

CREATIVE SHORT SALE PROGRAMS - OPPORTUNITY OR LIABILITY?

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There is a program that has developed which teaches short sale techniques, in a very “creative” scheme.

In a nutshell, the short sale program being marketed takes a form similar to the following scenario (with some variations).

Real estate **Investor/Buyer** (often a real estate agent) approaches **seller** (who may or may not have home listed) to buy seller’s house. Seller is usually in default and facing foreclosure. Investor offers to buy Seller’s home, contingent on bank approval for a short sale. Investor often asks Seller to appoint Investor as “short-sale negotiator” or to give Investor authority to talk with the bank directly. In some versions, Investor has Seller sign forms giving Investor access to all of Seller’s personal financial information linked to that loan (or sometimes a basic power of attorney to access any financial information related to the transaction). Investor often begins negotiating a short sale with the bank, perhaps not even clearly identifying Investor’s role, or that Investor is actually intending to become a “purchaser”.

Ultimately, Investor typically gets the home under contract and immediately markets the home for resale (despite the fact that Investor is a purchaser who has not yet purchased/closed on the home). Investor will have a purchase agreement to purchase, or in some cases an option agreement to purchase. In both scenarios there is usually fine print stating if Investor can’t find a “replacement buyer” to purchase the home, Investor doesn’t have any responsibility/liability to purchase. In a simple example, Investor tries to negotiate a \$100,000 mortgage debt to \$50,000, with the bank’s approval of this “short sale” with the purchase price of \$50,000. Then Investor tries to sell the property to a new buyer at \$75,000, often through a simultaneous closing or assignment.

If this actually occurred as two independent transactions, with a short-sale purchase at a price seller agreed to and bank approved, with a second sale later from the Investor to a third-party buyer, many concerns would be removed. At that point, Investor would have dealt at arms-length with each party, and would take the risk of buying and then reselling, making a profit on the difference. The problem with the programs we have seen is the Investor gets the home under contract, then markets the home to a new buyer before purchasing himself. That new buyer typically is the actual purchaser at closing.

The main concerns with such a program are these. First, the Investor, particularly when that person is a real estate agent, is often taking a great risk by taking

a role that can be misleading throughout the transaction (which raises concerns regarding Chapter 82 prohibitions on Fraudulent, Deceptive and Dishonest practices).

The Investor is often an undisclosed principal in the transaction and in some instances is a straw buyer (negotiating a purchase agreement on his own behalf which he is using as “bait” without ever intending to close). In many instances, the market price of the home has been misrepresented to the seller, bank and ultimate buyer, as the Investor (in my example above) is “purchasing” at \$50,000 (telling the bank and seller that’s all the home is worth), then reselling it to a third party for \$75,000. The third-party buyer doesn’t know that the Investor has it under contract to purchase for \$50,000 or that the investor then pockets the \$25,000 difference.

Although making a profit on real estate investment is not illegal, this type of self-dealing smells bad. Investor works opposite angles with the “real” seller and the “real” buyer while serving as a straw buyer middleman and negotiating with the bank for the profit Investor will take without anyone’s knowledge. This clearly has elements of deception. Meanwhile, the seller may even be held responsible for the unpaid mortgage debt.

Where the Investor is a real estate agent, entrusted with a responsibility not to deceive parties to a transaction and having a legal obligation to disclose *material facts* to the prospective buyer, serving as middle-man to obtain a profit without the actual buyer’s knowledge of these facts would be a concern. This is particularly true when the buyer could have purchased directly from the seller at a lower price. In that case, the \$25,000 profit to the Investor could have eliminated. Although a real estate agent collecting a fee from a transaction is not unusual, it is in this instance where the agent does not represent the buyer or the seller and pockets a fee without the knowledge of either.

Since various versions of this program also state that Investor may be able to cancel/withdraw from the purchase at any time for any reason (hence the “straw buyer” issue), Seller may have great risk in working with Investor believing that person will buy, meanwhile losing other opportunities to sell to a legitimate buyer (perhaps the 3rd-party buyer Investor is separately courting).

In the scenarios we have seen, Investor makes no representations to Seller that Seller will be free of any additional liability to his/her bank, with whom the Investor is negotiating the short sale. Consequently, while Investor is negotiating the deal with the bank (to benefit Investor, not Seller), Investor could agree to a deal which keeps the Seller on the hook for debt not satisfied in the sale.

To illustrate from my example above, the Investor may have negotiated a short sale for \$50,000 on a \$100,000 debt, but it contains an obligation for Seller to repay \$25,000 of the deficiency to bank over the next five years. Had Seller instead worked with the ultimate buyer directly, and cut out the “middle-man”, he could have sold for \$75,000 and not had the debt obligation. Some of the contracts we have seen even

indicate Seller will not be privy to the “deal-making” between Investor and bank, and cannot approve or disapprove; they are simply left with whatever the Investor negotiates.

The reason we bring this to your attention is to alert you to this emerging (and in our estimation growing) problem. Agents should exercise caution in two ways. First, they should not be involved in this type of “scheme” as either the Investor or as an agent, as it may create significant liability. Second, agents should be cautious not to let their seller client be taken advantage of in such a scenario.

In an era of lender fraud and heightened regulatory intervention, such “creative programs” may be more likely to get scrutinized by regulatory agencies than in less turbulent times. Thus, although short sale opportunities and investments may be beguiling, some of the investment programs involve a significant amount of risk.