

Weekly Insight 6-16-2010

Now there is a Short Sale Jail!

I just got back on the red-eye from Los Angeles after an Alaskan cruise. I caught fish, found gold dust in a stream and even sent a King Salmon back to have for dinner. While in our hotel before the flight back, Nan gave me an article from the Seattle Times. I am going to quote parts of the article in some places, so there is no misunderstanding, because now there is a Short Sale Jail.

I have been saying for a couple of years that short sales can have legal problems with non-disclosure and what I believed to be bank fraud in certain deceptive practices about influencing the BPOs that has been taught by national gurus. My drum beat has fallen on deaf ears because the few who do short sales successfully were banking the profits and probably calling me an idiot for trying to get them to change how they do their short sales.

Here is how the article from *The Bloomberg News* by *John Gittelsohn* as reprinted in the Seattle Times started – “Two Connecticut real-estate agents found a way to profit in the U.S. housing bust: Buy low, sell fast. That tactic was also illegal.” Sounds like good old fashioned real estate investing, but read on.

The article gave the names of the agents and that they have **pleaded guilty to fraud** and will be sentenced in Hartford’s federal court in August. The article went on to say that, “Their crime involved persuading lenders to approve the sale of homes for less than the balance owed – known as a short sale – without disclosing there were better offers. They then flipped the property for a profit.”

A statement from the loan servicing manager of Regions Bank who was involved in the short sale as the seller’s lender, said “It’s just that criminals are always trying to find ways of profiting.”

The realtors didn’t use transactional funding or option contracts as are so common to close a short sale and flip the property. They actually closed on the property and eight weeks later sold the property to an end-buyer. The problem was that the selling lender felt the property value was understated and that the buyer should have purchased the property directly from the homeowner at the higher price. In the seller’s lender’s mind, the value of the property (FMV) was much higher than the short sale price they accepted.

What was the crazy profit the realtors/investors made? They bought and closed on the property for \$102,375 and resold it (again 8 weeks later) for \$132,500 for an “unconscionable” gain of \$30,125. Hum, sounds like more than a few of the purported profits short sale gurus advertise to their students.

The first question that should be asked is, “How does the lender know that \$102K isn’t a fair market value?” Only with hindsight, and a buyer who paid more, and assuming no BPO or appraisal frauds, can they claim that they should have gotten more money. The lender did just that by asking and getting a criminal investigation.

I think every lender should do their own due diligence by getting at least two BPOs from different agents, and the Fed should require the lender spend a couple hundred bucks and get a real appraisal. The lender’s cheapness of paying less than \$75 for BPOs, versus \$300 for an appraisal, has caused much of their problems in this area. Even with a FMV for the property, it doesn’t mean the property will sell anywhere near that price. Why don’t these lenders finance these prices if they believe in them so much? They know better!

Still we as investors are in the cross-hairs of the legal actions that are to follow. The beauty of our business for us and investigators is that we have an audit trail in the transactions which can be reviewed for years to come. Exactly how long depends on the statute of limitation for each state – somewhere between 3 and 20 years.

You have to make a conscious decision about what is the right thing to do if you are doing a short sale. The reporter for this article Googled “How to influence a BPO” and got back over 74,000 sites. Influencing the BPO is standard practice to get the lowest possible price to make a profit. Unduly influencing the BPO is criminal fraud, and the fine line between them is in the eye of the beholder and with hindsight by the bank or the end buyer.

Every time an investor talks to me about doing short sales I explain my position, “I like low hanging fruit without legal complications.” The guru who got them into short sales has almost a hypnotic power over them because the investor goes on to argue with me that the guru is doing these deals and wouldn’t be if they were illegal. I disagree because he may not have been prosecuted just yet.

The investor is influencing the BPO locally and is the one on title for that fraction of a second that the transactional funding covered or when the option contract is exercised. Remember, the couple above carried the property for 8 weeks (open market risk and loss of the “supposed buyer”) and still got in trouble. So how do you think a couple of minutes of ownership would sound to a judge and jury? How many buyers would be OK knowing that the investor made a 30% profit on the deal above? They all would until they realized they could have bought it for less – hindsight is always perfect vision!

So here is a simple solution to the problem when there is not a cash buyer for a short sale property. This simply means an end-buyer must get conventional financing for the purchase, so clearly just treat the lender as you would like to be treated. Well, since the lenders got the country into this mortgage crisis we know

they can't be trusted, so treating them as you would like to be treated isn't going to work.

What needs to be done, and many short sale specialists are doing, is full disclosure to all parties involved. These parties include the homeowner, the homeowner's lender, the buyer and the buyer's lender, the closing agent and you as the investor. This document would need to disclose how much profit you would be making, where your funding money was coming from and that all parties agree.

What are the chances of this perfect agreement being signed, probably less than zero! Knowing this, it brings up the point that if everyone isn't willing to agree, then there exists a potential liability later that one or more parties claim unfair business practices, undue influence and, of course, fraud. Unfortunately, the state or the Fed will do the prosecution so no one but the investor has attorney's fees to worry about. Later will come the civil lawsuit by the buyer if the investor has any money left.

Here is another interesting obstacle to consider – where did the buyer come from, the MLS or somewhere else? This may make a critical difference, but your position is more difficult to explain if the buyer came from the MLS. This is because the price history will show what you purchased it for and when. If the buyer has a buyer's agent or the buyer's lender checks the MLS (as he should) your deal may be dead.

This is why the lenders have seasoning periods to avoid flipping properties – lenders get bent out of shape when they check to see the transaction history of the property months later that it was resold for 30% more. They have to ask themselves, "What are we paying our seller's agent for if not to get the highest price?"

I am sure to draw all types of criticism from short sale gurus about this article, but I wrote it with all investors' best interests in mind. The gurus are not on the front lines and will likely not be prosecuted for fraud as will the lowly investors who do the deals. As I mentioned in a former Weekly Insight, I was told by one of these gurus that he made his money on his monthly membership fees rather than from actually doing deals.

For you who want the full article, it came from The Seattle Times, June 13, 2010 in the Real Estate Section and was called "Flipping houses turns into 'flopping'". The original source and author as mentioned above is *The Bloomberg News* by John Gittelsohn.

Be careful out there and don't let your common sense be overcome by a sales pitch and your personal need for money. Just because it hasn't happened to you doesn't mean it won't.

To your limitless success,

Dave Dinkel