

What is a Short Sale?

A **short sale** is a sale of [real estate](#) in which the sale proceeds fall short of the balance owed on the property's [loan](#). It often occurs when a [borrower](#) cannot pay the [mortgage loan](#) on their property, but the [lender](#) decides that selling the property at a moderate loss is better than pressing the current debtor. Both parties consent to the short sale process, because it allows them to avoid [foreclosure](#), which involves hefty fees for the bank and poorer [credit report](#) outcomes for the borrower.

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Process

In a short sale, the [bank](#) or [mortgage](#) lender agrees to discount a [loan](#) balance because of an economic or financial hardship on the part of the borrower. The home owner/debtor sells the mortgaged property for less than the outstanding balance of the loan, and turns over the proceeds of the sale to the lender. Neither side is "doing the other a favor;" a short sale is simply the most economical solution to a problem. Banks will incur a smaller financial loss than foreclosure or continued non-payment would entail. Borrowers are able to mitigate damage to their [credit history](#), and partially control the debt. A short sale is typically faster and less expensive than a foreclosure. It does not extinguish the remaining balance unless settlement is clearly indicated on the acceptance of offer.

Lenders often have [loss mitigation](#) departments that evaluate potential short sale transactions. The majority have a pre-determined criteria for such transactions, but they may be open to offers, and their willingness varies. A bank will typically determine the amount of [equity](#) (or lack thereof), by determining the probable selling price from an [appraisal](#) or Broker Price Opinion (abbreviated BPO or BOV).

Lenders may accept short sale offers or requests for short sales even if a [Notice of Default](#) has not been issued or recorded with the locality where the property is located. Given the

unprecedented and overwhelming number of losses that mortgage lenders have suffered from the [2009 foreclosure crisis](#), they are now more willing to accept short sales than ever before. This presents a opportunity for "[under-water](#)" borrowers who owe more on their mortgage than their property is worth and are having trouble selling to avoid foreclosure as a result.

Additional parties

Multiple levels of approvals and conditions are very common with short sales. Junior lien-holders - such as second mortgages, [HELOC](#) lenders, and HOA (special assessment liens) - may need to approve the short sale. Frequent objectors to short sales include tax lien holders (income, estate or corporate franchise tax - as opposed to real property taxes, which have priority even when unrecorded) and mechanic's lien holders. It is possible for junior lien holders to prevent the short sale. If the lender required [mortgage insurance](#) on the loan, the insurer will likely also be party to negotiations as they may be asked to pay out a claim to offset the lender's loss in the short sale. The wide array of parties, parameters and processes involved in a short sale makes it a relatively complex and highly specialized type of real estate transaction. Unsurprisingly, short sale deals have a high failure rate and often do not close in time to prevent foreclosure when they are not handled by a knowledgeable and experienced professional. The best sources of knowledge and expertise in short sales are short sale negotiators, loss mitigation specialists, and real estate lawyers who specialize in short sale.

Consent

Short sales are different from foreclosures in that a [foreclosure](#) is forced by a lender, whereas both lender and borrower consent to a short sale. However, this consent may change at any time, and negotiations may be ongoing between the lender and borrower even while the short sale is on the market. The borrower may decide to remain and [refinance](#) their house, or become obstinate and force foreclosure. The bank may renege as well if they decide to stick with the current borrower, or if they disapprove of the sale price. Any short sale contract includes a [contingency](#) where the bank must approve the sale.

Changing consent can present a perilous situation for potential buyers. It can waste considerable time and money for a prospective buyer who anticipated a sale. Typically, deposits with the bank will be refunded but money for paid inspections or other services cannot be.

There are several defenses against this. If the seller has moved out of a property, that is a clue that they have no intention of staying or negotiating further with the bank. "Bank Approved Short Sales" are advertised by real estate advertisements, indicating that a [real estate broker](#) has verified the selling bank's position. This still does not guarantee acceptance, and it often does not take junior lien-holders into account, but it is better than situations where the bank holding the mortgage has only been lightly involved in the borrower's decision.

Credit implications

Short sales are a type of settlement, and they adversely affect a person's [credit report](#), though the negative impact is typically less than a [foreclosure](#). Like all entries except for bankruptcy, short sales remain on a credit report for seven years. Depending upon other credit information, it is typically possible to obtain another mortgage 1-3 years after a short sale.

While lenders sometimes forgive the remaining loan balance, other [lien](#)-holders likely will not. Further, it is common for a lender to omit updating mortgage balances zero balance after a short sale. However, willfully misrepresenting information on a credit report can constitute libel in some jurisdictions, and lenders may be sued in civil court for engaging in this behavior.¹

Business

Short sales are common in standard business transactions in recognition that creditors are not doing debtors a favor but, rather, engaging in a business transaction when extending credit. When it makes no business sense or is economically not feasible to retain an asset, businesses default on their loans (called bonds). It is not uncommon for business bonds to trade on the after-market for a small fraction of their face value in realization of the likelihood of these future defaults.

Mortgage Forgiveness Debt Relief Act of 2007

The **Mortgage Forgiveness Debt Relief Act** was introduced in Congress on September 25, 2007, and became law on December 20, 2007. This act offered relief to homeowners who would formerly owe taxes on forgiven mortgage debt after facing foreclosure. The act extends such relief for three years, applying to debts discharged in calendar year 2007 through 2009. (With the [Emergency Economic Stabilization Act of 2008](#), this tax relief was extended another three years, covering debts discharged through calendar year 2012.)

Normally in US law when a lender decides to forgive all or a portion of a borrower's debt and accept less, the forgiven amount is considered as income for the borrower and is liable to be taxed.

However, after the signing of the Mortgage Forgiveness Act, amendments have been made to remove such tax liability and allow the borrower and lender to work freely together to find a common solution that is beneficial to both parties. This protection is limited to primary residences -- rental properties are ineligible for relief -- so consultation with a tax advisor is necessary to ensure that a borrower qualifies. The amount of forgiven mortgage debt allowed to be excluded from income tax is limited to \$2 million per year.

More recent legislation provides for a specialized type of refinancing option, available for mortgages made after 2006, for owner-occupied homes. Under this program a debtor provides information similar to that necessary for a short-sale but rather than selling the house to a third-party an FHA guaranteed loan at a fixed-rate is available if the original lender is willing to write-off all but 85-percent of outstanding of the debtor's obligations (including principal, interest, late-fees, prepayment penalties, and all other fees). FHA-backed refinance packages are available beginning October, 2008, and carry a fee equal to 1.5% of the value of the house. Debtors who exercise this option must sacrifice 50-100 percent of equity that builds in a house, and may not participate in home equity loan programs. This program is only available to owner-occupied residences. This program requires consent from a lender: consent is not automatic and may be freely withheld, though withholding consent can result in a foreclosure with adverse financial results.