Beware the Fine Print—Short Sale Clawback Provisions

As market participants and regulators implement risk controls and reforms to address the current real estate climate, the relocation closing process has become an exercise in adaptability. Lenders are reexamining their underwriting practices and looking for ways to minimize their exposure to the risks associated with distressed property, such as title defects and fraud, while federal agencies seek to protect consumers going forward and reintroduce liquidity to the market. These trends present unique challenges to the successful transfer of relocation property, which already is misunderstood by the general real estate community. This series of articles (the first, "Revisiting the FHA Anti-flipping Rule," was featured in the May 2010 issue of MOBILITY) examines three developments that relocation professionals should be aware of to ensure a successful real estate closing. Working out a short sale of transferee property always requires vast stores of patience, finesse, and industry expertise. Yet once the lender sends the agreement and/or closing instructions, it is more important than ever to be on the lookout for potential pitfalls. In response to a very real risk of fraud in the short sale market, lenders are including various clauses in their documentation that purport to allow them to unwind the short sale approval (i.e., reinstate the lien) under certain circumstances. While the language varies by lender, there generally are clauses addressing both fraud and flipping. A few of the more prevalent include:

• “If the property was acquired by any means of fraud, Lender reserves the right to pursue any and all actions available to it to offset its losses. If it is determined that Seller(s) and/or Buyer(s) participated in any way to the fraud, this short sale will be void, and the Note and Security Instrument will remain in full force and effect.”

• “Lender requires full disclosure, which includes all details of the transaction on both the Seller and Buyer side of the HUD-1. If Lender finds full disclosure was not made at the time of the approval, the approval becomes null and void.”

• “There are to be no transfers of property within 30 days of the closing of this transaction.”

There are two major issues with these clauses. First, few underwriters would be willing to insure title when the sale is subject to any of these provisions, as there is no way for them to know whether full disclosure was made, whether the property will be resold in the near term, and the like. The possibility of the lien being reinstated and property foreclosed on typically will lead to a policy exception or inability to insure title. At best, the title policy would include an exception to any title defects relating to one of these clauses, and may require further assurances such as affidavits from the relocation management company (RMC). Second, and of particular importance to AV and buyer value option (BVO) homesale programs, a RMC’s ability to resell the property to a potential purchaser may be limited by a clause that prohibits subsequent transfers for a period of time (e.g., 30 days, close of escrow, and so forth).

If any of these clawback provisions are present, it typically will be necessary to explain the relocation process and have the lender remove the language or seek written assurances from an authorized person at the lender that it will not be enforced under the circumstances presented. In discussions, it is important to remember that when a lender sees two sales in close proximity, they assume that there is a profit being made on the resale, and in the context of a short sale, they often are correct to conclude that it is coming out of their bottom line. It then becomes vital that they understand there is no such motive in a managed relocation—the lender is receiving fair market value for the property, not a fraudulently depressed value presented as fair market in order to pocket the spread on resale. The RMC’s interests actually are aligned with the lender’s—the RMC’s goal is to facilitate the transfer of the transferee’s distressed property, and the lender wants to avoid the additional expense and burden of foreclosure proceedings and the REO market. As with many of the recent risk controls being implemented industry-wide, opening a dialogue with the lender as soon as possible to explain the relocation process is the best way to ensure a transaction will not be unwittingly compromised.

Eric Arnold is counsel for Stewart Relocation Services, Houston, TX. He can be reached at +1 713 561 7974 or e-mail earnold@stewart.com.

Piper Sheffield, CRP, is senior vice president, director, for Stewart Relocation Services, Houston, TX. She can be reached at +1 713 625 8194 or e-mail psheffie@stewart.com.

Reprinted with permission of Worldwide ERC®, from the August 2010 issue of MOBILITY.