



STRATEGIC REAL ESTATE COACH

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A Must Read for
every Investor and
Real Estate Agent
- Josh Cantwell*

NAVIGATING THE SHORT SALE JUNGLE

How to Legally and Profitability Invest in Pre-Foreclosures in 2009

by Jeff Watson, Esq.

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INTRODUCTION

In the current era of bank woes and liquidity crises, and skyrocketing foreclosure rates, short sales are an excellent strategy for real estate investors. Unfortunately, due to these overwhelming losses many title insurance companies and underwriters are becoming more concerned about what is their duty of disclosure to all the parties involved in a short sale. Furthermore, various state legislatures are enacting legislation to “protect consumers” and their “equity” from foreclosure purchasers and investors.

The following report looks at several areas of importance for those interested in learning about short sales: preventing fraud; fiduciary responsibility and legal issues; bankruptcy; and the option contract method for closing back-to-back short sale transactions.

This text is not designed to be an authoritative legal opinion but rather some common sense guidelines to real estate investors. Strategic Real Estate Coach (SREC) understands that the real estate industry is always shifting, especially when it comes to short sales. The intent of this report is that legal counsel for various investors, title insurance underwriters and legislators will read this and agree with the principles contained herein.

I. ADEQUATE DISCLOSURE

For a long time, SREC has been advocating what is now the current buzzword throughout the escrow and title insurance industry when it comes to foreclosures and short sales: “disclosure, disclosure, disclosure.” Real estate investors and real estate agents have always been told “location, location, location.” Proper and adequate disclosure is essential in order for a short sale investor to stay out of trouble. “Trouble” means accusations of fraud or other illegal activities. In case anybody is wondering, a good definition of fraud is: “All multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprises, tricks, cunning or dissembling, and any unfair way which another is cheated.”¹

¹ Black’s Law Dictionary, 5th ed., by Henry Campbell Black, West Publishing Co., St. Paul, Minnesota, 1979

Fraud is generally defined in the law as an intentional misrepresentation of a material existing fact made by one person to another with knowledge of its falsity and to induce the other person to act, and upon which the other person relies with resulting injury or damage. Fraud may also occur by an omission or purposeful failure to state material facts, which nondisclosure makes other statements misleading. Fraud also may include reckless acts done with no regard for the truth.



A key aspect of avoiding fraud is understanding what is a “material” fact that needs to be disclosed. A “material fact” is something that if it was known it would or could change the outcome of the transaction. Some examples of material facts that should be disclosed in a short sale transaction would be obviously that the roof leaks or that the property is in foreclosure and that the investor who is resolving these title issues by buying the property plans on reselling it promptly for a profit. Examples of non material facts that do not need to be disclosed would be that the woodwork throughout the house is painted in antique white rather than bone white.

Next, it must be determined to whom should material facts or information be disclosed? The answer is as follows. A person engaged in a short sale should disclose relevant and non privileged material facts to:

- a) the homeowner from whom they are attempting to buy the house while the house is in foreclosure;
- b) to the lender that is currently foreclosing on or trying to collect on the note or mortgage that is in default;
- c) to the any real estate agents involved in the transaction;
- d) to the end buyer that wants to purchase the house from the investor; and
- e) to the end buyer’s lender.

What relevant material information each person should be told varies depending on his/her relationship in the transactions and his/her role therein. What is a relevant material non privileged fact depends on the various parties’ relationship to each other. For example, the

homeowner in default needs to be informed about potential tax issues relating to the forgiveness of non-acquisition indebtedness and the need to consult a tax professional while the end buyer has no need of such disclosure. The end buyer must be told about all known problems with any of the mechanical systems in the house.

A. DISCLOSURE TO THE HOMEOWNER



The most important and most detailed disclosures should be made by the short sale investor to the homeowner who is in default or foreclosure. These disclosures need to be in writing and need to be provided to the homeowner when or before any documents are signed. It is important to make sure that these disclosures comply with any applicable state law regarding formatting, type size and exact wording. In addition to any applicable disclosure required by state law, each short sale investor should make

many significant disclosures to the homeowner. Those disclosures can be set forth in “An Affidavit of Understanding” (this may be found on the SREC website). The investor needs to clearly disclose to the homeowner that the short sale investor is not guaranteeing that they will be buying the house. Moreover, the investor needs to make it clear to the homeowner that the purchase of the house is contingent upon several events and factors occurring favorably for both the investor and homeowner/seller. Sometime lenders decline all attempts to short sale a property, for no valid reason.

B. DISCLOSURE TO THE FORECLOSING LENDER

The second entity to whom disclosure should be made by the investor is to the lender with whom they are seeking to obtain a discount on the note or mortgage. What should be disclosed to that lender is a subject of hot debate among those in the short sale industry. The following items need to be disclosed to the foreclosing lender.

1. That the buyer attempting to buy the property through a short sale is a real estate investor. This disclosure is made in the short sale submission by the purchase and sales agreement, the cover letter, and other documentation contained within the short sale package. (Again, see examples on the SREC website)

It should clearly show that the buyer making the offer is a real estate investor. This disclosure puts the bank on reasonable notice that the investor/buyer is seeking to make a profit (short term or long term) by purchasing the house through a short sale.

2. The second disclosure that the short sale investor should make to the foreclosing bank is that the investor has the right to and may be planning to promptly resell the property for a profit.

Putting that information and that terminology in the actual purchase and sales agreement used to negotiate the short sale makes it clear that the bank is being put on notice that the buyer is an investor and is seeking to buy and then re-sell the property for a profit and may do so quickly. (see SREC P&S Agreement on websites)

At this time there may be certain title insurance underwriters who believe that the discounting lender needs to be told that the investor is promptly reselling the property and the exact amount that the investor is reselling the property for and the size of the gross profit.

Consider the following policy by one title underwriter:

DOUBLE ESCROWS

“Double escrows” are dangerous because of the possibility that 1) a seller has been misled into selling the property for too little, 2) a buyer has been misled into purchasing for too much or 3) a lender and/or an assignee have been misled to loaning on property whose value has been artificially inflated. Escrow holders should not be liable in these situations, but if a lawsuit is filed, it will not matter whether you win or lose at trial - you will spend so much money in attorney’s fees that even if you win, you lose. On the other hand, most of these are legitimate transactions.

Deciding whether to handle a double escrow must be done on a case-by-case basis. The attached supplemental instructions are tools that can be used in deciding whether we will handle any part of the double escrow. However, obtaining these signed instructions does not necessarily mean we can automatically handle the transaction. We still need to make our decision after considering the entire situation.

The parties we need to sign the acknowledgments [as to the “double escrow”] are the:

Seller,
Buyer,
Lender and
Lender’s assignee.

SREC’s legal team thoroughly disagrees with this; the above guidelines are inappropriate and a violation of the confidentiality rules that apply to residential real estate transactions. Each real estate transaction is a separate independent transaction. Each transaction should “stand on its own two feet” by being separately and independently funded. Escrow and title insurance fees are collected when an actual closing between buyer and seller occurs. What happens in that transaction should stay in that transaction with information going only to the parties of that transaction.



Concerns of fraud can be eliminated by explaining to the title and escrow agent(s) that they should comply with the following protocol to insure back to back closings or “short sale” transactions:

1. There must be zero or negative equity in the property, evidenced by the following:
 - Receipt of “gross” payoff letters (showing the actual total amount of indebtedness against the property, before discounting) as well as “discounted” (net) payoff letters (second)

- Final sales price minus the actual total amount of indebtedness must yield zero or negative equity
2. There must be no amount of proceeds being paid to the property owner. There must be a purchase agreement or addendum which has a purchase price which is equivalent to the total of the amounts set forth in the discounted payoff letters. A conveyance fee must be paid on this amount when the deed from the property owner to the investor/buyer is filed. Consent must be given (by the buyer and seller) to release the HUD-1 if the new purchaser's lender requests documentation as to payoff of the underlying liens. The buyer must bring its own good funds to close on the first sale.
 3. The Second Sale must be an "arms-length" transaction in that the buyer (from the investor) must be an independent third party who is unrelated to the prior property owner.
 4. Property owner (vested owner) must be present at the closing and evidence full knowledge of the sales price and the terms of the sale by signing a copy of the relevant HUD-1.
 5. There must be written evidence that the buyer's funding lender on the purchase has full notice of the "double transfer" (property owner to investor, then investor to purchaser) involved in the overall sales transaction(s).



As of the date of this writing, SREC is unaware of any state or federal legislation requiring disclosure to the lender being discounted (short sale lender) that the property is being resold and the amount of the profit that the investor is making. Nor is SREC aware of any type of terminology contained in any mortgage or regularly used

promissory note that entitles the bank to that information.

The lender who is approving the short sale is only doing so if it makes financial sense for them. The terms of the short sale are being negotiated by two separate parties each looking out for their own financial welfare.

Short sale approvals are intelligent business decisions by foreclosing lenders in accordance with their own business strategies.

The following quote from a U.S. Federal District Judge offers insight as to the bank's decision making process in the foreclosure process:

“There is no doubt every decision made by a financial institution in the foreclosure process is driven by money. And the legal work which flows from winning the financial institution’s favor is highly lucrative. There is nothing improper or wrong with financial institutions or law firms making a profit — to the contrary , they should be rewarded for sound business and legal practices.” *In re Foreclosure Cases*, 2007 WL 3232420 (N.D. Ohio Oct. 31, 2007).

The bank's approval of the short sale is set forth in a written document called a short sale approval letter. An approval letter usually insists that the buyer at the closing be the person who made the offer to buy that was accepted by the lender and pursuant to the purchase and sales agreement between the homeowner/seller and the investor/buyer.

That transaction needs to be funded and closed by the investor and a deed from the homeowner in default needs to be recorded transferring title from the homeowner in default to the investor. In so doing the short sale as agreed to by the parties is completed.



If the investor chooses to keep the property for 90 minutes or 90 days or 90 months it doesn't matter. It now belongs to the investor. The lender's mortgage or lien is released. The promissory note is paid and cancelled. The lender that took the agreed upon discount does not have a legal right to be told that the property is being resold for a profit.

Consider the fact that T.I.L.A., Regulation Z and H.O.E.P.A. exist to protect borrowers from lenders and that they do not exist to protect lenders from homebuyers seeking to do short sales. These laws acknowledge the lender's superior knowledge and bargaining position when dealing with individual people.



During the process of negotiating the short sale the investor should never submit anything to the bank that the investor knows to be untrue or inaccurate in any material way. Investors and Realtors who advocate that people should stop making payments or who conceal material facts from lenders in the process of negotiating short sales or who coach homeowners into writing inaccurate or untruthful hardship letters do so at their peril of engaging in wire fraud, mail fraud, and other Federal felonies.

There are more than enough legitimate short sale opportunities out there that no one needs to take the time to try to craft a short sale out of something that it should not be a short sale.

C. DISCLOSURE TO REAL ESTATE AGENTS, REALTORS AND BROKERS

The third area of disclosure that the short sale investor needs to be concerned about is disclosure to all of the real estate agents, realtors and brokers that are involved with or know about the property being on the market. At all times that the home is "listed" on the market by either the investor or homeowner it should be disclosed in the MLS listing that it is subject to third party lender approval. If the discount has already been obtained but the end buyer has not been found, then that information (written short sale approval received) should also be included in the MLS information.

Unfortunately, most real estate agents and brokers fail to understand how short sales really work. Specifically, that for a bank to evaluate and approve a short sale offer they must receive a legitimate arms length offer and the necessary supporting documentation proving the homeowner's financial distress and lack of resources to pay. To merely list the house on the market at a price below the total payoff and hope to receive an offer and then close the short sale is doing the homeowner a great disservice.

The belief that every short sale offer received on a property in foreclosure must be presented to the bank is **wrong** for two reasons. First, the loss mitigation departments at banks are designed to evaluate offers one at a time. If a bank believes that an offer has merit they will conduct their own investigation to determine if the deal makes financial sense to them. That will include but not be limited to obtaining an interior and exterior broker price opinion (BPO) or appraisal, pulling the homeowner's credit report, verifying the other information on the financial statement and determining the legitimacy of the buyer's offer. After reading many different mortgages SREC has yet to see any mortgage on record that



requires the homeowner to submit all offers received while in default or during the short sale process. This mistaken notion held by some agents comes from the habits and practice associated with REO sales. A corollary of that mistaken notion is the belief that listing agents and their client homeowners owe a fiduciary duty to the foreclosing lender.

Since a homeowner can only have one pending contract with a buyer in a primary position it is unreasonable and inappropriate to expect that homeowner to accept and/or submit any back up offers to the lender either directly or through the investor/buyer. This easily could become *tortious interference* with the first contract and the first buyer may have a strong claim for damages.

D. DISCLOSURE TO THE END BUYERS

The fourth area of disclosure is important and significant. The disclosures that must be made by the short sale investor to the end buyer are as follows. First, it must be disclosed in the purchase and sale agreement or contract that the transaction is “subject to written short sale approval that must be satisfactory to the seller.” It should also be disclosed that “the short sale transaction needs to be completed or closed before being able to complete the sale to the end buyer.”

The second essential disclosure that the short sale investor must make to the end buyer is that the property is being sold “as is, where is”² and that the short sale investor has no actual knowledge of the condition of the property because the short sale investor has not lived in the property.



The short sale investor must make sure that any information disclosed to him/her by the homeowner in default regarding the condition of or any problems with the house is passed on in writing to the end buyer. This is commonly done through the written residential real estate disclosure forms that accompany most real estate purchase agreements.

Finally, if the end buyer or their representative asks what legal basis the short sale investor has for selling the property, the short sale investor must be able to provide appropriate and legally valid documentation verifying their position to sell the property. Such documentation could be a recorded notice of option (contract) that specifically gives the investor the right to list, market buy and then resell the property during the term of the option period. If the investor is marketing the property via a real estate agent on the MLS make sure that the rules of that local MLS board are being followed.

²Texas Investors must consult with an attorney about the significance of this term

E. DISCLOSURE TO THE END BUYER'S LENDER

The final area of disclosure that the short sale investor must make is to the end buyer's lender. The end buyer's lender is being told in the purchase and sales agreement that the sale of the property is "subject to a short sale that is satisfactory to the seller," and that "the short sale needs to be completed or closed (A-B) before the closing of this transaction" (B-C). This is an obvious disclosure that the property is either in default or foreclosure.



The end buyer's lender also gets more notice than that and the notice that comes to them is clearly and explicitly set forth in the title commitment prepared by the title agent/attorney. The title commitment clearly indicates the status of any legal proceedings or foreclosure action relative to that house. Furthermore, it may also clearly disclose each of the vested homeowners for the last 24 months. In many instances it will only be the homeowner who is in default or foreclosure. Other items that need to be disclosed in the title commitment are the nature of the investor's relationship with the property. Do they hold an option to purchase the property? If so, that must be listed as an exception to the title in Section 2 Part B of the title commitment.

If there is any type of deed delivered by the owner in default/foreclosure being held in escrow by the title agent or title attorney then that should also be disclosed in the title commitment or in a separate written letter to the end buyer's lender.

Some title agents and title attorneys believe that disclosure can be taken one step further. The disclosure in the title commitment can include a listing of all documents that will need to be prepared, executed and recorded to complete both transactions. When an end buyer's lender receives a title commitment indicating that the necessary documents to close this transaction will be:

- 1) a deed from the homeowner in default (vested owner) to the investor;

- 2) release of all current liens and dismissal of foreclosure if any;
- 3) a (second) deed from the investor to the end buyer so as to release/satisfy the recorded notice of option; and
- 4) a mortgage then given by the end buyer to the lender (who is ordering the title commitment).

The above documents give the end buyer's lender adequate written notice of the entire nature of the transaction(s).

The funding lender may ask what the short sale price is and what potential gross profit the investor is making. If they ask, tell them.

II. FUND EACH TRANSACTION SEPARATELY

In addition to providing adequate disclosure to all of the other involved parties in a back-to-back short sale transaction, the short sale investor needs to take other steps to avoid committing fraud or avoid the appearance of committing fraud. One of those key things is for the short sale investor to make sure that each transaction is a separate and independent transaction that stands on its own.

The essential element of doing that is each transaction must have its own funding. The era of "pass through funding" or "dry closings" is done. This type of "funding" involves manipulating the escrow account of the closing or title company. This results in misrepresentations, breach of fiduciary duty and "good funds" requirement. Each major title underwriter is frequently forbidden this type of closing.



For several years, one of the ways SREC has differentiated itself from other short sale training companies is by insisting that each transaction be separate and distinct. Each transaction has its own particular parties, source of funding, escrow and title fees, documents

and adequate document prep fees. The transaction should include title insurance and be detailed on the HUD-1.

III. AVOID USING POWERS OF ATTORNEY

A power of attorney gives the holder great power to act on behalf of the principal. With that power comes responsibility, or a fiduciary duty. Investors create a potential conflict of interest or worse by having this fiduciary duty while also doing business with the person over whom they hold the POA. Your actions as an investor seeking to make a profit may conflict with your fiduciary duty as attorney in fact.

IV. READ, UNDERSTAND AND OBEY THE VARIOUS STATE LAWS REGARDING FORECLOSURE PURCHASES OR DISTRESSED PROPERTIES



Ignorance of the law is no excuse for either failing to comply with the law or failing to properly understand and discuss. The short sale buying and selling methods used by legitimate investors will comply with relevant legislation. Even a casual reading of that legislation will dispel many of the rumors and myths that frequently permeate real estate investor and agent circles. Carefully read each definition in the statute so that you understand what the legislation really covers.

It is the duty of each reader to verify that there have been no changes or amendments to the legislation in their state since they last read the statutes.

FIDUCIARY AND LEGAL RESPONSIBILITIES OF REALTORS

For several years SREC has been teaching real estate investors how to work with real estate agents to get back-to-back short sale transactions done. In essence, by teaching both of these separate camps how to work with one another, we've shown how they can combine their strengths as a way to offset their individual weak areas for one common purpose: close more deals.

As a regulated professional body, real estate agents have many rules that they must follow to do business or otherwise risk losing their license. This presents challenges that many agents and investors have difficulty in resolving.

A growing issue among Realtors® regarding short sales is their concern over what are their fiduciary duties, as well as what are their legal responsibilities, when they choose to represent a party involved in a short sale transaction.



While the language may vary from state to state, the common principle is that licensed professionals must only handle professional matters upon which they are adequately trained and/or have adequate resources and supervision to make sure that these matters are competently handled by the licensed professional. This is a principle that applies to lawyers, doctors, accountants and real estate agents.

The first area of concern is to whom does a Realtor owe a duty? The real estate agent owes a duty — a fiduciary responsibility and/or legal responsibility — to whomever they choose to represent in a transaction. Often it will be a homeowner in distress, default or foreclosure. The duty that flows from the agent to the homeowner does not extend to the lender who has started the adverse or hostile foreclosure action against the homeowner in default or distress. This is important because some Realtors mistakenly believe that they are responsible for keeping the lender abreast of any new offers on the property that are received during the short

sale negotiation process, even after the property is under contract and the initial short sale package has been sent to the bank for evaluation. Realtors must understand that they work for the homeowner or the buyer. Not both, and never for the Bank.

While the Bank has the veto power over the offer, it is the homeowner who makes the decision regarding which offer to accept. Furthermore, it is up to the homeowner to decide whether they want to pursue a short sale.

Realtors who choose to work in the world of distressed properties and work with homeowners who are either in default or foreclosure must understand that there are two inevitable facts that change the entire landscape. Number one, they are in the world of negative equity (the property is worth less than what it owed). Second, as a result of adverse financial circumstances being experienced by the homeowner the inevitable foreclosure is coming. It is not a question of IF, it is only a question of WHEN. The freight train of trouble is coming down the tracks, it will arrive, but we don't know exactly when.



Therefore, all actions and decisions must be made in the perspective of a) the home has negative equity, and b) the homeowner is going to lose their house. Sellers that lose their home to foreclosure and are forced then to file for bankruptcy to discharge all of the hundreds of thousands of dollars of personal debt end up in the worst situation possible. Sellers who are able to successfully sell their house by way of a short sale and have

avoided the actual foreclosure from completely occurring, and have paid off via the short sale hundreds of thousands of dollars of indebtedness that they were personally responsible for, are in the best situation. Homeowners can fall into any one of these categories or anywhere in between.

It is absolutely critical for a Realtor to realize that once they are dealing with a property that has negative equity with an inevitable foreclosure date, the traditional rules of seeking to sell to a buyer who provides the highest and best offer go out of the window; getting the property sold is more important than trying to get the highest purchase price.

EXPLAINING TO THE HOMEOWNERS WHAT THEIR CHOICES ARE

This is the first obligation of a Realtor. A real estate agent who chooses to become involved in a distressed property or in a short sale transaction must have adequate knowledge and training to convey all the necessary material information to a homeowner so that the homeowner can make an informed decision about possible choices.

The choices facing a homeowner in foreclosure can be separated into four categories. The first is to remain in the property as a “squatter” using multiple bankruptcy filings until the foreclosure auction occurs and they are evicted. This allows the homeowner to stay in the property for as long as possible for a low cost.



The second option that the homeowner has, which is usually unrealistic, is to list the property for an amount high enough to pay all liens and closing costs in full and pray that some buyer will come along and pay that price. Ultimately, the result is that the homeowner lives in the property without making payments, experiences foreclosure, and then is often confronted with the need of having to file bankruptcy to discharge the personal responsibility of hundreds of thousands of dollars of debt.

The third option and one that is frequently recommended by many traditional real estate agents who do not understand all of the complexities of the short sale world is for the homeowner to list the property seeking a short sale buyer and hope that the short sale buyer has the patience and endurance to wait out the 90 plus day process as the seller(s) or their

agent negotiates with the lien holders all of the things necessary to get the short sale approved. The biggest concern and drawback to this approach is that the typical buyer will get frustrated over waiting 90 or more days and focus on another house that is already available. Second and a more insidious concern is that the real estate agent and the seller are not always properly trained and equipped to handle the negotiations with the lender(s). The lender(s) are in the process of seeking to collect a debt and they will use any means at their access to attempt to obtain money and information. Unless the agent is extremely familiar with the entire short sale process as well as the BPO process they can make fundamental or critical errors that will either delay or destroy the short sale process. Many agents assume that deficiencies and seller signed promissory notes post short sale are usual and customary. **That assumption is wrong!**



The fourth option that can be presented to a homeowner is for the homeowner to list the property seeking a short sale and to work with a competent and knowledgeable investor who seeks to buy the property. In exchange for the investor agreeing to wait the 90 plus days to be able to buy

the property the investor assumes the responsibility for negotiating the short sale so that the investor knows where the process is at all times. The investor/buyer may be choosing to keep this property in their own keeper portfolio as a rental property or they may be seeking to quick-turn this property for a profit. The advantage to this approach is that there is a competent, persistent, committed end buyer who has submitted a legitimate arms length contract to the Bank to buy the property. An additional benefit to this strategy is that the investor is knowledgeable about the entire short sale process and understands all the key steps in the negotiation process. Furthermore, they are able to handle the BPO in a manner that will more likely result in favorable short sale outcome. Few, if any, homeowners realize that during the BPO they should be emphasizing the negative aspects of the distressed property, rather than promoting its benefits, features and attributes. An investor who is aware of how the BPO process works will make sure that the BPO agent has all the necessary information to properly and accurately complete the Fannie Mae BPO form.

A Realtor that adequately understands these choices can then present the foregoing choices to the homeowner who is in default or distress, and the let homeowner choose how to continue.

UNDERSTANDING THE RULES OF NEGATIVE EQUITY AND DISTRESSED SELLERS



To better assist the homeowner in making the decision between these four options, the homeowner needs to have an understanding of the consequences upon the long term creditworthiness of a homeowner when it comes to filing a Chapter 7 or Chapter 13 bankruptcy. They need to be able to understand the difference between a Chapter 7 and Chapter 13. Chapter 7 is a total discharge and Chapter 13 is a reorganization or

payment plan. They also need to understand that a bankruptcy of and by itself will only temporarily stop a foreclosure proceeding until either an abandonment of assets or a relief of stay is granted by the Court. Furthermore, a Realtor must become aware of the differences between various types of abandonment of assets. The Realtor must also be proficient in understanding the significance of the Mortgage Debt Forgiveness Act enacted December 20, 2007. They need to be able to give a layman's explanation of the difference between acquisition and non-acquisition indebtedness. In addition to having a competent understanding of the Mortgage Debt Forgiveness Act, real estate agents should also be familiar with IRS publication 4681 that deals with this issue and have a working knowledge of how Form 982 is completed and made part of a homeowner's tax return. They need to be able to refer the homeowner to a competent tax practitioner to properly complete the necessary IRS forms.

Another area of responsibility that a Realtor has is understanding how secondary or junior liens are prioritized and handled. Not only must these liens be released and/or satisfied as part of a short sale, they must understand what to do when a first mortgage holder will only allow a second mortgage holder to receive \$2,000 and the second mortgage holder demands a minimum of \$10,000 to release their \$50,000 lien. This common stumbling block will trip up many uninitiated and inexperienced Realtors and will nearly always befuddle every homeowner

who is attempting to negotiate their own short sale. However, experienced real estate investors know exactly which one of many solutions to implement to overcome this seemingly insurmountable obstacle.

Realtors need to be aware of how to handle a lender request for seller contributions. Many times aggressive debt collection practices will result in lenders wanting the seller to contribute something towards the pay off either by signing a promissory note or by reaching into retirement accounts such as an IRA or 401(K) to pay down any indebtedness. Realtors who fail to understand the protected nature of such retirement accounts are jeopardizing the homeowner and the homeowner's future financial security. Telling a seller to withdraw money from retirement accounts to complete a short sale may be "malpractice" by the Realtor, as well as the Realtor's broker. Realtors must understand in what states mortgage debt is recourse and which states it is non-recourse.

Another area that Realtors frequently fail to live up to their necessary obligations and duties is in making sure that the title and escrow companies responsible for closing the transaction have a complete understanding of the process. In addition, they need to be aware of what their underwriter requires.

In this era of declining business many title and escrow companies will claim that they understand how to close short sales; however, the difference in handling a short sale transaction as compared to a regular transaction is the same difference as seeing your general practitioner for a physical versus undergoing a procedure performed by a neurosurgeon. The latter requires a great deal more skill, training and expertise. It is the same with closing short sale transactions.



Most Realtors do not understand two key facts regarding HUD-1s. First, a preliminary HUD-1 is an absolutely crucial and vital negotiating tool in a short sale transaction with one or more lenders. Furthermore, when a short sale transaction appears to be closing, a preliminary HUD-1 must be completed by the appropriate title and escrow company and sent to the lender or lenders for approval before closing the short

sale transaction. The HUD-1 that is sent for approval to the lender must be consistent with the most recent negotiating or preliminary HUD-1s but it also must be the absolute complete, honest, gospel truth, fully documenting every dollar being involved in the closing.

When a Realtor is working with a homeowner who has chosen to use an investor to negotiate their short sale transaction then a critical element is providing timely insight and information as to the status of the short sale transaction and negotiations. Knowledgeable Realtors realize that some investors are able to make available through various special software programs 24/7 access as to the status of the short sale transaction in which the Realtor is representing the homeowner (www.realeflow.com). This is crucial in order to give the agent proper insight into the status of the short sale transaction. The agent has a fundamental role in providing timely and accurate updates to the homeowner as well as making sure that the homeowner understands that there will be periods of time where it looks like nothing is happening but the file is moving closer and closer to a resolution on the loss mitigator's desk.

Recognition of the overwhelming workload of loss mitigators is absolutely crucial. Realtors who fail to understand this and who fail to understand how to properly assemble and submit a complete short sale package are doing the seller a tremendous disservice. Use of a competent and proven investor or loss mitigation negotiation company can overcome this problem. More than one loss mitigator has made it clear that a fully documented and properly assembled and prepared short sale package will receive their prompt and undivided attention. Loss mitigators prefer working on such matters and will put off handling and dealing with disorganized, incomplete or poorly and improperly submitted short sale packages.



Finally, contrary to what some traditional Realtors believe, it is not a breach of fiduciary duty to involve an investor in a short sale transaction wherein the investor buys the property at a discount and then sells the property for a profit to an end buyer. The resale price is obviously less than the original indebtedness owned by the seller in distress or default. The investor is being compensated for their time and effort in negotiating the short sale and being committed to the property for 90 or more days and they are often able to understand what is necessary to overcome and

solve any Bank's concerns or objections regarding approving a short sale package. Lenders only approve short sales when the numbers make sense for themselves. The basic question they ask is this: will they get more money sooner through a short sale than if they have to sell the house as an REO?

The objection that a seller might feel that they got less money than they would have had the Realtor "done his job" and not handed over the negotiations to an investor is misleading and illusory. A homeowner who is in distress or default and sells their property by way of a short sale is not going to receive any of the sales proceeds irrespective of whether the property sells for \$20,000 or \$30,000 more or less. When the bank accepts the payoff as payment in full, then there is no greater deficiency. Also deficiency issues go away if the homeowner has already chosen to stay in the property longer by filing a Chapter 7 bankruptcy.

The argument that by involving an investor who buys and then resells for a profit to an end buyer results in a higher deficiency to the homeowner may initially seem to have merit as a reason for why Realtors should not deal with investors on short sales. However, a deeper examination reveals that such a suggestion is based upon a combination of facts that rarely occur. Furthermore, when it appears to happen it ignores the fact that the end buyer was procured not by the efforts of the Realtor, and not by the efforts of the homeowner but by the efforts of the investor. The investor may have done things to improve the overall condition and appearance of the property, particularly if the homeowner has voluntarily chosen to abandon the property. Even in instances where the homeowner remains in the property and the investor has not been able to do anything to improve the value of the property, the end buyer who is willing to pay more to the investor is only there as a result of the investor's efforts in a) understanding the overall problem involving the property and knowing how to negotiate a short sale, and b) while negotiating a short sale continuing to market the property in a way that will produce an end buyer in the event that the Bank does not accept the investor's original offer to buy the property. The end buyer usually materializes and is interested in the property because the investor has done all the hard, time consuming work of negotiating the short sale.

The foregoing argument against working with investors is usually made by people who are ignorant of the percentages or ratios of the BPO that the short sale lender will accept as payment in full. An investor buying at 92% of the BPO value, where the 92% includes all commissions and closing costs, has a good start to legitimately creating a profit. Additionally,

BPO value can legitimately be less than market value. Time, location and circumstance all affect the value of a property.

The likelihood of an end buyer making a higher price offer at the same time as the investor and patiently waiting all the months necessary to negotiate the short sale is unrealistic. Often investors can increase their offer to get the deficiency waived. End buyer's can't do that. It is often not until the end of the short sale negotiation process that the homeowner and the other parties involved learns that the Bank is adamant in that they will not accept any short sale as payment in full, and rather they are insisting on a deficiency. In these rare instances ethical investors have been known to step out the middle and let the house get sold to the higher paying end buyer.

Finally, it has been suggested that Realtors should just submit fictitious offers from "straw buyers" as part of a short sale process in order to get things started and not deal with investors, so once the bank responds to that offer, they will then have the short sale approval from the Bank much closer at hand and therefore be able to sell to an end buyer for a much higher price. That methodology is fraudulent and misrepresents facts to the Bank.

Anyone that suggests that a higher sale price is helpful to a homeowner in dealing with a 1099C tax issue is ignorant of how the IRS treats these types of transactions. A person who makes such a statement has never read publication 4681 prepared by the IRS and has not completed a tax return which includes form 982.

In summary, just as Realtors choose to only handle areas relative to real estate upon which they are properly trained and experienced whether it be residential, commercial, new construction, condominium, high-rise, etc. the same should apply to Realtors who choose to become involved with either distressed properties or homeowners who are in default, distress or foreclosure. The Realtor is required to obtain the necessary knowledge and education to competently perform their duties and assist homeowners and/or buyers who are engaged in the process seeking to either buy or sell a property by way of a short sale.



DISCLAIMER: BANKRUPTCY IS A COMPLICATED AREA OF LAW. NON-ATTORNEYS WHO HELP PEOPLE FILE BANKRUPTCY ARE ENGAGED IN THE UNAUTHORIZED PRACTICE OF LAW. THESE MATERIALS ARE NOT TO BE USED TO FACILITATE THE UNAUTHORIZED PRACTICE OF LAW.

The bankruptcy reform act of 2005 changed the entire bankruptcy landscape as we used to know it. Today most competent bankruptcy attorneys need at least three weeks before any major impending event such as a foreclosure auction date to adequately prepare a bankruptcy petition and file the same with the Court.

Homeowners who have waited too long to deal with foreclosure often find out that there is little that can be done to help them by bankruptcy lawyers.

I. ESSENTIAL FACTS ABOUT BANKRUPTCY

This section is not designed to be a comprehensive discussion about bankruptcy as it relates to foreclosure. Instead, the purpose here is to give you the essential facts that you need to know so that you become knowledgeable when dealing with people who are in foreclosure and bankruptcy or who are in foreclosure and contemplating bankruptcy. You will deal with bankruptcy issues while doing short sales because homeowners will have filed bankruptcy in an effort to save their house, before they contact you about selling the house.

The first and most important thing you need to know is that ***filing bankruptcy does not permanently stop or prevent a foreclosure from occurring, it can only stay or temporarily freeze a foreclosure action.***

A. Federal Law Controls

All bankruptcy law is federal law that is legislation passed by the United States Congress. In October of 2005, major bankruptcy reform legislation that had been passed by Congress took effect. The reform legislation that was passed made changes to the two types of bankruptcies that individuals can file. Those two types of bankruptcies are referred to various Chapters in the code, Chapters 7 and 13.

Chapter 13 - Repayment Plan

The reform legislation has made Chapter 13 the more common type of bankruptcy. Essentially, Chapter 13 is a Court-supervised and Court-monitored repayment plan where the debtor provides the Court with a listing of all of their debts, a budget for their monthly needs, and all extra money per month is applied to pay the arrearage owed on the debts. One of the benefits of a Chapter 13 repayment program is that many of the outrageous late fees, interest rates, and other charges can no longer apply on these kind of debts. The typical repayment program usually lasts between 48 and 60 months.

The vast majority of Chapter 13 repayment plans falter and eventually fail. Plans can falter even where the debtor gets a grace period from the Court due to unusual and unexpected circumstances. Often the Court will grant additional time to the plan and they can get a break to try and catch up for missed payments to the trustee.



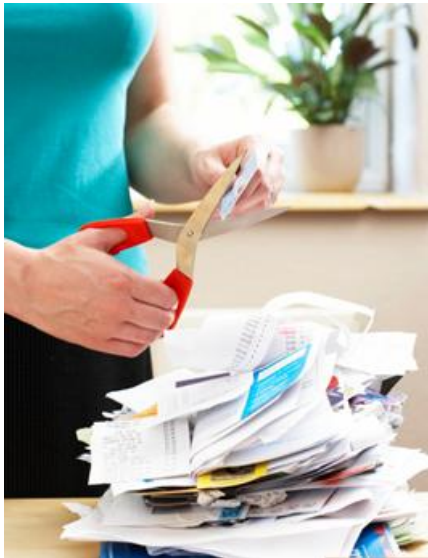
The typical Chapter 13 plan is that the debtor wages are automatically sent to the Court appointed trustee and paid out to the creditors according to a plan presented by the debtor and agreed to by the creditors.

After the bankruptcy reform act of 2005, Chapter 13 repayment plans also include partial repayments in what once was a complete discharge. Chapter 13 bankruptcies can be filed again within a shorter period after the last plan, either failed or terminated. However, to prevent abuse, if a Chapter 13 plan is dismissed by the Court due to the debtor's noncompliance, the debtor cannot file a new Chapter 13 for at least one year.

Several new rules exist about automatic stays and re-filing, they are:

- 1) Automatic stay is terminated 30 days after petition in case filed by individual under Chapters 7, 11 or 13 if case pending within 1 year preceding was

- dismissed other than that re-filed under dismissal under 7078; may be continued if Court finds re-filing in good faith.
- 2) No automatic stay is in effect in cases filed by individual under Chapters 7, 11, or 13 if two or more cases pending in 1 year preceding were dismissed other than that re-filed under dismissal under 70; Court may impose stay is established later filing in good faith.
 - 3) Stay automatically terminates 60 days after sec. 362(d) motion filed in case filed by individual under 7, 11, or 13 unless there is final decision or extension reached.
 - 4) Automatic stay does not apply to enforcement of residential eviction judgment entered prepetition. Provision not effective until 30 days after petition is filed if certain requirements met. Exception may not apply under certain circumstances.
 - 5) Automatic stay does not apply to continuation of residential eviction action based on endangerment of property or illegal use of drugs on property if certain requirements met.



Many times people will not include their house payment in the Chapter 13 plan. This is frequently the result of individual preferences of the attorneys that they hire to represent them as well as the characteristics of the trustees appointed by the probate Court to administer Chapter 13 plans. Even if a house is not included in any Chapter 13 bankruptcy, the bankruptcy does temporarily protect the house by filing a stay on the foreclosure action and that stay may remain in effect as long as the homeowner then gets and remains current on their house payments.

Chapter 7 - Discharge Debts

Chapter 7 bankruptcies provide for the total discharge and liquidation of debts. Because of this powerful debt relief tool, individuals are only able to file a Chapter 7 bankruptcy once every eight years. In a Chapter 7 bankruptcy, people may list their home and mortgage as one of the debts that they are seeking to discharge. In this case, it is clear that they have

abandoned all hopes of saving the property and continuing to live in the property. If an individual chooses not to include their house in a Chapter 7 bankruptcy, then they are still intending to keep the house, and must stay current on the payments on the house while the other debts are being discharged.

Many people think that if they can discharge their other debts, then they will have enough available cash to get caught up on their house payments and stay current. More often than not, they are wrong. Even if the house is not included in a Chapter 7 bankruptcy, the stay granted by the filing of the bankruptcy will apply to the mortgage and the foreclosure action. If the homeowner can then bring the mortgage current, then the foreclosure action should go away.

Usually the homeowner is unable to bring or keep the mortgage current and the bank then files a motion for relief of stay to resume the foreclosure. Chapter 7 is a valuable tool and a homeowner who realizes that they are going to lose their house may be best served by waiting until after the foreclosure action is completed or until after the short sale is done and then using the Chapter 7 bankruptcy to wipe out any deficiency judgment that may remain. By



waiting until after the short sale, the homeowner may not need to file bankruptcy.

B. State Options

While bankruptcy law is federal law, each state has its own characteristics and additional pieces of legislation affecting bankruptcy. Furthermore, each bankruptcy Court is located within certain areas of the state and based upon the political makeup of that area of the state it can influence the character and nature of the trustees serving Chapter 13. Additionally each state has various options as to the amount and type of exclusion of certain assets that are exempt

from being included in the bankruptcy and that the debtor can continue to own after the completion of the bankruptcy. The most common of these is a homestead exemption. For many years, Florida had a very generous homestead exemption, and so did the state of Texas, while Ohio has had a meager homestead exemption.

If a homeowner is contemplating using the “do it yourself” bankruptcy forms, they are probably headed for a rude surprise because they will not be aware of the various state options and considerations as to the exclusions and exemptions of certain assets.

C. Key terms

For the purposes of understanding bankruptcy in the context of foreclosures and short sales, the following key terms need to be learned:

1) Bankruptcy Stay

A Bankruptcy stay is likened to an immediate freeze halting all legal action in an effort to collect money or assets from a debtor. This means that a Bankruptcy filed even less than one hour before the foreclosure auction, serves the purpose of stopping the foreclosure and allowing the homeowner additional time to try to do something else with the house.

2) Motion for Relief of Stay

Creditors, particularly lenders, who are seeking to foreclose on a house will frequently file motions for relief of stay with the Bankruptcy Court in an effort to get the bankruptcy trustee in a Chapter 13 case or the Judge in a Chapter 7 case to agree to let them pursue or restart the foreclosure action. The two most frequent reasons for filing a motion for relief of stay are i) that the value of the house is equal to or less than the amount of the debt owed on the house, therefore there is no equity in the house that can be used to pay other creditors and no other creditor will be harmed if the mortgage holder proceeds to foreclose on the house; or ii) the homeowner has fallen behind in the payment program established in the Bankruptcy Court and as a result of falling behind in

the payment program, protection that they are entitled to in bankruptcy is withdrawn from them and the creditor is allowed to proceed after the asset.

3) Abandonment of assets

In some instances, people who file bankruptcy will discuss with their attorneys the nature of their financial condition and they and their attorneys will agree that the house is worth less than what is owed on the house and they will agree with the Court that the asset should be abandoned which means that they no longer believe there is any value in the asset or home that could be used to pay creditors other than the secured lien holders.

4) Bankruptcy Discharge

Bankruptcy discharge is the Court order at the end of Chapter 7 proceeding or a Chapter 13 proceeding which indicates that all of the debts that were owed by the individual filing bankruptcy have either been paid in full or the individual is no longer responsible for the debt. The debt has been wiped out or discharged.

5) Bankruptcy Dismissal

This term is frequently used in a Chapter 13 bankruptcy because the individual filing Bankruptcy has failed to comply with the regularly scheduled payment program established by the Bankruptcy Trustee, or they have failed to file the necessary information with the Court at the beginning of the process. In this case the Bankruptcy is automatically dismissed and the stay that goes with it is lifted. The legislative reforms that became effective on October of 2005 limited individuals ability to refile bankruptcy if it has been dismissed due to their failure to either file documents or comply with the plan.

II. POTENTIAL TOOLS

A. Bankruptcy is a serious legal event involving usage of the Federal Courts and is not something to be taken lightly; however, certain homeowners may find various strategic

advantages to filing bankruptcy at key times during a foreclosure process. A bankruptcy filing, Chapter 7 or Chapter 13, stops (stays) a foreclosure action even if the bankruptcy is filed just before the foreclosure sale is scheduled to begin. Under the electronic filing system used by all Federal Courts now in bankruptcy cases, there will be a time stamped filing notice from the bankruptcy Court indicating the date, hour and minute of the Bankruptcy filing. This is significant because sales of properties have gone to auction because the auctioning authority was unaware of the Bankruptcy being filed moments before, are null and void.

If the homeowner has relocated to a different state, the Bankruptcy can be filed in the state where they now live and still stop the foreclosure auction on the house even if the house is in a different state thousands of miles away. However, the filing of a bankruptcy



action even though it stops a foreclosure action does not automatically clear the way to do a short sale. Once the house comes under the protection of the Bankruptcy Court, not only does the Bankruptcy Stay stop the foreclosure action, but it also prevents purchase and sale of the property. Therefore, it prevents the bank's loss mitigation department from dealing with the homeowner or someone else to try to negotiate a short sale on the property.

The bankruptcy reform that came into effect October 2005 contained provisions to punish people who had a history of filing Bankruptcies and then allowing them to be dismissed shortly thereafter because it was believed that they were merely doing this to prevent the house from going to foreclosure sale.

B. Appropriate disclosure. Due to the bankruptcy reform legislation that became effective October 2005 whenever dealing with anyone who is in bankruptcy or contemplating bankruptcy, make sure that you have a written disclosure to them stating, " you (or your company) are not a debt relief agency and that you (or your company) do not help people file for bankruptcy relief under the Bankruptcy Laws of the United States or provide Bankruptcy assistance. Any written or verbal statement made by you (or your company) about the subject of Bankruptcy are only

our opinions, since you (or your company) are not Attorneys at Law, you must consult an Attorney at Law to obtain Bankruptcy advice.”

C. PACER, the web site at <http://www.pacer.uscourts.gov/> provides excellent online access to bankruptcy filings. PACER is an incredibly valuable and important tool to anyone doing short sales for the following reasons. You can get information online regarding what is happening in bankruptcy cases involving the properties you are working. You can download Court orders granting motions for the relief of stay, the abandonment of assets letters, so that you can then go forward with purchasing the property. Other ways that PACER can be valuable is that you have insight into all of the assets and overall financial picture of the homeowner. You will also be able to use PACER as a way of skip tracing individuals who have filed for Bankruptcy and abandoned their property. Do not try to deal with a homeowner in a high end property who is in foreclosure without determining what types of bankruptcy they have filed and reviewing everything through PACER. In summary, PACER gives you information. Information is power when dealing with homeowners who are in foreclosure or bankruptcy.

UNDERSTANDING THE OPTION CONTRACT IN CLOSINGS



Several years ago SREC introduced the option contract method as a way to do back-to-back short sale transactions because we saw a need to create a method of completing these transactions that was transparent to all parties.

In the option contract investor short sale method the two closings are done in the following manner. The first transaction which is referred to as the A-B transaction is where the vested party (A) usually the homeowner in default is selling to the optionee/investor (B). The investor who holds the option to buy is the optionee in that transaction. They have the right to go ahead and buy the property provided certain conditions are met.

The term “back-to-back” is a far more favorable term to use rather than the term “simultaneously.” The term “simultaneously” implies funding is being used from the second transaction in the first transaction. This type of “pass through” funding is no longer legal without the written consent of all the parties in the second transaction. Any title agent that is doing that is violating a number of regulations from their underwriter as well as various state and possibly federal laws. Note: another term for this is “dry funding.”

The back-to-back transaction is closed in accordance with the terms set forth in the option contract. The closing occurs between the vested party (A) and the optionee/investor (B) in the A to B scenario. The transaction must be closed and funded before and independently from the second transaction.



It is important to understand that the option that has been recorded is a matter of public record and it needs to be released or removed from the public record in order for the end buyer to receive marketable insurable title or to get it off the record of title. There are two ways of removing that option from the record of title. One is a release and the second is by completion of it. By completing it there is a deed transferring title from the vested homeowner to the optionee/investor.

Title will be transferred from the vested party to the optionee/investor, thus satisfying the option. Then title will transfer from the optionee/investor to the end buyer.

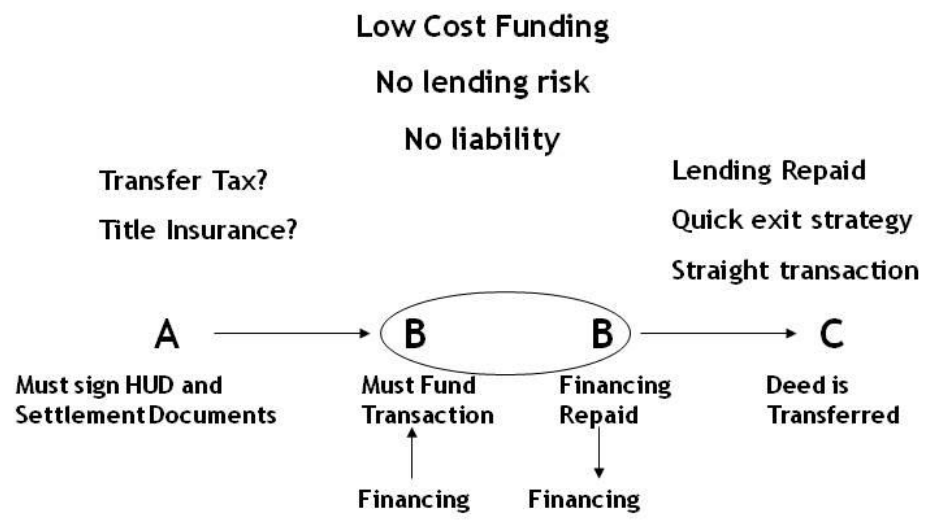
Since title vests for even a few moments in the name of the optionee/investor that party is then able to extract whatever profits they have earned by negotiating the discount and reselling for more.

It is important to understand that the property will be resold by the optionee/investor for an amount less than the original indebtedness owed by the vested homeowner. The B to C sale price must be less than what A owed on the property. When the property is resold by the

optionee/investor for an amount less than what was owed by the vested party there can be no argument regarding mortgage fraud, equity skimming or undue influence of appraisers.

The proceeds used for the A to B transaction are not the funds from the B to C transaction. Each transaction of the back-to-back closing must be an independent stand-alone transaction. In addition to each transaction being an independent stand-alone transaction, each transaction will have its own separate HUD-1 and what is disclosed on the HUD-1 will be the true essence of the deal with the numbers being accurate.

In understanding the transactions it is important to note that subsequent to the A to B closing, the B to C transaction will close and fund, thereby transferring title from B to C. The end Buyer's lender will be funding this transaction. The first transaction will be funded by the Optionee/Investor (B). The diagram on the next page gives a visual overview of this process.



JEFFERY S. WATSON



Jeff has been a full time practicing attorney for the last 18 years, and has an active trial/hearing practice. He and his wife Lorri have been real estate investors since 1994. Their real estate investing experience includes: rehabbing, creative buying, long term holding of numerous rental properties and apartment buildings and handling several short sales in more than one state at any given time. Jeff frequently assists and represents other investors in their deals, negotiations and in litigation. He prepares deeds and other documents for local title company and real estate brokerage.

Jeff has responsibilities and involvement with Realeflow LLC, Loss Mitigation Solution LLC and Strategic Real Estate Coach (SREC) as legal counsel and part owner. He is a frequent guest speaker at various real estate investor meetings.

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