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Introduction

Increasingly, lenders are making loans in amounts that become too difficult for borrowers to repay. Some of these borrowers may not be able to fulfill their mortgage obligations. When a borrower is no longer in a position to make the mortgage payments, is facing foreclosure and the current market value of the property--including escrow costs--is less than the loan on the property, the borrower may consider a short sale. This could save the lender the expenses of foreclosure proceedings and from having another REO property on its books. From the borrower's perspective, the short sale prevents having the foreclosure on the borrower's credit history, and releases the borrower from an obligation that he or she can no longer afford.

In essence, a short sale is a sale transaction subject to a lender's approval in which the lender consents to a sale of the security interest for less than what is owed on the note and accepts the proceeds in full satisfaction of the loan amount. A short sale requires much paperwork and preparation on behalf of the borrower. Typically, before applying for a short sale, the seller must have a ready buyer and all the paper work prepared to present to the lender. The buyer of the property must also be prepared for a protracted time period to conclude the purchase of the property.

I. Lender's Options Upon Borrower's Loan Default

Q 1. What options does a lender have on a debt secured by California real property if the borrower does not make the payments on the loan?

A A lender may foreclose on the defaulting borrower's real property which secures the loan. There are two types of "foreclosures" available to a lender: a trustee's sale and a judicial foreclosure. (*Bank of Italy National Trust & Savings Assoc. v. Bentley*, 217 Cal. 644 (1933).) Technically, a trustee's sale is not a "foreclosure" but the term has been used for both a trustee's sale as well as a judicial foreclosure.

For certain loans, a lender has no choice and must conduct a trustee's sale. With a trustee's sale, a lender cannot go after a deficiency judgment. A deficiency occurs when the current market value of the property is less than the loan on the property. See Questions 3 and 4 for more details.

The lender may also be able to pursue "guarantors" of the debt who have signed written guarantee agreements (not including the borrowers).

Q 2. What other options may the lender consider instead of foreclosure when the borrower is delinquent?

A Depending on the situation, a lender may consider one of the following:

Loan Workout: Basically, a loan workout is any resolution of a problem loan between the lender and borrower that modifies the original loan agreement. Some of these options include forbearance (e.g. forgiving a portion of the debt or late charges); deferment; renegotiating interest rate, monthly payment amount, principal amount, maturity date; or the enforcement an acceleration clause in the loan.

Deed in Lieu of Foreclosure: After the borrower is in default, the borrower voluntarily delivers title to the lender for consideration and the lender accepts the conveyance of the property in full satisfaction of the mortgage debt. Using this method, the lender saves the costs of foreclosure and the borrower avoids having a notice of default on his/her records. (*Hamud v. Hawthorne*, 52 Cal.2d 78 (1959).)

Short Sale*: A short sale is a transaction in which a lender allows the real property securing the loan to be sold for less than the remaining mortgage amount due and accepts the proceeds as full payment of the loan. A lender may accept a short sale when the borrower is in severe financial straits and market conditions make a short sale the best choice to mitigate the lender's damages. Like a deed in lieu of foreclosure, this saves the lender the costs of foreclosure and the borrower avoids having a foreclosure on his or her credit report.

Short Payoff*: With a short payoff, the lender accepts less than the remaining mortgage amount as full payment of the loan. The property need not be sold.

*Note: Some lenders do not differentiate between a short sale and a short payoff.

Q 3. What is a deficiency judgment?

A A deficiency judgment is a judgment obtained by the lender in court against the borrower for the difference between the unpaid balance of the secured debt and the amount produced by sale or the fair market value of the security, whichever is greater, in a judicial foreclosure. (Cal. Code Civ. Proc. § 726 (b).) A lender may obtain a deficiency judgment only with a judicial foreclosure. With a trustee's sale foreclosure, the lender cannot go after a deficiency judgment. See Question 4 for more details.

Q 4. Can a real estate lender obtain a deficiency judgment against a defaulting borrower following foreclosure?

A It depends. California has "anti-deficiency statutes" that protect certain borrowers from deficiency judgments. Under those circumstances, a lender would opt for a trustee's sale foreclosure which is quicker and less expensive than a judicial foreclosure. A trustee's sale foreclosure does not involve the courts. Generally, there are five situations in which a deficiency judgment is prohibited:

1) Purchase Money. If the loan is obtained to purchase a residential 1-4 unit dwelling all or part of which is owner occupied and the loan is secured by that property, the lender may not obtain a deficiency judgment against the defaulting borrower. This loan is entitled to "purchase money" protection. (Cal. Code Civ. Proc. § 580b.) Note, however, that should the buyer refinance the home, the new loan is no longer "purchase money." Thus, the buyer would lose the protection against a deficiency judgment in the event of a default.

2) Seller Carryback. If the purchase money loan for any type of real property is financed by the seller and secured by that same property, the lender/seller may not obtain a deficiency judgment against the defaulting borrower/buyer. (Cal. Code Civ. Proc. § 580b.)

3) Trustee's Sale. A lender may not pursue a deficiency judgment against the borrower should the lender opt to foreclose by a trustee's sale foreclosure (a non-judicial action). (Cal. Code Civ. Proc. § 580d.)

4) 3 Month Time Limit. An action for a deficiency judgment must be brought within 3 months from the time of judicially-ordered sale. (Cal. Code Civ. Proc. § 580a.)

5) Fair Value Limitations. A deficiency judgment is limited by the difference between the amount of the indebtedness and the fair market value of the property, unless the actual sale price exceeds that value. (Cal. Code Civ. Proc. §§ 580a, 726 (b).)

When a deficiency judgment is permitted, the lender may obtain one only following a judicial foreclosure, or when the security has become valueless (such as when security for a second trust deed loan is wiped out when the first trust deed lender completes its foreclosure). Holders of a junior deed of trust (second, third, etc.) should note that if the "wiped-out" junior lien is not purchase money or seller carryback, then the junior lien holder may sue on the note and the borrower on the junior loan may be personally liable. (*Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35 (1963).)

Q 5. Can a lender avoid the foreclosure process and just sue the borrower on the note (i.e., treat it as an unsecured note)?

A No. A lender cannot sue on a debt secured by a mortgage or trust deed except for a judicial foreclosure. This is called the "one action rule" or "one form of action rule." (Cal. Code Civ. Proc. § 726.) One exception to this rule is if the security for the loan has become "valueless" after the lender's security interest was recorded (e.g., a "wiped out" junior lien holder). In this case, the lender can sue directly on the debt (note) unless the borrower's loan falls into category 1) or 2) in Question 4.

Q 6. Why would a lender agree to accept a short sale?

A Lenders may have ample incentive to negotiate a short sale with a distressed borrower. For example, should the lender take back a property pursuant to a foreclosure sale, the lender would become responsible for a variety of costs, including property maintenance, utilities, HOA fees, and might risk destruction of the property by vandalism. Furthermore, lender-owned properties (REO) may take a long time to sell, in part because so many REO properties are now for sale.

A lender will typically evaluate the financial situation of the borrower as well as current market conditions to determine whether or not to agree to a short sale. It is really a business decision for the lender to determine whether it would receive more money by accepting the short sale, or completing a foreclosure, reselling the property, and pursuing personal liability (i.e., deficiency judgment against the borrower and/or claims against guarantors, for loans on which those remedies are available.)

II. Effect On Borrowers of Short Sales

Q 7. *Does a short sale adversely affect a defaulting borrower's credit rating?*

A Yes. Lenders will report the short sale as being settled for less than the full balance. This would show up on the borrower's credit report as a negative mark for seven years. (Cal. Civ. Code § 1785.13.)

Q 8. *Suppose the borrower is late with his/her mortgage payments, causing the lender to begin the foreclosure process by filing a notice of default. Before the foreclosure sale occurs, the borrower pays the lender what is owed on the note. Could these activities appear on the borrower's credit report?*

A Yes. The lender can report to a credit bureau receipt of any payments made 30, 60, 90 or more days after their due date. This may appear on a borrower's credit report as a "foreclosure in process," "foreclosure proceedings," "current was 30," or in some other way. Any such terms, or other similar reporting comments, harm that individual's overall credit rating.

Q 9. *Is the method by which lenders report a short sale a negotiable item?*

A Typically, no. The short sale is usually reported to credit reporting agencies as settled for less than the full balance. However, a borrower may try to negotiate this at the time the short sale is being arranged.

Q 10. *Are there any special risks to borrowers when negotiating a short sale with their lender?*

A Yes. In particular, REALTORS® who assist borrowers should be aware and warn their clients of one particular risk. If the borrower was less than completely honest when using the stated income method in applying for the loan, this information may become apparent to the lender when the documentation listed in Question 17 (such as tax returns and paycheck stubs) are submitted to the lender in the application for short sale approval. This may put the borrower at great risk of potential liability for their dishonesty.

Q 11. *Are there any tax effects of a short sale?*

A Yes. The tax implications for the borrower could be so significant that a short sale would not be in the borrower's best interest. Before a short sale is contemplated, it is strongly recommended that the borrower seek the advice of a professional tax advisor.

Generally speaking, any relief of indebtedness from a short sale, regardless of whether the loan is a recourse or nonrecourse loan, is taxed as ordinary income. There are, however, some exceptions to this rule that may benefit a taxpayer involved in a short sale. For more information on the tax implications of short sales, see the CAR legal article, [Taxation of Foreclosures, Deeds in Lieu of Foreclosure, and Short Sales](#).

III. Licensing Requirements for Short Sales

Q 12. *What is a short sale consultant?*

A A short sale consultant is someone who advises on short sales. Depending on the agreement between the parties involved, the typical short sale consultant assists a homeowner or listing agent to prepare a short sale application package, submit it to the homeowner's lender, and negotiate with the lender on the homeowner's behalf to approve the short sale.

Q 13. *Does a short sale consultant have to be a real estate licensee?*

A Yes. Generally, if a short sale consultant negotiates real estate loans or performs services for borrowers or lenders, both the short sale consultant and the short sale consulting company must be properly licensed with the California Department of Real Estate (DRE). More specifically, unless an exemption applies, a real estate license is required for someone who, for compensation or in expectation of compensation, does or negotiates to do any of the following acts on behalf of another:

- Solicits borrowers or lenders for loans secured by real property;
- Negotiates loans secured by real property;
- Performs services for borrowers, lenders or note holders for loans secured by real property; or
- Collects payments for loans secured by real property.

(Cal. Bus. & Prof. Code § 10131(d).)

To check someone's license status with the DRE, go to its Web site at <http://www2.dre.ca.gov/PublicASP/pplinfo.asp>.

Certain exemptions to the licensing laws may apply. For example, a real estate license is not required if someone merely performs clerical or administrative services, such as assembling a short sale package as long as final determination as to its completeness is made by the broker (see 10 Cal. Code of Reg. § 2841 which lists other permissible clerical activities). For other exemptions to the licensing laws, see C.A.R.'s legal articles, [Licensing Guide for REALTORS®](#) and [Licensing Chart for REALTORS®](#).

Q 14. Can a licensed short sale consultant collect an advance fee?

A No, unless certain requirements are met. An advance fee is a fee charged upfront for services not yet performed. An advance fee is broadly defined to include a fee claimed, demanded, charged, received, collected or contracted from a principal for negotiating real estate loans (Cal. Bus. & Prof. Code § 10026). Among other things, no less than ten calendar days before collecting an advance fee, a real estate broker must submit to the DRE the advance fee agreement and all other materials to be used for advertising, promoting, soliciting, or negotiating the advance fee (10 Cal. Code of Reg. § 2970). Furthermore, if a Notice of Default has been recorded against a property involving one-to-four owner occupied residential units, an advance fee is prohibited for foreclosure-related consulting services under the foreclosure consultant law (Cal. Civ. Code § 2945 et seq.). For a list of real estate brokers who have received "no objection" letters for their advance fee agreements, go to the DRE Web site at http://www.dre.ca.gov/mlb_adv_fees_list.html.

Q 15. If a real estate broker collects an advance fee, does it have to be handled in a special way?

A Yes. A real estate broker who collects an advance fee must deposit it in a trust account with a bank or other recognized depository. Amounts may not be withdrawn for the agent's behalf until actually expended for the benefit of the principal or five days after a verified accounting as specified is mailed to the principal in compliance with Section 2972 of Title 10 of the California Code of Regulations. (Cal. Bus. & Prof. Code § 10146.)

IV. Disclosure Requirements in Short Sales

Q 16. Must a real estate transfer disclosure statement be given to a buyer in a short sale transaction?

A Yes, if the property being sold is a residential 1-4 unit dwelling and the transaction doesn't fall into one of the regular TDS exemption categories. No exemption exists for a short sale transaction in which the borrower sells the property to an outside buyer, using the sale proceeds to pay off the lender. See the C.A.R. legal article, [Exemptions from the Transfer Disclosure Statement \(TDS and MHTDS\) Law](#), for a list of all the exemptions from the TDS requirement.

Q 17. Must other disclosures be given to a buyer (or seller) pursuant to a short sale?

A Yes. Short sales are treated just like any other sales transaction. See C.A.R. legal article, [Sales Disclosure Chart for REALTORS®](#), for a summary of the disclosure requirements.

Q 18. Suppose a distressed seller enters into a contract to sell his/her home to a buyer pursuant to a short sale. Should the listing agent inform the lender if and when other offers are made on the property?

A Probably. Although the lender is technically not a party to the real estate contract, lender approval is nearly always a contingency of the agreement. Therefore, REALTORS® should obtain the client's permission to keep the lender apprised of any relevant developments, including the presentation of other offers.

Q 19. *Should a listing agent working with a distressed seller attempt to negotiate a future listing agreement with the lender?*

A No. Listing agents working with distressed sellers owe them a fiduciary duty. Since in a short sale situation a lender could choose to foreclose on the seller, the lender's interests are potentially adverse to the seller's interests. Attempting to negotiate a future listing agreement with the lender raises the issues of "to whom is the agent's loyalty devoted" and "has the agent violated the fiduciary duty he/she owes the seller." The safer practice is to avoid putting oneself in such a position.

V. Short Sale Application Process and Other Issues

Q 20. *What is the process for applying for a short sale?*

A It is always in the best interest of the borrower to keep the lender informed. If the borrower is in default of the loan and is contemplating a short sale, it would be best for the borrower to let the lender know before the foreclosure proceedings are well under way. The lender may or may not grant more time to the borrower to find a buyer. In general, the process goes as follows:

- First, the borrower must find a buyer for the property.
- Second, the borrower must prepare all the necessary documents (See Question 17).
- Third, the borrower must submit all documents to the lender.
- Fourth, the lender will send out their own appraiser to make sure that the buyer's offer is at fair market value.
- Fifth, the lender will make a determination on whether or not to agree to the short sale.

Q 21. *What documentation will a lender typically require?*

A Lenders will typically require a distressed borrower to furnish a variety of documents, which could include the following:

- Written explanation (and proof) of the hardship the borrower is experiencing;
- Copy of the purchase contract signed by both the buyer and seller (borrower);
- Copy of the TDS;
- Proof of the buyer's ability to purchase the property, i.e., a completed loan application, pre-approval by another lender, or evidence of cash on hand (bank statement);
- Copy of the certified escrow instructions;
- Preliminary title report;
- Estimated net/closing statement certified by an escrow officer acceptable to the lender;

- Completed and signed IRS Form 4506, "Request for Copy of Tax Form;"

- Completed and signed personal financial worksheet;

- Previous two years tax returns;

- Employment paycheck stubs for the past two months;

- Profit and loss statement (if the borrower is self-employed);

- Past three months bank statements.