



Update to DRE Issued Consumer and Industry Alert(s) Regarding Short Sales Fraud, and Related Issues

Several months ago, the California Department of Real Estate ("DRE") issued a publication on residential Short Sales which provided an overview of the practice area, and a warning to the real estate industry about legal and ethical minefields and the growing fraud in this area. The publication also discussed and pointed out certain egregious and unlawful practices of short sale flippers, and it was followed by a DRE Consumer Alert on Short Sale transactions.

Unfortunately, Short Sale fraud is growing, and it too often seems that licensees and those counseling licensees may wrongly conclude that unlawful or questionable practices "cannot be bad" because "everyone is doing it." Licensees must understand that fraudulent and unlawful practices will invite disciplinary action by the DRE and possible civil and criminal liability.

This DRE Short Sales update is written on the growing, questionable, and sometimes unlawful practice of short sale negotiators ("SSN") requiring/compelling Buyers to pay the SSN's fee.

The DRE will publish and disseminate additional updates as necessary and appropriate to protect the public and to inform its licensees of practices that are problematic, questionable and/or unlawful.

Discussion

Many brokers have noticed and reported a sharp increase in the number of Listing Agents and SSNs who are requiring that Buyers pay the SSN's fee. The Buyer's agents are sometimes told (either in the Remarks Section of the MLS and/or in a pre-sale instruction sheet) that Buyers must sign a special Addendum created by the SSN in which the Buyers agree to pay the SSN's fee if they intend to present an offer.

Buyer's Agents may also be told that their clients' offer will not be presented if the Buyer does not agree to sign that SSN Addendum and include it with the offer. If the requirement for the Buyer to pay the SSN fee is being driven by the Listing Agent and/or the SSN¹, and is really not a requirement of the Seller, there is potentially an ethics violation and a breach of the Listing Agent's fiduciary duty to the Seller by stifling and limiting the presentation of legitimate offers.

¹ The SSN is (or must be), unless exempt under very narrow statutory exemptions, a California licensed real estate broker. See sections 10130 et seq. of the California Business and Professions Code, for the licensing requirements and the exemptions. Also, see the discussion in paragraph (c) below.



One version of this scenario is where the Buyer is told that he or she “must” request a credit for non-recurring closing costs (“NRCC”) (the NRCC is typically 3%) as part of the Buyer’s offer with the understanding that the Buyer will use that money to pay the SSN’s fee as well as any other party who is not satisfied with the amount authorized by the Short Sale Lender (such as a second Lender). The NRCC will or may be shown on the HUD1 and if the fee is paid through escrow it would appear on a late-escrow HUD-1. However, these additional fees are often paid outside of escrow since the Lenders may not approve the same. Remember, in Short Sales, the Seller’s Lender may require, and in many cases makes it clear, that the Seller is not to receive money or any other benefit from the sale.

The SSN Addenda that have been created to shift the payment responsibility for the SSN’s fee to the Buyers may raise significant legal concerns for Brokers. In some instances the Listing Agent is trying to get paid extra money to serve as both the Listing Agent and the SSN. In other cases, the Listing Agent has hired an outside SSN because that agent is not able or willing to provide short sale negotiation services to their clients, but at the same time the Listing Agent does not want to share his or her commission earnings with the outside SSN that has been hired to do that work.

NOTE : A representative sample SSN Addendum form is provided with this DRE Short Sales update so that the reader can understand why, in the totality of the circumstances -- where Buyers are being required to pay the SSN fee -- it could be an unlawful practice and the real estate industry and the public will benefit by understanding the pitfalls and perils involved in these types of arrangements:

(a) Although the SSN Addendum is a contract document, the primary reason that these terms and conditions are on a separate Addendum may be to better enable the Listing Agent and/or SSN to conceal this information from the Seller’s Lender and, in some instances, the Buyer’s Lender. Based upon anecdotal reports from lawyers and real estate practitioners, it appears that unscrupulous SSNs are purposely not sending these Addenda to the Lenders as part of the package of information requesting Short Sale approval from the Seller’s Lender. This practice of intentional concealment would support and/or may lead to a finding of Lender Fraud. If the SSN Addendum is not sent to the Seller’s Lender, the Lender may not be aware that the Buyer (whether or not they are approved to get the NRCC credit) is being required to direct funds to others in the transaction including, but not limited to, the SSN. It is noted that in addition to paying for the SSN, Buyers may be asked to pay off the Seller’s credit card debt, the Seller’s moving expenses, to buy the Seller’s furniture at an inflated price, and to otherwise provide funds for the direct benefit of the Seller. If those funds/payments are not expressly approved by the Seller’s Lender, those “additional” payments could be extremely problematic from a legal standpoint.

(b) Including the payment of the SSN’s fee on a HUD-1 is arguably not sufficient to qualify as a realistic, timely disclosure to the Seller’s Lender that such a payment will be made. The Seller’s Lender’s Term Sheet usually specifies the total amount of



commission compensation that is to be paid to the Listing and Selling Brokers in the transaction. That Term Sheet may constitute escrow instructions from the Lender, and the Lender might not approve a payment to an SSN that is to be added to the amount authorized as payment for the Listing and Selling Brokers. Lenders may consider any fee charged by a SSN to be a commission payment because the SSN is performing California real estate licensee activity. When the Buyer's separate payment of the SSN's fee appears on the final HUD-1 and that payment had not been authorized in the Lender's Term Sheet (*i.e.*, when added to commission that the Listing and Selling Brokers are receiving it may exceed the limit authorized by the Lender), Lenders may take the position that this constitutes a violation of the Lender's Escrow Instructions, and that may constitute Lender Fraud. Recently, a Northern California Title Company (that had also served as the escrow holder) settled a case by paying the Lender the entire amount of the forgiven loan (plus attorneys' fees and costs) simply because the escrow holder authorized a minor payment that was not approved by the Lender.

(c) The SSN Addenda may contain provisions which purport to establish that the SSN (who is negotiating with the Seller's Lender on behalf of the Seller) is also representing the interests of the Buyer in order to support the rationale given as to why the Buyer is to pay the SSN fee. The muddled and unsettled issue of who the SSN is actually representing can be used, depending on the facts and circumstances, as the basis to allege undisclosed dual agency which could lead to a rescission of the transaction, disgorgement of all commissions earned by all Brokers and sales associates involved in the transaction, and ultimately to the revocation or other discipline of some of the real estate licenses. It is possible that an SSN might fall entirely outside the scope of the statutory agency disclosure law which generally pertains to Listing Agents (defined under California Civil Code section 2079.13(f) as "a person who has obtained a listing of real property to act as an agent for compensation") and Selling Agents (defined under California Civil Code section 2079.13(n) to generally be an agent "who sells or finds and obtains a buyer for the real property"). For example, California lawyers performing legal work and rendering services in the course of their legal practice are not included in the above-identified disclosure law. An ill-conceived creation of a dual agency relationship might not be properly confirmed in the Purchase Contract or the Addenda (as required by California Civil Code sections 2079.13et seq.) and the SSNs might not provide the Seller with the Agency Disclosure form in a timely fashion (if they provide it at all). Nor does the SSN generally bother to give the Buyer an Agency Disclosure form, although the same would be required in the event there is an agency ("Selling Agent") relationship between the SSN and the Buyer. Failure to provide a timely Agency Disclosure can invalidate the obligation to pay commission under the terms of a Listing Agreement (please see Huijers v. DeMarrais, 11 Cal.App.4th 676 (1992)). That same reasoning and analysis may form a legitimate basis to negate the SSN fee.

(d) While much of the written documentation with reference to the Short Sale transaction will refer to a sale for fair market value ("FMV"), the SSN and Listing Agents may orally emphasize the payment of less than the FMV as part of a scheme to induce



the Buyer to want to pay the SSN fee. Unfortunately, if the Buyer acknowledges that he or she is paying less than the actual FMV of the property, then he or she is acting in direct contravention of what Buyers and Sellers may be required to certify to secure the Seller's Lender's approval of the Short Sale. In the past, Sellers have been required to certify under penalty of perjury that the property is being sold for FMV. More and more Lenders are now requiring that the Buyers also execute comparable certification documents. Misrepresentations, perjury, and/or the subornation or perjury, have serious legal, criminal and/or disciplinary consequences. Also, any "artificially lowered" purchase price would not prevent the taxing authorities from assessing the taxable value of the property at FMV. If that occurs, additional liability exposure may be created for the Brokers, depending on their involvement in a fraudulent scheme.

(e) As discussed above, the SSN's fee that is charged to the Buyer might not be part of the "negotiations" between the principals. Rather, it may be a requirement of the sale according to the Listing Agents' comments in the MLS and/or on any pre-sale "terms of the sale" sheet distributed by the Listing Agent or SSN to prospective Buyers' Agents. The latter may be effectively told that their clients' offers will not even be considered (*i.e.*, at times not even presented) unless the offer contains the required terms, including the credit and/or the requirement that the Buyers and their Agents must sign the SSN Addendum. Since the SSN is a service provider that should be paid through escrow, if no real or added services are actually performed for the Buyer, requiring the Buyer to pay that "extra" fee(s) also appears to constitute an unlawful "junk" fee under the federal law known as RESPA.

(f) If the SSN's fee is paid outside of escrow, so that the fee is not disclosed on the HUD-1, the concealment may be in violation of federal law. In addition, depending on their involvement, all of the parties to that transaction (Sellers, Agents, Buyers and Escrow holders) could be alleged and be found to have participated in a conspiracy to violate federal law by agreeing to structure the deal to include "hidden" payments outside of escrow.

(g) The SSNs may claim that the Buyers are not really paying them a fee because the SSN's fee is coming out of the 3% credit from the Seller to the Buyer for NRCC. Negotiators are often able to have the Lender approve such a credit on their "Term Sheet". As discussed above, there may be Lender fraud issues involved in the redirection/misdirection of the credit, and this could also be the basis for a deceptive and unfair business practice lawsuit. If the Buyer is authorized by the Seller's Lender to receive the credit as specified in the Purchase Contract with the Seller, but the Buyer is compelled to and must give up some or all of the credit to pay the SSN (or others), then the SSNs may be involved in a "shell" game. If that occurs, the Buyers' interests might not be properly protected by either the SSN who may owe them fiduciary duties (as discussed above) or their own Agent who has those same fiduciary obligations. Breaches of fiduciary duties have consequences in terms of civil liability and license discipline.



(h) Finally, it must be noted that many of the Addenda or other documents used to require payments to SSNs may contain hold harmless language that may give real estate licensees a false sense of security as to the propriety of such transactions. . It should be noted that because there is usually no separate consideration paid for the hold harmless language, the enforceability of the obligation to hold the signers harmless is problematic.

Conclusion

There are many complexities in the area of Short Sales transactions. As noted above, fraud in this area is growing. The varieties of fraud continue to evolve. While examples of fraud and questionable and unlawful practices are discussed above, the discussion is not exhaustive, as fraud purveyors continue to modify their schemes and methods of operation.

When dealing with the myriad issues arising with respect to Buyers being compelled to pay a “junk” fee(s) to an SSN, real estate licensees must understand how truly unsafe and problematic this practice is in terms of potential license discipline and civil and criminal liability.