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With distressed sales comprising a big chunk of the inventory, knowing the legal issues that go along with short sales and REOs is crucial. Meanwhile, fair housing, settlement service, and other laws never recede in importance. Staying on top in sales means staying on top of changing laws and rules.



Illustration by Steve Maggrave © 2009

Short Sales: 7 Legal Pitfalls

In many areas, short sales are the biggest game in town. But you don't want to jump into this niche willy-nilly. In addition to educating yourself on the ins and outs of these complex deals, you also need a good picture of the legal risks that exist for you.

Misrepresenting tax consequences.

Although it's true that the federal government passed a law in 2007 directing the IRS not to count mortgage debt forgiven by a lender as income, the provision is limited. It applies only to purchase money; it doesn't apply to debt on a cash-out refinancing, and it doesn't apply to second homes. There's also a dollar limitation, albeit a generous one (\$1 million for married couples filing separately, twice that for joint filers). "A lot of associates are telling people there are no tax consequences," says Lance Churchill, a short sales specialist and trainer who operates in Boise, Idaho, and San Diego. "But it's a limited law and you just need to be accurate about it."

Misrepresenting how secondary debt is treated.

Practitioners might mistakenly tell sellers that all the house debt is forgiven once the primary lender approves a short sale. But that might not be the case, Churchill says. Holders of second deeds of trust don't typically forgive the debt. More commonly, they accept a partial payment, like \$2,000; and rather than write off the balance, they sell the balance to a collection agency for another few thousand dollars. In many

states, these second loans are recourse, so sellers can be caught by surprise when the collection agency contacts them a year later seeking payment of the debt.

Acting on inappropriate lender requests for seller contributions.

It's not uncommon for lenders to go after money that the sellers have in the bank or in a retirement account before they approve a short sale request. They'll sometimes seek to put the onus on the real estate practitioner to get sellers to sign over a note for the amount they have in the bank as a condition of sale. But in states where mortgage debt is nonrecourse, lenders have no right to the money, and associates that suggest otherwise to the sellers might be later sued for negligence.

Breaching fiduciary duty.

Investors are increasingly executing what's known as a "double close and flip," a type of short-sale transaction that can leave practitioners exposed to irate sellers who say they got a raw deal. Here's what typically happens: Investors insist on handling short-sale negotiations with the lender, freeing up their real estate practitioner to concentrate on finding a buyer. During

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the negotiations, the investors—often without the practitioner's knowledge—talk the sellers into turning over the deed. Once the practitioner finds a buyer, the investors do a double closing, buying it themselves at a deep discount and then flipping it to the buyer at the listed price, making money on the spread. "The seller might feel he got less than he would have had the associate done his job and not handed over negotiations to the investor," says Churchill.

Providing poor oversight of a loss mitigation company.

Companies that specialize in managing short sales promise to focus on the complicated details of the short sale, freeing up practitioners' time to find buyers. But if you take a hands-off approach, you can be charged with negligence if a deal falls apart. "A lot of these companies are fly-by-night or have one person who's overworked," Churchill says. "Practitioners are coming back a month later to find no one's even opened the file."

Lacking the required license to undertake loss mitigation.

It often makes sense for practitioners to take a two-pronged approach with clients facing a difficult time paying their mortgage—first trying to help them accomplish a loan modification (for a fee), and then finding a buyer if a modification doesn't work. But watch out. Depending on your state, you could need a specific license, sometimes called a credit repair license, to earn a fee for helping owners modify mortgage terms. Without having the right credentials, taking a fee for loan modification assistance could be a criminal offense.

Facilitating transactions not listed on the HUD-1 form.

It's not uncommon for investors to offer incentives to sellers to move a deal forward, but lenders typically frown upon sellers who walk away with money when they're supposedly taking a loss. Investors sometimes work around this limitation by offering to buy something from the sellers at an attractive price, such as a couch for \$5,000. Associates who communicate these offers to sellers can get tied into charges of lender fraud because the deals may be deceptive.

6 Ways to Avoid Illegal Steering

When buyers ask you to recommend neighborhoods, be careful how you respond. It's possible to inadvertently violate the Fair Housing Act by steering a customer to or from certain areas. Here's how to help clients find their dream community without crossing the line.

ASK ABOUT HOBBIES.

This will often elicit information that helps you determine properties in neighborhoods that fit their lifestyle without your having to get into questions of religion, ethnicity, or other sensitive matters. Swimmers might want to be near a park with a pool, while biking enthusiasts might prefer proximity to a nature preserve.

OFFER SCHOOL DISTRICT RESOURCES.

When buyers ask questions about schools, point them to the school district's Web site and encourage them to schedule a visit to the schools. You can help them locate the district boundaries to ensure they'll be purchasing within the school district they choose. But don't say anything yourself about the quality of the schools.

DIRECT THEM TO THE POLICE. If buyers want to get a picture of the area's crime rate, direct them to the police department or other sources of information. Don't disclose crime statistics or say a neighborhood is a safe place to live even if you believe it to be true.

MAKE A LIST OF SPIRITUAL PLACES.

Develop a list of all houses of worship in the neighborhoods you serve and provide that as a resource to buyers.

GET TO KNOW THE CENSUS BUREAU.

If buyers want to know the demographics of the area, refer them to the "fact finder" section of the U.S. Census Bureau's Web site (www.factfinder.census.gov), where they can find racial, ethnic, and income breakdowns. If buyers want to dig deeper, refer them to the city government or local nonprofits.

STICK TO THE RULES.

If buyers persist in asking questions that could result in a charge of steering against you, be polite but firm in telling them: "I'm sorry, but I can't provide that information. Fair housing laws prevent me from steering people away from or toward a certain neighborhood based on race, color, or other protected categories." Help buyers get their own information.

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