



July 2010

**SPECIAL REPORT
(Second in Series)**

**SHORT SALE NEGOTIATORS
Fiduciary Duties / Contractual Relationships / MLS Issues**

In last month's article, we discussed various issues regarding short sale negotiators, including, among other things, their use, license requirements, and duties. This month, we continue the discussion of issues arising from the utilization of short sale negotiators, highlighting the various rules and obligations that apply to their use. Like last month's article, we acknowledge and thank the California Department of Real Estate for permission to use material from the recent short sale article by Wayne Bell and Mark Tutera, published in the *DRE California Real Estate Bulletin*, Spring 2010.

Recent Development in Fraudulent Short-Sale Activities

The DRE article details an example of a fraudulent straw-man flipping scheme for short sale properties. Let's recap that scenario and then briefly discuss the applicable laws, Articles of the Code of Ethics and MLS Rules that are violated in that scenario.

The example includes an unlicensed short sale service company (we will refer to it as "the Service Company") that contacts a distressed homeowner to tell him that it will facilitate the sale of the homeowner's "underwater" (negative equity) property. The Service Company demands an up-front fee from the homeowner. To induce the homeowner to hire the Service Company, the Service Company may promise payments to the homeowner after the home sells.

The Service Company then finds a licensed California real estate broker who may be unfamiliar with short-sale transactions, and offers to refer the short-sale listing to the broker. The broker pays a referral fee to the Service Company for the business. The Service Company has the broker list the property on the MLS at the market price, which is less than is owed on the property. The listing broker is not involved in the negotiations with the lenders.

The next step involves the Service Company withholding legitimate offers on the property and convincing the lender that the market price is too high. The Service Company then submits to the lender a lower offer from a straw-man purchaser. (A straw-man is a person who allows the Service Company to use their personal information, but who never had any intention of purchasing the home.) The lender is led to believe that the below-market offer is the highest and best offer, and so

it accepts it. Once escrow is opened, the Service Company will go through the legitimate offers it had previously withheld to find a second buyer at the market price. Often double escrows are used in these transactions. If the Service Company succeeds, it will keep the money that is obtained from purchasing the home low and selling it at market price.

The foregoing scenario begs several important questions:

1. What is the potential liability for both the listing broker and the cooperating broker?
2. Which rules, articles and laws are implicated in this scenario?
3. How can a broker safeguard against potential problems from these and other fraudulent short sale schemes?

Potential Liability for Brokers who Present Offers to Short Sale Negotiators

The Service Company and its principals may have violated California Business & Professions Code, Section 10130, *et seq.*, by “engag[ing] in the business, act[ing] in the capacity of, advertis[ing] or assum[ing] to act as a real estate broker” by representing the distressed homeowner and by collecting advance fees. They also engaged in fraud through misrepresentation, which could be federal loan fraud, subjecting them to imprisonment and fines. These actions could also lead to civil liability for both the Service Company and the broker who agreed to work with it. The Service Company’s actions would likely be imputed to the listing broker under the doctrine of respondeat superior. Additionally, there are other Code of Ethics and MLS Rules that were violated in this scenario, which may also lead to difficulty for the broker, as discussed below.

Articles of the Code of Ethics of the National Association of REALTORS® (referred to as “Code of Ethics”) that were likely violated include the following:

- A REALTOR® must refrain from deliberately misleading an owner as to market value (withholding valid offers, among other things). (Article 1, Standard of Practice 1-3)
- A REALTOR® can only represent both sides of a transaction after full disclosure and informed consent (bringing in a straw purchaser, whom the Service Company likely represents). (Article 1, Standard of Practice 1-5)
- A REALTOR® must submit offers and counter-offers objectively and as quickly as possible. (Article 1, Standard of Practice 1-6)
- A REALTOR® must advise the seller of any potential for the listing broker to act as dual agent. This is because the Service Company brought in a straw purchaser. (Standard of Practice 1-12)
- A REALTOR® must avoid exaggeration, misrepresentation, or concealment (the REALTOR® has a duty to make sure nothing is concealed) (offers and straw-man were not disclosed to the lender). (Article 2)
- A REALTOR® is required to disclose the existence of accepted offers. (Article 3, Standard of Practice 3-6)
- A REALTOR® must disclose their REALTOR® status and interest in relation to the property. (Article 3, Standard of Practice 3-7)
- A REALTOR® cannot accept compensation from more than one party without proper disclosure and informed consent. (Article 7)
- A REALTOR® must explain the nature and disclose the terms of the contractual relationships. (Article 9, Standard of Practice 9-2)

- A REALTOR® must disclose the status as owner and REALTOR®, since the Service Company is in reality an owner, instead of the straw-man. (Article 12 and Standard of Practice 12-6)

There could also be other Articles violated in connection with the example provided. However, this list gives a sufficient description to let a REALTOR® know of some of the potential issues a short sale negotiating scheme could raise.

In analyzing which MLS rules were violated, the California Association of REALTORS® Model Multiple Listing Service Rules (we will refer to “Model Rules”) will be used. However, it is recommended that each REALTOR® check their local rules to determine whether the same or similar rules apply to them. CARETS rules dominate the Southern California market.

Model Rules 4.6 and 4.7 state that the Model Rules apply to those who work for their respective brokers and further state that the broker can be found responsible for Model Rules violations of the sales agent. This raises questions as to whether a broker can be liable for the Service Company’s actions. The Model Rules that may apply to the example used here are as follows:

- Model Rule 7.15.2 relates to the disclosure requirements for any reductions in commissions on short sale transactions. This rule is sometimes indicated in short sales as commissions on short sales are often subject to lender approval. Though not specifically discussed in the example provided, brokers need to be careful to avoid violating this rule. On March 1, 2009, Fannie Mae affected a rule limiting the ability of Fannie Mae loan servicers to demand lower commissions as a condition for sale. Under this rule, the listing broker can reduce the gross commission offered in the MLS if the lender reduces the gross commission it pays to the listing broker. But, in order to do so, the listing broker must publish the fact that the sale and gross commission is subject to lender approval and the amount or method by which the compensation will be reduced. The language in the remarks is generally something like: “50/50 subject to lender approval.” (See the Fannie Mae Servicing Guide, Part VII, section 504.02)
- A listing broker must disclose any interest in the property. It is possible that a broker could be found in violation for the Service Company’s interest in the property if not supervised adequately (due to the straw-man, who really has no interest in the property). (Model Rule 7.17)
- A listing broker must present the offer as soon as possible or provide the cooperating broker a satisfactory reason for not doing so. (Model Rule 9.4) Clearly this rule was broken by the Service Company’s actions.
- A listing broker must submit all offers until closing, unless precluded by law. (Model Rule 9.5) The Service Company clearly violated this rule, and the listing broker may be held responsible for that violation.
- Model Rule 9.6 may also be violated because cooperating brokers, who are presenting offers that are ignored by the Service Company, are not actually able to present their offers.

Again, there could also be other rules violated in connection with the example provided. However, this list gives a sufficient description to let a MLS user know of some of the potential issues a short sale negotiating scheme could bring.

Additional Issues

The example also raises a question regarding the liability of the cooperating broker if the buyer is paying the fees that compensate the Service Company. The answer to this question is rooted in determining whether or not an agency relationship was created by the transaction. This is because a principal (broker) can only be held liable when an agent (an authorized representative of that broker) did something unlawful. *Lehmuth v. Long Beach Unified School Dist.* (1960) 53 Cal.2d 544, 550. The California Civil Code, section 2295 defines agency as: "...one who represents another... in dealings with third persons." A buyer and seller relationship, created by contract, does not generally create agency. *Anderson v. Badger* (1948) 84 Cal App 2d 736. Even though the buyer/cooperating broker ended up paying for the Service Company through the commission, neither are responsible for the Service Company's actions. This is because the Service Company was not an agent of the buyer/cooperating broker. Model Rule 4.7 also sheds light to answer this question. It states that there can be liability for the broker when the broker's employees or agents act on the broker's behalf. But it does not suggest liability for the other guy's employees or agents.

Another question comes up if the Service Company tells the buyer that the Service Company will get the buyer money from the lender as a concession if the buyer will split the concession with the Service Company. Everyone please pull out your smell-test kit. This smells like a bad idea. Assuming nothing illegal happens to get the concession, and that is a big assumption, it is still a bad idea for other reasons.

First of all, this deal may violate RESPA, as all costs associated with the purchase or sale of real estate should be included on the HUD-1 form. Then there are the other rules and articles that apply to a deal like this. The National Association of REALTORS® Code of Ethics, Article 16, prevents REALTORS® from interfering with the exclusive representation of other REALTORS® and their clients. This means any type of deal made between the Service Company and the buyer is inappropriate. Even if the Service Company respects that relationship by approaching the buyer's agent, Standard of Practice 16-4 prohibits REALTORS® from knowingly obligating them to pay more than one commission unless they have informed consent. Informed consent means that the buyer needs to know the impact of the transaction, including legal ramifications, and still consent to it.

In addition, the Code of Ethics, Standard of Practice 16-15 prohibits paying a licensee employed by a broker without that broker's prior express knowledge and consent. In this example, the buyer's agent would have a duty to notify the listing broker of its intent to pay additional money to the Service Company and the listing broker would have to give actual consent. The Service Company would likely not have told the listing broker about this deal. Furthermore, Article 1 of the Code of Ethics states that REALTORS® have an obligation to be honest to all parties. Even though the Service Company may not have a fiduciary duty towards the lender or the buyer, the broker is responsible for the honesty of its agents. Making a deal like this would appear dishonest, at least to the lender, who likely would not know the substance of any such transaction.

Model Rule 7.12 prohibits a member from making the offer of compensation contingent upon any performance, activity or event. So the concession of the concession money is made conditional on the buyer splitting it with the Service Company. This concession offer is therefore a violation of the Model Rules.

Yet another consideration is that a real estate license carries with it fiduciary obligations to its broker under California law. Those duties require a licensee to refrain from making misrepresentations or obtaining any advantage over the broker, and to make the fullest disclosure of all material facts concerning the transaction that might affect their broker's decision. *Stevens v. Briles* (In re Briles) (1998) 228 BR 462. Any deal that leaves the listing broker out of the loop would likely violate the agent's duties owed to the listing broker.

Again, this discussion assumes that the method used to obtain the concession is appropriate, and it is very likely not. Remember, violations by the Service Company can be imputed to the listing broker, whose agent the Service Company is. Even if you are the buyer's agent/broker, do you want to be involved in that transaction?

The bottom line is that there are many, many potential violations in the example provided and a REALTOR® should be careful in determining whether the short-sale negotiator is adhering to all of the laws and rules to avoid any problems in a short-sale transaction.

If you have questions about a transaction, information is available from your local association office or the CAR Hotline at (213) 739-8282. Our firm's transactional real estate attorneys are available for consultation and to offer guidance and legal advice on all aspects of your real estate business.

Next month we will address specific member questions and share some member thoughts. We welcome your input.

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