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Avoiding Potential Legal Pitfalls in Residential Short Sales

Introduction

Over the past two years, the subprime mortgage¹ crisis has caused lenders to create “workout” alternatives for nonperforming mortgage loans, including voluntarily reducing outstanding loan balances to enable their borrowers to sell their property and avoid foreclosure – i.e. a “short sale.” In light of the current increase of foreclosure activity nationwide, short sales are becoming increasingly common.

Essentially, short sales allow a homeowner to sell their property for less than the amount owed on their mortgage. This also allows the lender to remove a potentially non-performing asset from their books, without the time and expense associated with foreclosure proceedings. Below is a synopsis of leading issues in this area of emerging importance; the legal considerations and potential liability pitfalls in the context of short selling; and how to potentially avoid liability.

How Does a Short Sale Work?

A typical short sale transaction will follow the following basic steps from listing to closing:²

1. **Broker and Seller Agreement:** The seller, working with a real estate agent, lists the property with a “short sale” designation.
2. **Lender Approval of Seller:** Lenders require detailed financial information from the seller to verify that they cannot reasonably pay the outstanding loan amount.³
3. **Lender Approval of Listing:** Lender obtains a Broker’s Price Opinion (BPO) to determine the property’s “present” value, and compares this BPO against the short sale offering price of the listed property.
4. **Lender Approval of Contract:** Even though the seller and buyer may agree on a selling price, the lender must further approve the contract. The standard Florida Association of Realtors® (FAR) short sale addendum gives lenders 45 days to do this, however, lenders are increasingly requiring 90 days or more to complete this approval.

How Agents in Short-Sales Face Potential Liability

A real estate agent generally owes a legal duty to the party who retains them. Accordingly, a real estate broker’s failure to share material information with this party may be considered both

actual and “constructive fraud,” a cause of action which does not require any showing of actual fraudulent intent on the part of the agent or broker.⁴ As part of their legal duty, a real estate agent/broker is required to exercise fidelity and good faith, and may not act adversely to their client’s interests.⁵ It should be noted that the agent/broker’s duty extends only to the person who actually hired them to perform brokerage services (aka, their “principal”).

Nevertheless, it is also common for the non-principal party to a transaction – generally the real estate purchaser – to attempt to assert this and other legal relationships and duties upon the broker/agent, in order to impose liability in the wake of a failed or unsatisfactory transaction.

With respect to short sales, agent/brokers have a further duty to disclose as much information about the property as possible to prospective buyers, including that the property is specifically listed as a short sale. This disclosure must be made in the “comments section” of the Multiple Listing Service (MLS) listing.

This information is considered a material fact in a real estate short sale, as the contract of sale always requires the approval of the lender, and a buyer would likely consider this an important factor when making a decision about whether to make an offer to purchase a given piece of property, or on what terms to make such an offer.⁶ Accordingly, failure to disclose this information may be actionable in and of itself.

Avoiding Claims in Real Estate Short Sales

As noted above, an agent/broker owes a legal duty to the person(s) who retain their services and must exercise the utmost good faith and loyalty in the performance of all matters with the scope of the agent/broker’s employment.⁷ In any short sale transaction, specific issues may arise that will further complicate the already delicate and precise process of residential real estate sales. Below are some common issues that may be encountered in the short sale process and how to avoid legal liability resulting from same.

Make Sure The Seller Adequately Discloses the Condition of the Property:

It is very important in any transaction that the seller give full disclosure about all aspects and defects of the property, including any defects in the physical condition. In addition to their own independent investigative research into condition of the property, the agent/broker should encourage the seller to be 100% forthcoming and truthful about the condition of the property including any defects or potential hazards. In many short sale transactions, the sellers often feel desperate to sell may be

unwilling to disclose damaging information about the property. This must be avoided, as failures to disclose defects may result in legal action against both the sellers and the agent/broker, sounding in various causes of action including misrepresentation, fraud and breach of contract

Make Sure that the Agent Adequately Discloses All Relevant Information:

The seller's agent/broker may be equally liable for failing to disclose known information about the property, even if it was not previously disclosed by the homeowner to the seller. Keep in mind that the agent/broker has their own independent duty to disclose unfavorable information about the property to all other parties involved in the transaction, if they are in possession of such information. While an agent/broker may face substantial pressure to withhold potentially "deal breaking" information, this temptation must be avoided.

In the end, the possible commission from withholding this information is far outweighed by the risk of liability, especially as many insurance policies will not cover acts of alleged fraud.

Communicate the Unique Aspects of Short Sale Pricing and Timing:

Neither the seller nor the buyer should rely on any representations that are made prior to the final approval of the lender. Accordingly, any "assurances," "guarantees" or "warrantees" given by sellers or their agent/broker as to when a particular transaction will close, or that it will in fact close for a certain price, may give rise to liability for negligent and/or fraudulent misrepresentation. Many times residential properties are listed for short sale even though the listing price was never accepted by the bank. Further, sellers and lenders are under no legal obligation to accept even a full listing price offer. A short sale transaction can "fall apart" at multiple points in its lifespan, resulting in frustration and potentially in litigation. Accordingly, agent/brokers should clearly communicate to both the buyer and the seller that they should not rely upon statements regarding timing and price until the lender approves a given price.

Inform All Parties of the Possibility of Long Delays Before Closings:

It is important that, at the very beginning of the transaction, the agent/broker disclose the potential for delays in obtaining lender approval for a short sale. Quite often, lenders require a minimum of thirty (30) days to even respond to an offer, due to the approval process commonly undertaken once an offer is received. Accordingly, if the parties do not understand that even lender approval does not render a contract binding – until expiration of the due diligence period built into the sales contract – or if the parties believes that lender approval is in some way automatic or pro-forma, a seller or buyer may suffer damages based upon such a misunderstanding. If the loan is not

approved, and the sale is lost, the seller or the buyer may engage in litigation for damages based upon an alleged failure to fully advise them of the potential risks and delays in such transactions. Therefore, care should be taken to inform all parties of the possibility for these delays and the real risk of lender rejection of any offer/contract.

Be Aware of Other Considerations Unique to Short Sale:

There are unique situations which may extend the even beyond the closing of the transaction. For example, a seller may not necessarily be free from liability to their mortgage lender when the short sale transaction is closed, unless the seller obtains a "release" from their mortgage lender for any "excess" mortgage obligations, over and above the short sale price. Further, a short sale may negatively impact the seller's credit rating, and the seller should be made aware of this possibility. Keep in mind that the seller will probably rely on his or her agent/broker to ensure that the transaction is complete and that they have been legally protected, and accordingly, liability may arise if these unique aspect of a short sale is overlooked.⁸ Potential liability may be avoided by ensuring that during the initial stages of the transaction, matters involving releases and finalization documentation are discussed and included in the purchase and sale agreement, or obtained directly from the lender, to avoid "post-closing" issues and the resulting litigation.

Make Sure You Are Adequately Trained:

As should be clear from the foregoing, an agent/broker hoping to transact short sales is faced with numerous unique complications and concerns. Accordingly, they should be adequately trained on all aspects of these types of transactions. A real estate agent/broker's duty to advise its clients' on subjects such as "workout options," the advantages and/or disadvantages of these options, and the procedurally complex nature of "short sales" may go beyond the scope of their general duties as broker/agent in a typical real estate transaction. Consequently, mistakes made at the "explanation" stage may result in liability if the process takes longer than the parties anticipated, if the seller is denied permission by the lender to sell, or if the seller or buyer relies upon a signed contract as a binding legal document and it is later withdrawn. Adequate and ongoing training of agents/brokers regarding these types of transactions, as well the legal duties and the potential pitfalls that may occur in same, should be viewed as a requirement for a given agent/broker's handling of short sale transactions.

Conclusion

As noted above, it is anticipated that litigation involving residential short sale activity will increase so long as the housing markets continue to decline. The real estate agent/broker who must navigate this complex and emerging field of real estate practice is in the difficult position of balancing the increased

difficulty in negotiating these transactions and the additional potential legal pitfalls presented. With adequate training before taking on short sale transactions, and a vigilant effort to keep all parties informed of the risks, the delays, and the unique complexities which are part and parcel to any short sale, however, an agent/broker may navigate this challenging – but potentially rewarding – specialty. While no set of generalized rules can take the place of individualized advice from your own attorney, clear communication of these issues, as well as a consistent refusal to “guarantee,” or even “predict,” when or if a particular transaction will close, will assist the agent/broker in keeping on the right side of most relevant legal standards and will provide an enviable margin of safety in deals of these type.

¹ A “subprime mortgage” is generally defined as a loan to a borrower with a high credit risk, with “subprime lending” encompassing the industry that has evolved to originate and service these loans. Sabry, Faten, Schophlocher, Thomas, “The Subprime Meltdown: A Primer,” June 21, 2007; Practising Law Institute, 1633 PLI/Corp 89.

² Tobin, Toby, “Real Estate Short Sale Contracts Come up Short of Expectations,” http://www.gotoby.com/news/Real_Estate_short_sales.htm (July, 2008).

³ Although actual data on this issue is sparse and generally not disclosed by lenders, it appears to the authors that a growing number of lenders are approving short sales with little or no evaluation of the homeowner’s “ability to pay” or “hardship.” This may tend to show that homeowners who – in a more robust market for real estate – would not qualify as a “shortseller” are now being granted this approval by their lenders.

⁴ Id.

⁵ Licari v Blackwelder, 539 A2d 609 (Conn. App., 1988). This duty is referred to as a “fiduciary duty,” which requires a greater level of care, precision and loyalty than the “reasonable person” standard of care generally applied in day-to-day business transactions.

⁶ Short Sale and Foreclosure Resource Guide: “Get a Grip on Short Sales,” <http://www.mdrealtor.org/LinkClick.aspx?fileticket=luLZvsDuJT4%3D&tabid=300>; Benedict, John Esq., “Common Pitfalls of Short Sales,” http://erealestateexec.com/legal_notes/short_sales.php (June 2008).

⁷ Michel v. Palos Verdes Network Group, Inc., 156 Cal. App. 4th 756 (2d Dist. 2007).

⁸ Schlicke, Jillyne, “Short Sales,” <http://www.raincityguide.com/2007/03/05/short-sales>, (March 2007).

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