

Real Estate Sales in a Troubled Market: A Crash Course on Terminology

INTRODUCTION

The ongoing downturns in both the housing and credit markets have created a significant obstacle to completing real estate transactions, particularly in the residential marketplace. The loss of easy access to credit has shrunk the pool of available buyers, leading to increased inventory and a decrease in property values. In addition, the stagnant market has led to property owners (including builders and developers) being forced to hold their real estate inventory for a longer period of time, leading to increased holding costs (such as mortgage debt and real estate taxes) and, in some cases, loan defaults due to lack of liquidity. Welcome to the distressed real estate market.

The current realities of the distressed real estate market and the tight credit market have forced a change in the mechanics of completing a real estate transaction. Short sales, REO properties, rent-to-own, and contracts for deed have entered (or re-entered, for those practitioners who navigated through the last real estate downturn) the collective vernacular. This article provides an overview of these types of arrangements and how practitioners can navigate the current market on their clients' behalf.

SHORT SALES

A "short sale" is a sale of real property at a price which results in insufficient proceeds

to pay all existing mortgages on the property in full. Each lender who is being asked to accept less than the full amount of its loan balance must consent to the short sale in order for the sale to close. Otherwise, the mortgage lien against the property will not be removed at closing.

There are advantages to both the property owner and the lender(s) in a short sale. For owners, a short sale avoids a foreclosure by the lender and typically extinguishes any deficiency(ies) which the lender could otherwise enforce. For the lender, a short sale results in funds paid to the lender, albeit less than the full amount of its loan, without the lender being required to complete the foreclosure, wait through the redemption period (six to 12 months, depending upon the nature of the property being foreclosed upon), and list the property for sale.

Practitioners who are involved with negotiating short sales with their clients' lender(s) must be aware of several pitfalls in the process. First, as part of the short sale consent, the lender should be asked to extinguish its rights to a deficiency judgment for the unpaid balance of the loan. Some lenders will require a certain percentage of the loan to be paid in order to extinguish a deficiency, and thus a payment plan for a portion of the balance following the short sale may be negotiated between owner and lender.

Additionally, there are tax issues to be considered in a short sale. To the extent that the lender discharges any amount of the remaining mortgage debt against the borrower, Section 61(a)(12) of the Internal Revenue Code (IRC)¹ of 1986 requires that such "cancellation of indebtedness income" be included in the borrower's taxable income unless certain exceptions apply. If the property in question is the borrower's principal residence, then the Mortgage Forgiveness Debt Relief Act of 2007 provides an exception to Section 61(a)(12) which does not require the borrower to include the discharged debt as taxable income in the year of the short sale.



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If the property subject to the short sale is investment property, however, the analysis of whether the discharged debt is included in taxable income under IRC Section 61(a) (12) focuses on whether the borrower is insolvent (i.e., the borrower's total debts exceed the fair market value of total assets). This analysis can be complex and the advice of a tax professional is recommended.

REO PROPERTIES

Real estate owned property, otherwise known as "REO property," is a term used to describe real property owned by a lending institution. REO property is real property which the lender has foreclosed upon and for which the statutory redemption periods have expired. REO property can be sold by the lender (who is now the owner) on the open market.

Purchases and sales of REO property proceed like any other type of real estate transaction, with the sole exception that most of these sales are "as is" sales. In other words, lenders who have little-to-no knowledge of the physical conditions of their REO inventory are seldom willing to offer to a prospective buyer any representations and/or warranties as to physical condition. In these cases, it is imperative that prospective buyers request a physical inspection of the property and be satisfied with the results of the inspection (or, alternatively, timely cancel the purchase agreement if adverse conditions are found in the inspection).

CONTRACTS FOR DEED

A contract for deed is, simply put, a seller-financed acquisition of real estate. Instead of a bank loaning the money to the buyer to pay the seller in full at a closing, the seller agrees to accept some amount of a down payment (to be negotiated between the parties) and periodic (usually monthly) installments of principal and interest for an agreed upon duration of time. Many contracts for deed cover a shorter period of time than the typical, 30-year fixed-rate mortgage, with a balloon payment due at the end of the contract term. At the end of the contract term, if all payments are made, the seller (also known as the contract "vendor") delivers a deed to the buyer (the contract

"vendee"), which deed conveys fee title to the subject property to the buyer.

If a buyer and seller desire to enter into such a contract, the uniform statutory form contract for deed (and applicable addenda) should be used. The seller/vendor should always insist on the parties executing the uniform statutory contract for deed addendum, as the form contains several pro-vendor check-the-box provisions, including the ability to charge default interest on late payments and the ability to accelerate the entire contract balance upon a default (without the signed addendum, in the event of a default, the vendee need only pay the amount of past due installments in order to reinstate the contract). Once signed, the contract for deed must be recorded with the county recording office.

The buyer on a contract for deed is said to own "equitable title" to the subject property. Hence, in the event that the buyer defaults on the payment obligations under the contract for deed, the seller must follow a cancellation process set forth in Minnesota Statute Section 559.21. This statute requires that a 60-day written notice of cancellation be served upon the buyer. If the buyer objects to the grounds for cancellation, the buyer can proceed with a court action and an injunction to stop the cancellation from becoming effective. If the buyer takes no action, the contract is cancelled, the seller may retain any payments previously made by the buyer, and equitable title to the property reverts to the seller.

RENT-TO-OWN TRANSACTIONS

In a "rent-to-own" arrangement, the parties enter into a lease agreement for the property, together with an option to purchase agreement (alternatively, the parties can include purchase option provisions within the lease agreement itself). Under this structure, the landlord retains all title to the property and the tenant pays monthly rent for a specified term. If the tenant remains current on his or her obligations under the lease agreement,

the tenant has the right to purchase the property upon the conditions set forth within the option to purchase agreement (or the option provisions of the lease).


It is important to note that, when entering into a lease with an option to purchase, Minnesota courts do not enforce "agreements to agree." Hence, it is vitally important that the parties agree to all material terms of

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the purchase at the time the lease is entered into in order to avoid future uncertainty. In fact, it is highly recommended that the parties agree on the form of the purchase agreement to be used in the event the tenant exercises the option to purchase, and to attach that form to the lease or option to purchase agreement, as applicable.

Under Minnesota law, an option to purchase must be supported by valuable consideration (meaning that the party receiving the option must pay something to the party granting the option). While the facts and circumstances are the driving force behind determining what is a reasonable option price, it is a good practice to require payment of at least \$1,000 from the tenant/optionee to the landlord/optionor.

CONCLUSION

Purchases and sales of real estate continue despite the current market conditions, albeit in a much different form than they have had in the past few years. Practitioners engaged in transactional real estate work must familiarize themselves with the concepts discussed herein in order to effectively represent their clients. 

¹ 26 U.S.C. § 61(a)(12).