

## Understanding Short Sales

### Part I - Seller's Perspective

By John Stemplar, Sage Real Estate Advisors, LLC

Some homeowners have a mortgage balance that exceeds their home's value. In these situations, and where the owner is unable to make the mortgage payments, a *short sale* may offer an alternative to foreclosure that benefits both the homeowner and the lender. A short sale is not always viable; in most cases, it is a complicated, adversarial and drawn-out process. For a seller, a successful short sale requires an understanding of the short-sale concept, as well as skillful management of the process.

#### Short Sale Defined

In real estate terminology, a *short sale* is the sale of a home for less than what is needed to pay off the mortgage, after the costs of the sale. In a short sale, the mortgage lender agrees to release its lien for less than what is owed on the loan so that the property can be sold with clear title. The lender may or may not also agree to forgive all or part of the difference between the loan balance and the short-sale proceeds (known as the *deficiency*). A short sale is often more attractive to a lender than having to foreclose.

#### Short Sale Versus Foreclosure

A *foreclosure* is when a mortgage lender forces the sale of a home in order to pay the delinquent loan. If the property cannot bring a price higher than what is owed, the lender will purchase it for an amount equal to the loan balance. The foreclosure sale extinguishes any junior liens on the property, and the lender (now the owner) is able to market the home for sale with clear title. Foreclosed homes appear on the market as "foreclosure" or "lender-owned" properties.

A key distinction between a short sale and a foreclosure is that in a foreclosure, the lender takes title to the home and then must sell it to recover as much of the loan as it can (usually pursuing the borrower for the deficiency). In a short sale, the home is sold by the borrower, with the lender's agreement to release the mortgage for the net sale proceeds, which are less than the loan balance (possibly agreeing to also forgive all or part of the deficiency).

#### The Advantages of a Short Sale

From a homeowner's perspective, a short sale is preferable to a foreclosure. Because a short sale is, in effect, a *negotiated settlement* of a debt, it typically has a less adverse impact on the borrower's credit rating than a foreclosure. Further, to the extent a short sale is more attractive to the lender (and it often is), the homeowner has some leverage to employ in negotiating forgiveness of the loan deficiency.

In the case of a troubled mortgage loan, the lender's objective is to maximize its recovery / minimize its loss. A mortgage lender will consider a short-sale strategy where foreclosure is otherwise inevitable. From the perspective of the lender, a short sale avoids having to take title to the property through foreclosure. This, in turn, allows the lender to avoid the substantial time, cost and risk associated with acquiring, owning and selling the property.

#### Qualifying For Short Sale Approval

In considering a short-sale strategy, understand that lenders are not in the business of doing favors; the lender will attempt to get as much of the loan repaid as possible. A lender's initial response to a short-sale request will often be an attempt to *restructure* the loan. Accomplishing a short sale requires

*selling* the strategy to the lender as the best way for the lender to minimize its loss. From a lender's perspective, a short sale will make economic sense where all of the following apply:

- It is unlikely that the owner will become current or stay current on payments
- The loan balance clearly exceeds the property's value
- The owner has no assets from which the lender can recover a foreclosure deficiency
- There are few, if any, other mortgage lenders or lien holders

Short sales are most often approved when the lender believes that foreclosure is otherwise imminent and when a short sale represents the best chance to minimize its loss on the loan.

### The Short-Sale Package

Most lenders have a checklist of what they require in order to consider a short-sale request. All *Short-Sale Packages* will require borrower financial information, including tax returns, bank / investment account statements and pay stubs. An important part of the package is a compelling *Hardship Letter* explaining why the borrower can no longer afford to make the mortgage payments. The package should also include a letter authorizing the lender to speak / negotiate directly with the listing agent.

The most important part of the Short-Sale Package is a contract for the purchase of the home. While the mortgage lender is not a party to the contract, the contract is contingent upon the lender agreeing to release its mortgage for less than full repayment of the loan. The lender will typically require certain contract modifications, as well as a brokerage commission concession, as conditions to its approval.

A market analysis provided by the listing agent, along with an independent *Broker Price Opinion*, will indicate the value of the home. A *net proceeds calculation* – contract price less all costs, pro-rations and commissions from the sale – will show what is available to apply toward the mortgage debt. The lender will consider the market value of the home relative to the contract price and the anticipated net proceeds in determining whether or not to consent to the proposed short sale.

### Second Mortgages and Other Liens

In a foreclosure, a second mortgage and other liens are automatically extinguished, enabling the first mortgage lender to sell the property with clear title. With a short sale, however, the first mortgage lender must typically negotiate payments to second mortgagees and other junior lien holders for agreement to release their liens so the short sale can occur. The more liens on the property, the more difficult it is to make short sale work. At some point, it makes more sense for the first mortgage holder to just foreclose.

### Quality Real Estate Representation is Critical

Experienced, knowledgeable and competent real estate representation is critical to successfully pursue a short-sale strategy. The right agent can help determine if a short sale is, in fact, the best course of action and assess the likelihood of its success. Beyond simply marketing the property for sale, the agent should fully understand lender processes and be adept at packaging and *selling* the deal to the lender. At all times, the agent should be focused on promoting and protecting the seller's interests, particularly as it relates to forgiveness of the deficiency.

### Obtain Legal and Financial Advice

A short sale will likely have negative financial consequences, relating to the loan deficiency, credit score and possibly income taxes. Before initiating (and in pursuing) a short-sale strategy, a homeowner should obtain legal and tax advice from qualified professionals.