



Barnes Walker & Goethe, Chartered
3119 Manatee Avenue West, Bradenton, Florida 34205
Ph: (941) 741-8224; F: (941) 708-3225

SHORT SALE AND FORECLOSURE TIPS FOR BUYERS & THEIR REALTORS®

A. PREFACE

This article covers the legal aspects of purchasing a home *from a buyer's and a selling Realtor's® perspective* in a down housing market when sellers are involved in short sales or foreclosures of their homes. Thus, this article provides some legal points and the practical aspects *for buyers and their Realtors®* to consider in purchasing a home that is a part of a short sale, a foreclosure, or simply a good buy in the current market.

Importantly, this article is also designed to be an *upbeat handout* for you to give to potential buyers who need a home, but are worried about whether now is the time to buy. It also emphasizes to buyers *the need to have a Realtor®*, particularly in this market.

B. SHOULD I EVEN CONSIDER BUYING A HOME IN THIS “BAD HOUSING MARKET”?

Almost every form of media, including print, broadcast, and the internet, refers to the current housing market as being “bad,” or even worse. We think everyone needs to consider that the media knows “bad news” sells newspapers and magazines and increases audiences and ratings for news shows and articles. As a result, media outlets in general seem to be focusing only on one side of the housing market – the sellers’ and landlords’ side.

Basic economics, however, tells us there are two sides to every financial market. What about the buyers’ and tenants’ side? The housing market may be bad for sellers and landlords as far as decreasing prices and rents and increasing difficulty finding buyers or tenants for their homes because of the large number of homes on the market. The market, however, is actually good in general for buyers and tenants who need homes at cheaper prices or rents, although, for buyers, lenders have higher standards for making home loans than in previous years. As basic economic principles tell us, in general, an increased supply of a product (a home) decreases its price or rent, and a decreased demand (fewer buyers) also decreases a product’s price or rent. This is the current condition of the housing market for buyers, sellers, tenants, and landlords in Manatee and Sarasota Counties.

Therefore, if a person or couple wants or needs a new home (including a condominium unit), we believe now is the time to act. In deciding whether to buy versus rent, potential buyers need to compare the costs of buying versus the costs of renting. Some of these costs are set forth below:

Purchase Costs

1. Initial down payment (3%–20% of the price) plus closing costs to purchase the house and obtain a mortgage loan. (There are, however, some programs and means, other than buyers' savings, to help pay the down payment.) *versus*
2. Monthly mortgage loan payments, each of which:
 - (a) pays off a portion of the home; and
 - (b) is deductible on the buyer's income tax return as to the portion of the payment that is interest.*versus*
3. Other monthly payments, including those for water, sewer, electric, telephone, cable tv, internet, insurance, real estate taxes, and HOA or condominium dues. *versus*
4. Payments for repairs, replacement of items, and maintenance of homes. *versus*
5. The offset for some or all of these costs for homeowners is the historical, long-term appreciation in their home's value. However, if an owner has to sell during a price drop, as in the current market, the owner may suffer a significant loss despite long-term appreciation. *versus*

Rental Costs

1. A security deposit (and maybe the last month's rent), which, however, is refundable or usable by the tenant if the tenant meets the lease terms. (We are not aware of any programs that assist a tenant in paying a security deposit.)
2. Monthly rent payments, no portion of which can normally be used to purchase the rental home and no portion of which are deductible. However, one must remember that rent payments have decreased along with house prices as homeowners who could not sell their houses then offered them for rent.
3. Same, except the tenant can often depend on the landlord paying for insurance and real estate taxes and can sometimes, particularly in the cases of apartment complexes or condominium units, count on the landlord paying one or more of the following: water, sewer, cable tv, internet, and dues.
4. Typically none.
5. There is no such positive offset for tenants since they do not own their homes, but the tenant also does not run the risk of loss from the sale of the home. At the termination of the lease, the tenant can simply leave.

Prior to the current market, the preceding cost analysis between purchasing and renting a home would typically indicate that one should buy rather than rent, but do not be surprised if your analysis, given current costs, indicates just the opposite. As a part of this cost analysis, however, one must also consider whether the costs and appreciation discussed above will increase or decrease in the long term, and not just rely on their current levels. While no one can predict what the housing market will do in the future, historically – and, we believe, even now – long-term analysis has and will continue to indicate that, for many potential buyers, buying a home (with continued ownership) is more economically rewarding than renting one.

Even if the preceding analysis indicates that a buyer should purchase a home rather than rent one, that same analysis should not be used in determining whether to purchase a second or vacation home or an investment rental house. The analysis of whether to purchase these homes is very different from the one used to decide whether to purchase a primary residence. First, a person does not have to purchase a second, vacation, or rental house – the person already has a primary residence to provide him or her with shelter. Therefore, all of these house purchases are optional and carry initial costs and monthly costs that a buyer

does not *have* to incur. If a buyer wishes to purchase such a home, the buyer, to be conservative and absolutely safe, particularly in the current market, should have sufficient surplus income to cover all of these costs, whether or not the buyer intends to rent the house. In the current market, there seems to be a surplus of houses to rent and a decrease in rents, so rental house owners cannot be assured of obtaining a tenant or, if they do, of receiving the amount of rent that they need to cover the rental house's expenses and any mortgage payments.

C. I HAVE DECIDED TO BUY. WHAT DO I NEED TO KNOW ABOUT "SHORT SALES"?

A "short sale" is a transaction in which the price agreed upon by a seller and buyer for the sale of a home is less than the total amount the seller owes on his or her mortgage loan (and there may be more than one loan), and the seller cannot pay the lender (and, again, there may be more than one) the remaining excess owed on the loan. Thus, the seller must obtain the lender's consent to the sale and a release of the lender's mortgage lien. The seller typically has to provide to the lender a substantial amount of personal financial information and a copy of the real estate contract executed by all buyers and sellers. The lender typically takes 60 – 90 days and often longer to process all of the information and the request for approval. If the lender agrees, the lender may or may not forgive the seller's repayment of the unpaid balance of the loan, but that is of no concern to the buyer, since the lender is consenting to the release of the home from its mortgage lien. If the lender does not agree to the sale and the release of the mortgage lien, the short sale will fail, unless the buyer increases the price to an amount acceptable to the seller's lender.

Thus, in a short sale, the buyer risks spending a lot of time waiting for the lender's answer and then, if the lender does not consent, being unable to purchase the home at the original price. This risk increases if there is more than one lender, since only one lender has to object for the short sale to fail. Further, if the seller has subordinate mortgage or judgment holders who foreclose on the home, or if the seller has so many other creditors that the seller files bankruptcy, the short sale will also probably fail due to the additional loss of time and extra expense caused by these adverse legal actions against the seller. Finally, the buyer will often lose the interest rate "lock" on the loan that the buyer has obtained to purchase the home while waiting on the seller's lender to approve or disapprove the short sale. If interest rates are decreasing, loss of the rate lock is not a problem in that the buyer can simply "re-lock" at a lower interest rate, but, if rates are increasing, a re-lock will increase the buyer's interest rate and loan payments.

On the other hand, if a short sale is successfully completed, the buyers may be able to purchase their "dream home," which they otherwise could not have afforded or for less than they otherwise would have paid. Why? Lenders often agree to a low price despite the loss on their loan, which the low price will cause them to incur, because:

1. There is a glut of homes on the market and buyers are hard to find;
2. Their other alternative—foreclosing on the home—is expensive, requiring payment of attorneys' fees and court costs;
3. Sellers who are being foreclosed on are unlikely to maintain the home or pay HOA or condominium dues or real estate taxes, all of which the lender will have to pay;
4. Once the lender has foreclosed and owns the home, the lender will have to pay a Realtor® a commission to sell the home and pay closing costs typical for a seller; and
5. During the long period of time it takes to foreclose and sell the home, the lender is not being paid any interest on the defaulted loan, and the home may continue to lose value.

In other words, the lender may decide to "cut its losses" and accept a short sale with a low purchase price.

Given the potential risks and rewards of a short sale, a buyer should consider the following approach in deciding whether to attempt to purchase a home through a short sale. First, the buyer and the buyer's Realtor® should look at all other homes of the type the buyer prefers and in the price range the buyer can afford, then look at the homes being short-sold. If the buyer and the buyer's Realtor® believe that a home being short-sold is more desirable, of better quality, and/or larger than other homes on the market, and that the short-sale home can be purchased through the short sale process at the same or a lower price than the other homes, they may wish to engage in the short sale process, the potential rewards being greater than the risks.

Second, if the buyer and the buyer's Realtor® decide to pursue a short sale, the buyer should be aware that most real estate contracts for short sales require the buyer to take the home in an "AS IS" condition. At the very least, however, the contract should allow the buyer to inspect the home and have the alternative, after this inspection, to terminate the contract and receive a return of the buyer's deposit if the home requires too many repairs in its current state. Some buyers, however, have been able to negotiate a certain maximum amount to which a lender is willing to consent for needed repairs or buyer closing costs.

Third, it is important that an addendum be added to the real estate contract that prohibits the seller or the seller's Realtor® from submitting any higher priced contract for the home until the seller's lender has approved or disapproved of the buyer's contract. Further, the addendum should require that, if the seller signs any other higher priced contracts, these contracts should state that: (1) they are "backups" or subordinate to the buyer's contract; and (2) the other buyer and that buyer's Realtor® are prohibited from submitting that contract to the seller's lender.

Finally, the buyer should obtain pre-approval for the buyer's mortgage loan, and this status should be communicated to the seller and the seller's lender. Further, the buyer should be willing to make a significant deposit (for example, 5% at lower purchase prices and 2% at higher prices). These actions do not cost the buyer anything, but should send a message to the seller's lender that, if the lender approves the proposed short sale, the buyer will be financially able to close the purchase of the home. Given the failure of many title companies in this area, the buyer and the buyer's Realtor® should be certain that they select a real estate law firm like Barnes Walker & Goethe, Chartered, to hold the buyer's deposit as escrow agent, so that the deposit will not be lost in an insolvency or tied up in a bankruptcy case.

D. I HAVE FOUND MY DREAM HOME, BUT IT IS BEING FORECLOSED ON, AND THE LENDER IS NOT CONSIDERING SHORT SALE CONTRACTS. WHAT DO I DO?

If the home is truly a buyer's "must-have dream home," then the buyer should not wait until after the foreclosure sale to try to purchase it because another buyer might buy the home at the foreclosure sale, or, if the lender submits the high bid and becomes the owner, another buyer might offer the lender more for the home when the lender offers it for resale. If the buyer is willing to pay some additional attorney's fees, there are three alternatives:

1. The buyer could simultaneously: (a) purchase the home from the seller (for a nominal amount and subject to the lender's mortgage loan); and (b) negotiate with the lender to pay off the mortgage loan at a discounted amount.

2. The buyer could negotiate to purchase the first lender's mortgage loan, again, at a discounted amount, and then complete the foreclosure. While neither of these alternatives is very common, we would be happy to discuss the risks and advantages of these methods with you in more detail.

3. The buyer could wait to bid on the home at the foreclosure sale and hope to outbid the lender. This alternative, which is the most commonly asked about of the three, is subject to the risk that the foreclosure

sale may be preempted by another buyer using one of the two methods described above. On the other hand, this third method does prevent the scenario where the lender bids unopposed at the foreclosure sale and then resells the property to some other buyer. A buyer wishing to use this method should contact the foreclosing lender and the lender's attorney in advance and tell them that the buyer plans to bid at the foreclosure sale *if* the lender agrees not to bid the entire amount the lender is owed. This amount – which includes the full principal balance, all interest owed (much of it calculated at 18%), late fees, and the lender's attorney's fees and court costs – would probably far exceed the value of the home in today's market. Since the buyer must outbid the lender to buy the home, if the lender bids this amount, the buyer could easily end up paying more than the home is worth. The lender, though, may be willing to lower its bid. After all, if the lender outbids the buyer, the lender will end up with the home and all the costs associated with maintaining and reselling it. The lender might not, however, agree in advance to a particular bid amount, because the lender may hope that other bidders will be at the foreclosure sale. There may even be a little bidding war between the lender and the buyer, with the lender attempting to be paid as much as possible. The buyer should keep in mind, however, that the ultimate goal of the lender is to rid itself of the home, not to keep it. If there are no other competitive bidders present, the buyer can warn the lender that the buyer is nearing or has reached the buyer's limit. To make a foreclosure bid work, the final, big hurdle that the buyer must be able to clear comes from the rules regarding foreclosure sales, which require the high bidder: (a) to pay \$1,000.00 to the Clerk of the Court immediately at the time of bidding; and (b) to pay the Clerk the balance of the amount bid by cashier's check or wired funds *by the end of the day of the foreclosure sale*.

In addition, all of these alternatives require that a prudent buyer, before taking any action, hire an attorney to conduct a title search. In the first alternative, the buyer will take the home subject to having to pay any other liens against the property and pay any additional parties who may have an ownership interest in the home, so the buyer needs to know what liens and other potential owners are out there.

In the second and third alternatives, the buyer will also have to pay any other owners and subordinate mortgage, judgment, and tax lienholders, *if the foreclosure suit did not properly include all of these owners and lienholders as defendants*. Identifying these owners and lienholders requires a proper and comprehensive title search by the foreclosing lender. If the title search is not properly conducted or the foreclosure not properly handled, the buyer will take title to the home subject to the rights of any undiscovered lienholders and other owners who may come forward after the foreclosure sale. Unfortunately, we have come across a number of foreclosures that were deficient and did not properly foreclose out and terminate all of the owners or subordinate lienholders. Thus, prudent buyers should have their own attorney conduct an independent title search.

E. I AM BUYING FROM A LENDER WHO PREVIOUSLY FORECLOSED OUT THE OWNER. SHOULD I HAVE ANY CONCERNS?

This situation presents fewer concerns and risks than the three scenarios described above. However, buyers of bank-owned properties will continue to face some challenges. For example, the lender may wish to sell the home to the buyer "AS IS," with all the attendant risks of the buyer having to pay subsequent repair costs. If the price is low enough, however, a buyer may find these risks acceptable or more than acceptable.

These sales are typically conducted in the same way as any other real estate closings, with the buyer receiving a warranty deed or special warranty deed and a title insurance policy. This policy should protect the buyer against all title defects and any mortgages, judgments, taxes, or other liens filed against previous owners, *unless the policy contains exceptions for these items*. A prudent buyer will therefore retain an attorney to review the real estate contract prior to signing it, and should ask the attorney to ensure that the

contract requires such a deed and title policy, along with any other requirements or protections the buyer needs.

Prior to closing, the attorney should also review the title insurance policy for any exceptions and examine the deed and other documents prepared for closing to determine whether they meet the contract's requirements.

Given the defects we have found in certain foreclosures, a prudent buyer should also insist that the buyer's own attorney provide the title insurance and conduct the title search. As part of the title search, the buyer's attorney will have to determine whether the foreclosure process was properly conducted and was comprehensive in foreclosing out all lienholders and owners. If a defect is found before closing, the buyer can require the lender to correct and remove the defect, at the lender's expense, before the buyer pays for the home. While the title insurance policy should reimburse the buyer for all claims and expenses that might arise from undiscovered defects in the foreclosure process, buying a home with such a defect, although covered by insurance, is much like knowingly buying a car that is a lemon because it is still under warranty. Despite the warranty, does any car owner really want to go through the multiple repairs and hassles needed to fix such a car, which may not even be totally fixable?

F. I AM CONFUSED. SHOULD I CONSIDER HOMES THAT ARE NOT BEING SHORT-SOLD OR FORECLOSED?

Absolutely, buyers should consider these homes. As a Realtors®, you know that, if sellers want to maximize their chances of selling their homes, they have to be competitive and lower their prices to be at or below the levels of homes that are being purchased through short sales and after foreclosures. Sellers who have appropriately lowered the price on their home should be able to sell that home to a buyer faster than the buyer could purchase a home through a short sale or foreclosure. Also, the buyer should incur less attorney's fees in this type of purchase, since it is a standard transaction.

A buyer is forewarned, however, that many selling homeowners, despite the advice of their Realtors®, still tend to overestimate the value of their homes, even in markets like this one. This is another reason why buyers in this market should: (1) use a Realtor® to assist them in valuing the homes they are interested in purchasing, and (2) consider short-sale and foreclosure homes.

If you would like more information about these topics or how the law may apply to your buyer's specific case, please contact us at 741-8224.

Sincerely,

Garret T. Barnes

Adron H. Walker

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** The information contained in this letter and in any examples is summary in nature and is given for educational purposes only. It is not intended as specific or detailed advice, as we do not have any information specific to your situation, including whether you are in the market for a new home, and, if you are, your financial and credit standing, time goals, price range, home size needs, etc. You are receiving this information solely as a friend or past client of Barnes Walker & Goethe. Always seek legal counsel or advice regarding your own, unique situation.*

**ADDITIONAL INFORMATION REGARDING SECTION D:
BUYING A HOME WHEN A FORECLOSING LENDER WILL NOT CONSIDER SHORT
SALES**

As described in Section D of the above article, there are three alternative methods to use in a scenario in which the lender is not considering short sale contracts. Because alternatives 1 and 2 in Section D are rarely used, we did not include an in-depth discussion of the special risks and challenges buyers face when using them. If a buyer asks for more information on either of these alternatives, these are some additional points to discuss with that buyer:

1. The buyer could purchase the home from the seller subject to the lender's mortgage loan and then negotiate with the lender to pay off the mortgage loan.

- The buyer should offer the owner a very nominal price, since the owner would lose the home and receive nothing after the foreclosure was completed, anyway. The owner, however, will want something for cooperation and may try to obtain some protections from the buyer against any portion of the mortgage loan that is not repaid, since it is still the owner's obligation to repay that amount.
- The buyer should simultaneously attempt to negotiate a payoff of the loan with the lender that is less than the full amount owed. If the buyer cannot negotiate a lower payoff, the buyer will probably end up paying more than the home is worth, since many homeowners being foreclosed on owe more money on their homes than the homes are worth.
- The lender may also deduce that the buyer is anxious to own the home, since the buyer is trying to purchase it from the owner. This may embolden the lender to hold out for a higher payoff.
- This procedure will not work if there are subordinate mortgages, judgment liens on the home from other unpaid creditors of the owner, or unpaid tax liens, unless the buyer is somehow able to pay reduced amounts on these debts in exchange for lien releases.
- Since this is the most complex of the alternatives, the buyer will also pay more in attorney's fees.
- The buyer should be warned that unless the buyer is careful, this method can easily result in the buyer paying more for the home than it is worth.

2. The buyer could purchase the first lender's mortgage loan and complete the foreclosure.

- From a lender's standpoint, the sale of a mortgage is financially the same as a payoff of a mortgage, so the buyer would again have to attempt to negotiate the lowest price for the mortgage, just as if he was negotiating a lesser payoff.
- This alternative eliminates the buyer from having to deal with the owner or any subordinate mortgage, judgment, or unpaid tax lienholders (except real estate tax lienholders) because they will all be foreclosed out and their various mortgage, judgments, and tax liens terminated. The buyer will, however, have to pay an attorney to complete the foreclosure process and to do so properly.

- A buyer using this alternative risks being outbid by a second buyer at the foreclosure sale. In that case, though, the second buyer would have to offer a bid equal to or exceeding the first buyer's foreclosure judgment, which, in turn, would equal all the monies and costs the buyer had expended. The first buyer would therefore be paid this amount from the second buyer's bid monies to satisfy the foreclosure judgment. Thus, the first buyer would not lose any money, just the home. From the information that we have, there are currently very few outside bidders at foreclosure sales, so it is unlikely that a buyer would be outbid at a foreclosure sale, especially when a significant amount of money is owed to the foreclosing lender (being the buyer in this case).
- Given the cost of foreclosure, this alternative is the second most expensive alternative in terms of attorney's fees.