration of the redemption period, the seller will have no further rights to sell the property or complete the deal with the buyer.

The REALTOR® should also consider advising the seller that he should discuss the tax consequences of a potential short sale with a qualified tax advisor. Generally, if a short sale results in a forgiveness of debt by a lender (*e.g.*, if Acme Bank agrees to accept \$130,000 and forgives the \$20,000 remaining principal balance on the loan), the lender may generate an IRS Form 1099, indicating income to the seller in the amount of the forgiveness. Trying to explain to sellers who are losing their home in the foreclosure process that they could generate taxable income by walking away from the closing table with nothing is an extremely difficult proposition. Again, REALTORS® should not attempt to take on this job but instead should direct the seller to a qualified tax advisor.

Second, the REALTOR® must determine how he is going to deal with participants in the MLS. Assume that the REALTOR® is

going to list this property for \$230,000. He intends to offer cooperation and compensation to participants in the MLS in the amount of 3 percent of the purchase price. If, as is very possible, the property sells for \$200,000, then it is quite likely that there will not be adequate proceeds at closing to pay the full 3-percent cooperating commission. The legal question often posed over the MAR Legal Hotline in this situation is easy to answer. Does the listing REALTOR® have a legal obligation to pay the cooperating REALTOR® 3 percent of the purchase price when there are not sufficient proceeds available at closing to pay that commission? In almost all instances, the answer to this question will be "Yes." The offer of compensation made through the MLS is not made contingent upon net proceeds being available at closing. Further, there is no mechanism available in the MLS to make such offers contingent upon their being sufficient net proceeds at closing.

Our recommendation to a REALTOR® in this situation is to advise other participants in the MLS as soon as possible regarding the potential for a short sale. At a minimum, this would include a statement in the remarks section of the listing, advising MLS participants of the possibility of a short sale. (We would recommend that the REALTOR® get the seller's consent to include such a statement.) Further, when the listing REALTOR® becomes aware of the fact that there *will* be a short sale based upon an accepted offer, he should advise the cooperating REALTOR® of this situation as soon as possible. This

provides the cooperating REALTOR® with an opportunity to assist in trying to maximize the closing proceeds available for payment of commissions. An announcement by the listing REALTOR® the night before or at closing that there are insufficient proceeds to pay the cooperating broker the full commission is a surefire trigger for conflict.

Third, although in this hypothetical there were five months remaining in the redemption period, the REALTOR® must immediately begin dealing with the lenders to establish a basis for negotiating a forgiveness of debt by the lenders (*i.e.*, accepting less than is owed under their mortgages).

The first step in this process is simply identifying the lender and finding someone to talk to in the lender's organization. As many REALTORS® who are involved in this process can attest, this sometimes can be a very difficult process.

The next step is to determine if a specific lender will even entertain the notion of some forgiveness of debt in order to receive payment for a portion of their mortgage. If, in this instance, Acme Bank indicates that because its loan is insured, it will not forgive any debt, and the REALTOR® should advise the seller accordingly and determine the advisability of proceeding forward with the marketing of the property.

The third step is for the REALTOR® to determine what documentation the lenders will require in order to consider accepting less than the amount owed them. Typically, this documentation includes a *pro forma* or hypothetical closing statement that sets forth the amount the REALTOR® expects to obtain for the property, the amount of indebtedness on the property, and the anticipated commissions and other closing costs such as state and county transfer taxes. Further, the lender will typically require a personal financial statement from the sellers indicating that they truly have no funds to contribute toward closing and an explanation of how they got in this situation (*e.g.*, one spouse lost her job and the other spouse is suffering major medical problems). Finally, the REALTOR® may wish to submit to the lender the broker's price opinion or similar analysis which sets forth the basis for the anticipated purchase price of the property. Experience dictates that this analysis not be overly optimistic (*i.e.*, create an unrealistic expectation with a lender).

In establishing the relationship with the lenders in anticipation of a short sale, many REALTORS® are frustrated by the fact that these lenders will not agree in advance to a price that will be acceptable. In other words, in our hypothetical, the REALTOR® would be seeking to obtain Acme Bank's pre-approval of an offer of \$200,000. Generally, lenders will not provide pre-approval of any price. In the past, REALTORS® have called the MAR Legal Hotline demanding to know the law that

“... a REALTOR® should provide the seller with his best prediction as to whether the property will sell during the redemption period and at a price that would be equal to or better than the offer by the lender. The REALTOR® should make certain that the seller understands that he is making no promises that the home will sell during this period.”

requires the lenders to pre-approve a purchase price. There is no such law. Presumably, the lenders will not pre-approve a purchase price in order to cause the REALTOR® to obtain the very highest price possible under market conditions.

Assume that during the third month of the redemption period the REALTOR® receives an offer for the property in the amount of \$205,000. This offer is acceptable to the seller but must be approved by the lenders. The REALTOR® immediately provides the offer to Acme Bank, Ace Bank and Home Equity,

Inc. The closing is achievable if Acme Bank will accept \$140,000, Ace Bank will accept \$15,000, and Home Equity, Inc. will accept \$5,000. Ace Bank and Home Equity, Inc. quickly provide their approval of the offer, as they will at least be getting something to be paid against their loans. However, the REALTOR® simply cannot get a response from Acme Bank with respect to the offer. As the weeks go on, the buyer becomes antsy and is starting to talk about looking at other properties. The REALTOR® calls the MAR Legal Hotline and demands to know the law that requires the lender, Acme Bank, to respond to the offer. Again, the answer is that there is no such law. There is nothing that requires Acme Bank to accept less than the full amount owed to it by the seller.

Finally, assume that all three lenders have signed off on the offer and the REALTOR® is proceeding to closing. Closing is scheduled for Wednesday, and the redemption period expires on Thursday. As is often the case, a problem arises on the prior Monday that will prevent the closing from occurring until the following Monday, four days after the expiration of the redemption period. The REALTOR® calls Acme Bank to ask for a four-day extension of the redemption period and fully expects to get the extension. Obviously, if the extension is not granted, Acme Bank will lose the benefits of this sale and will end up with a vacant, foreclosed property on its hands for resale at presumably a much lower price. Generally, extensions of the redemption period are not granted by lenders. The REALTOR® calls the MAR Legal Hotline asking about the law that requires the lender to extend the redemption period. There is no such law. Upon expiration of the redemption period, the seller loses the right to sell his property; the buyer loses the right to purchase the property; and the REALTOR® has no right to be paid for the Herculean efforts he has undertaken over the past five months to make this deal happen.

DEFICIENCIES & CASH FOR KEYS

Many sellers exhibit great stress based on a concern that their property will not sell, there will be a foreclosure sale, and one or more lenders will be suing them for any deficiency in the sale. In our hypothetical, deficiency would occur if Acme Bank bid \$130,000 at the foreclosure sale, leaving a

shortfall of \$20,000. Simply put, this normally does not happen. If Acme Bank bids at the foreclosure sale, it will bid its debt (i.e., \$150,000). Upon its bid of \$150,000, the owner/borrower has no further financial obligations to Acme Bank. Further, there are no adverse income tax consequences to the seller, as there has been no forgiveness of debt by Acme Bank. (Ace Bank and Home Equity, Inc., whose mortgages have been cut off by Acme Bank's foreclosure of its mortgage, can attempt to recover the balance owed on their loans from the seller.)

Many lenders desire to have the sellers' leave their property long before the end of the six-month redemption period. The lenders attempt to achieve this result by offering cash in return for a deed in lieu of foreclosure and the keys to the sellers' property. If sellers receive such a proposition from a lender during the foreclosure process, the sellers will, in most instances, turn to their REALTOR® for advice as to whether to

accept the proposition. In that situation, a REALTOR® should provide the seller with his best prediction as to whether the property will sell during the redemption period and at a price that would be equal to or better than the offer by the lender. The REALTOR® should make certain that the seller understands that he is making no promises that the home will sell during this period. In considering this option, the seller should remember that he may remain in the property during the redemption period without payment of any kind to any lender.

REPRESENTING LENDERS IN FORECLOSED PROPERTIES

REALTORS® representing lenders who are foreclosing properties should keep one rule in mind. Lenders that are foreclosing property in Michigan generally have no right to possession or control of the property until the expiration of the redemption period. When asked by a lender to secure a foreclosed

property and prepare it for market, a REALTOR® must obtain some evidence from the lender or its foreclosing attorneys that the redemption period has expired. This documentation could include a copy of the notice of foreclosure or the sheriff's deed, both of which indicate the expiration date of the redemption period. If a REALTOR® secures a property prior to the end of the redemption period, he can subject himself to claims by the seller that the actions by the REALTOR® were unlawful.

There are many other questions with regard to foreclosures and short sales that simply cannot be answered within the confines of a two-part article. However, there is one conclusion that becomes clearer each day: If REALTORS® are going to deal with foreclosed properties, they need to be very well acquainted with the legal as well as the practical issues involved in selling or buying foreclosed properties. 🏠

