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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.

By Robert Freedman | April 2009

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 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.