

Loan Modifications

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I. GENERAL OVERVIEW

The economic downturn of the late-2000s has fueled a significant upsurge in loan modifications as a possible alternative to foreclosure. REALTORS® seeking to help distressed homeowners with loan modifications face certain legal and practical issues. They also frequently find themselves pitted against a variety of loan modification scam artists spawned by the mortgage crisis.

This legal article discusses the legal and practical issues surrounding loan modifications. It also provides working guidelines for REALTORS® assisting their clients with loan modifications.

Q 1. *What is a loan modification?*

A A loan modification is generally considered to be a permanent change in one or more terms of a borrower's existing mortgage loan. In the current economic downturn, a loan modification is generally involves a homeowner seeking more affordable payments in an effort to avoid foreclosure (see Question 3).

The specific terms and conditions of a borrower's loan modification depend on what that particular borrower successfully negotiates with the lender. The different types of loan modifications include, but are not limited to, the following:

- Reducing the interest rate;
- Forgoing an upward adjustment of the interest rate;
- Extending the repayment period;
- Reducing the principal balance owed;
- Adding delinquent payments to the principal balance;

- Forbearing a portion of the principal balance; or
- A combination of two or more of the above modification terms.

Q 2. *What is loss mitigation?*

A Loss mitigation generally refers to the process by which a lender attempts to mitigate or minimize its risk of loss with respect to a mortgage loan. A lender's methods of loss mitigation may include, but is not limited to, loan modifications, short sales, refinances, and deeds in lieu of foreclosure. The popular use of the term, "loss mitigation," may stem from the fact that many banks have "loss mitigation departments" that handle borrowers' requests concerning delinquent loans.

Q 3. *Why would a borrower seek a loan modification?*

A During the current economic downturn, the typical impetus for requesting a loan modification is to make the existing mortgage loan more affordable for the homeowner who may be facing foreclosure. Oftentimes, the borrower seeking a loan modification is experiencing difficulty repaying an adjustable rate mortgage with an interest rate that has adjusted upward significantly.

Another reason a borrower may seek a loan modification is to ask the lender to reduce the principal balance which has become more than what the property is worth. Homeowners are generally disinclined to continue making mortgage payments when they deem their property investments to be losing propositions. Yet, lenders do not seem to grant requests for principal reduction as often as other types of modifications.

Q 4. *Is a lender required to approve a borrower's request for a loan modification?*

A No, in most cases. It is generally up to a lender to decide whether to approve a loan modification request. For Bank of America, however, it announced in October 2008 that it will modify 400,000 loans held by recently acquired Countrywide Financial Corp. as part of an \$8.4 billion class action settlement agreement.

Q 5. *What would compel a lender to approve or reject a borrower's request for a loan modification?*

A The typical reason lenders approve loan modifications is to minimize their financial losses. Lenders also want to avoid the problems of foreclosure and to preserve their relationship with their borrowers.

On the other hand, some of the lenders' reasons for rejecting loan modifications include the borrowers' inability to qualify for the proposed modified loans and the lenders' general unwillingness to write down principal balances. For instance, borrowers who could only qualify for their existing mortgage loans by obtaining subprime loans with low introductory teaser rates may not qualify for modified loan payments, regardless of whether the modified loan has a low interest rate and is extended to 40 years.

Another reason loan modifications may not go through is the lenders' lack of staffing to handle loan modification requests coupled with the borrowers' lack of follow-through. Another obstacle to loan modifications is the difficulty to get approval if a borrower has two or more mortgage loans from different lenders. One lender may be reluctant to work with the borrower if the loan modification benefits another lender. Also another serious obstacle is, even if a borrower has only one loan, it may be difficult tracking down and getting an approval if the loan has been fragmented and sold in the secondary market to pension funds, hedge funds, insurance companies, and other investors around the world.

Q 6. Which lenders are considering loan modifications?

A Many major lenders have recently announced they are aggressively reworking mortgage loans to help homeowners remain in their homes. For instance, the Federal Housing Finance Agency, which oversees Fannie Mae and Freddie Mac loans, along with the HOPE NOW alliance of lenders, launched a "Streamlined Modification Plan" starting December 15, 2008 (see Question 9 for eligibility requirements).

Furthermore, in August 2008, IndyMac Federal Bank announced a systematic and streamlined loan modification program implemented by the Federal Deposit Insurance Corporation (FDIC) (which took over IndyMac Bank, FSB on July 11, 2008). As of November 2008, IndyMac had sent out over 23,000 modification letters to eligible borrowers and had completed 5,300 modifications.

Other major lenders intend to take proactive steps to modify loans for distressed homeowners. In October 2008, Bank of America publicized that, under an \$8.4 billion class action settlement agreement, it would modify an estimated 400,000 loans held by newly acquired Countrywide Financial Corp. Also in October 2008, JPMorgan Chase & Co. announced that it would modify an estimated \$70 billion in loans for 400,000 Washington Mutual customers. In November 2008, Citigroup announced it would make \$20 billion in mass-market modifications by preemptively reaching out to 500,000 at-risk homeowners.

For more information about the loan modification programs of the above-mentioned lenders, C.A.R. offers a legal article entitled [Mortgage Workout Programs for Homeowners](#), which includes program and contact information, available for members. For other lenders, contact the lender directly to determine whether it is considering loan modifications. Many lenders have information on loan modifications readily accessible on their Web sites.

Q 7. Where can a homeowner find assistance in doing a loan modification?

A A homeowner may seek loan modification assistance from a real estate broker. A homeowner may also contact a reputable housing, financial or credit counselor, attorney, or other qualified professional. The U.S. Department of Housing and Urban Development (HUD) has a list of HUD-approved housing counseling agencies in California, available at <http://www.hud.gov/offices/hsg/sfh/hcc/hcs.cfm?&webListAction=search&searchstate=CA>. Also, the non-profit organization Homeownership Preservation Foundation has a 24/7 toll-free Homeowner's HOPE Hotline at (999) 995 HOPE or visit its Web site at <http://www.995hope.org>.

Q 8. What does the loan modification process entail?

A A brief summary of the step-by-step process of a typical loan modification is as follows:

- Borrower contacts the lender's loss mitigation department to request a loan modification.
- Borrower fills out the lender's forms for requesting a loan modification. Some lenders post their loan modification forms online.
- Borrower submits completed forms to the lender along with other documentation required by the lender, such as a hardship letter, bank statements, paycheck stubs, and property valuation. An agent representing the borrower may also wish to complete and submit to the lender C.A.R.'s standard form Authorization to Receive and Convey Information (Form ARC) which authorizes the agent to communicate with the lender on the borrower's behalf.
- Borrower periodically follows up with the lender. Many practitioners believe that, to get an approval, borrowers must frequently check the status of their loan modification requests.
- Lender makes a loan modification proposal to the borrower or rejects the loan modification request.
- Lender and borrower negotiate the terms and conditions of a loan modification, and if an agreement is reached, the parties will execute the necessary documents to finalize the loan modification.

Q 9. *What are the eligibility requirements for a loan modification process?*

A It is up to each lender to decide its eligibility requirements. A lender generally considers its collateral position and the borrower's ability to make the modified payments.

As an illustration of eligibility requirements, the following are the major requirements for Fannie Mae and Freddie Mac under the new Streamlined Modification Plan:

- At least 90 day delinquency on the existing mortgage loan;
- Existing loan originated before January 1, 2008;
- Borrower has not filed bankruptcy;
- Owner occupied property;
- Single family residence;
- 90 percent or higher loan-to-value ratio;
- New principal, interest, taxes, insurance and HOA dues not to exceed 38 percent of the borrower's gross monthly income; and
- Borrower must demonstrate an ability to repay by making three monthly payments based on modified terms before modification is complete.

Q 10. Does a borrower have to be delinquent on the existing mortgage loan to qualify for a loan modification?

A It depends on the lender. Some lenders require borrowers to be delinquent on their mortgage before they will consider a loan modification. For example, to qualify under the Streamlined Modification Plan for Fannie Mae and Freddie Mac loans, a borrower must be at least 90 days delinquent on the existing mortgage loan (see Question 9).

Yet, mortgage delinquency can negatively impact a borrower's credit and start the foreclosure process. REALTORS® may encounter clients who entertain the idea of allowing their mortgage payments to go delinquent to qualify for loan modifications. To take that risk is a decision that only the homeowner can make. A real estate agent involved in this situation should encourage a homeowner in this situation to consult with an attorney or other appropriate professional.

Q 11. How long does the loan modification process take?

A The processing time for loan modifications generally ranges from several weeks to several months. More recently, however, the loan modification process may be getting easier as more lenders streamline their procedures, set standards for approving loan modifications, and increase their staffing to handle borrowers' requests.

Q 12. Should a borrower always agree to a modified loan as long as the monthly mortgage payments are less than what the borrower currently owes?

A No. A borrower should carefully consider all the terms and conditions of a proposed loan modification before agreeing to it. A loan modification may also have tax consequences for a borrower (see Questions 48 to 50). A borrower should make sure that the proposed modified loan terms are favorable as well as truly affordable for years to come. Otherwise, the borrower may ultimately end up financially worse off doing a loan modification than allowing the property to go straight to foreclosure.

Studies show that the re-default rate for modified loans is high. In December 2008, the U.S. Comptroller of the Currency John C. Dugan stated that over half of the loans modified in the first quarter of 2008 became delinquent within six months. (See "Comptroller Dugan Highlights Re-default Rates on Modified Loans" on the Web site of the Comptroller of the Currency, available at <http://www.occ.treas.gov/ftp/release/2008-142.htm>.)

II. ADVANCE FEE LOAN MODIFICATIONS

Q 13. Can a real estate agent act on behalf of a homeowner to obtain a loan modification?

A Yes. A real estate broker or a salesperson working under the broker's supervision can act on behalf of a homeowner to obtain a loan modification. For more information about real estate licensing requirements, see Questions 38 and 39.

Q 14. As an agent, I do not want to perform loan modification services, which may take many weeks or months, only to discover that the client cannot or refuses to pay for my services. Can I collect upfront my compensation for performing loan modification services?

A No, unless certain requirements are met. Unlike sales and refinance transactions, loan modifications generally do not entail the opening of a file at an escrow or title company, whereby a neutral third-party disburses funds as a matter of course, including the payment of the broker's compensation. Hence, real estate brokers who provide loan modification services consider collecting an advance fee, which is a fee charged upfront for services not yet performed.

California law defines an advance fee broadly to include a fee claimed, demanded, charged, received, collected or contracted from a principal for negotiating real estate loans (Cal. Bus. & Prof. Code § 10026). To collect an advance fee, a real estate broker must satisfy the following three requirements:

- The broker cannot receive an advance fee for foreclosure-related consulting services if the property is owner occupied with one-to-four dwelling units and has a recorded notice of default (see Question 15);
- The broker cannot use an advance fee agreement or advertising materials, and cannot collect an advance fee, unless the advance fee agreement, accounting format, and advertising materials have been submitted for review to the Department of Real Estate (DRE) and the broker has received a "no objection" letter from the DRE (see Questions 16 to 33); and
- The broker must place any advance fee collected into the broker's trust account as specified (see Questions 21 to 24).

The above requirements to submit an advance fee agreement for DRE review and to place advance fees into the broker's trust account apply to both residential and commercial loans. For a discussion of businesses that claim exemption from advance fee requirements due to an affiliation with an attorney, see Questions 43 and 44.

On the other hand, if an advance fee is not claimed or collected, a broker need not submit a loan modification agreement or advertisements for DRE review nor place any compensation received into a trust account. The broker may nevertheless consider doing other things to help ensure that the broker gets paid (see Question 35).

Q 15. Explain the prohibition against advance fees for properties in foreclosure.

A It's a double-edged sword. Briefly speaking, for certain properties in foreclosure, a real estate agent cannot collect an advance fee without implicating the foreclosure consultant law, yet if the foreclosure consultant law is implicated, it prohibits advance fees anyway.

More specifically, the foreclosure consultant law generally applies to a "residence in foreclosure" which is defined as follows:

- The owner occupies the property as a principal residence;
- The property is one to four family dwelling units; and

- There is an outstanding notice of default recorded against the property.

(Cal. Civ. Code § 2945.1(f) (citing Cal. Civ. Code § 1695.1).)

Real estate agents are generally exempt from the foreclosure consultant law. However, a real estate agent is not exempt if, among other things, the agent claims or collects any compensation before the licensed activities have been performed or cannot be performed because the owner fails to: (1) accept an offer from a buyer or lender who is ready, willing and able to buy or lend on terms set forth in a listing or loan agreement; or (2) make loan disclosures under section 10243 of the California Business and Professions Code (Cal. Civ. Code § 2945.1(b)(3)(C)).

If implicated, the foreclosure consultant law has various rules for someone who performs foreclosure consultant services as defined. One of the rules is a prohibition against the collection of any compensation until after the foreclosure consultant has fully performed each and every service the foreclosure consultant represented that he or should would perform (Cal. Civ. Code § 2945.4(a)).

For more information about foreclosure consultants, go to C.A.R.'s legal article entitled [Foreclosure Scams and the Foreclosure Consultant Law](#).

Q 16. *What is the requirement for submitting an advance fee agreement to the DRE for review?*

A No less than ten calendar days before publication or collection of an advance fee, a real estate broker must submit to the DRE the form of advance fee agreement proposed for use and all other materials for advertising, promoting, soliciting, or negotiating the advance fee (10 Cal. Code of Reg. § 2970). The information that should be included in an advance fee agreement submitted for DRE review is set forth in Question 20.

Q 17. *Is the DRE review of advance fee agreements a new law?*

A No. The law pertaining to advance fees is not new law. The law requiring DRE review of advance fee agreements was originally enacted in 1958 (Cal. Bus. & Prof. Code § 10085).

Q 18. *Does the DRE approve advance fee agreements that have been submitted by real estate brokers?*

A No. The DRE does not approve, endorse, recommend or make representations about any advance fee agreement. Agents who have undergone the DRE review process should be careful not to represent to their clients that their advance fee agreements have been “approved” by the DRE.

The purpose of the DRE review of advance fee agreements and advertisements is to determine whether the materials would tend to mislead. If the materials would tend to mislead, the DRE commissioner may, within 10 calendar days of the date he or she receives them, order that they not be used, disseminated nor published (Cal. Bus. & Prof. Code § 10085). Otherwise, the DRE may issue a “no objection” letter if appropriate.

According to the DRE, a broker cannot use an advance fee agreement or collect any advance fees until he or she receives a “no objection” letter from the DRE. (See “Advance Fees and Loan Modifications” in DRE’s Mortgage Loan Bulletin (Fall 2008) at http://www.dre.ca.gov/pdf_docs/mlb_fall08.pdf.) Yet, the applicable statute could be interpreted to mean that the DRE only has 10 days to review advance fee materials. (See Cal. Bus. & Prof. Code § 10085 (stating that “Should the commissioner determine that any [matter] would tend to mislead he or she may, within 10 calendar days of the date he or she receives same, order that it not be used, disseminated, nor published.”))

Q 19. Is there a list of DRE’s “no objection” letters for advance fee agreements?

A Yes. The DRE maintains a list of brokers who have received “no objection” letters for advance fee agreements for loan modification and similar services. The DRE’s Advance Fee Agreement Listing is available at http://www.dre.ca.gov/mlb_adv_fees_list.html. The list is updated periodically and may not include agreements which have recently been reviewed.

Q 20. What must be included in an advance fee agreement for submission to the DRE for review?

A The DRE provides a sample form “Advance Fee Agreement for Loan Modification Services” which is available at http://www.dre.ca.gov/mlb_intro_advfees_sample.html. A broker, however, is not required to use DRE’s sample form. If a broker prepares his or her own advance fee agreement, the DRE requirements for the agreement are as follows:

- Must be in contract form.
- Must be in at least 10-point type.
- Must set forth a specific, complete description of the services to be rendered for the advance fee.
- Must set forth the total amount of the advance fee.
- Must allocate estimated portions of the advance fee to each of the services the broker will provide. The services can be itemized with a description of each service.
- Must obligate the principal to pay a specified advance fee at a specified time.
- Must obligate the broker to complete the advance fee services by a specified date.
- Must contain the following notice in at least 10-point bold type: “Notice: The amount or rate of fees specified in this agreement for services is not fixed by California law. Fees are set by each broker individually and are subject to negotiation between the client (principal) and the broker.”
- Must obligate the broker to deposit the advance fee into a trust account.
- Must identify the trust account number and depository.
- Must obligate the broker to provide the principal with verified accountings (see Questions 24 and 25).

- Must obligate the broker to use the advance fee to fund specified services for the principal's benefit.
- Must not characterize any portion of the advance fee as "non-refundable." The advance fee remains the property of the principal and is refundable to the extent it is not expended for the services specified in the agreement.
- Must contain refund language for portions of the advance fee not expended if the contract is cancelled or the advance fee services are not performed.
- Must not contain any provision purporting to relieve the broker from any obligation to fulfill verbal agreements and representations made by the broker's employees and agents.
- Must have space for broker and principal to sign and date.
- Must include the broker's DRE license number.
- For loan modifications, short sales, and similar services, the agreement must include the lender name, address, loan number, and the following notice:

"Notice: California Civil Code Section 2945.1(b)(3) prohibits any real estate licensee from claiming, demanding, charging, collecting or receiving any compensation from a person whose residence is in foreclosure until all of the promised services have been fully performed and completed. DO NOT SIGN THIS AGREEMENT IF A NOTICE OF DEFAULT HAS BEEN RECORDED AGAINST THE PROPERTY."

- For loan modifications, short sales, and similar services, the advance fee agreement must include the following certification in at least 10 point bold type:

"PRINCIPAL/BORROWER CERTIFIES THAT A NOTICE OF DEFAULT HAS NOT BEEN RECORDED AGAINST THE PROPERTY, _____ (Initials of Principals)."

- For short sales, the agreement must describe whether the services include or exclude submitting a buyer's offer to purchase.

(10 Cal. Code of Reg. § 2970; see also DRE's "The Essential Elements of an Advance Fee Agreement" available at http://www.dre.cahwnet.gov/pdf_docs/adv_fees_essential_elements.pdf.)

For the DRE requirements of a verified accounting of an advance fee agreement, see Question 26. For more information on submitting advance fee loan modification agreements for DRE review, see Questions 28 to 33.

Q 21. What is the requirement of placing an advance fee in the broker's trust account?

A Even if a broker obtains a "no objection" letter for an advance fee agreement from the DRE, a broker entering into an advance fee agreement with a client must nevertheless deposit any advance fee collected into a broker's trust account with a bank or other recognized depository. Such funds are trust funds, not funds of the agent, and must be handled accordingly. For more information about trust fund handling, C.A.R. has a legal article entitled [Trust Fund Accounts Guide](#). See also DRE's Reference Book, Chapter 23 on Trust Funds, available at http://www.dre.ca.gov/pdf_docs/ref23.pdf.

Q 22. Can a broker deposit an advance fee into the broker's business bank account?

A No. A broker who collects an advance fee must deposit it into a trust account as specified (see Question 23).

Q 23. What are the requirements for a broker's trust account?

A A broker's trust account must meet the following requirements:

- It must be designated as a "Trust Account" in the name of the broker (or in a fictitious name if the broker is the holder of a real estate license bearing that fictitious name) as trustee; and
- It must be maintained at a bank or other recognized depository located in California.

(Cal. Bus. & Prof. Code § 10145; 10 Cal. Code of Reg. § 2832.)

Q 24. Under what circumstances can a broker withdraw an advance fee from the broker's trust account?

A For an advance fee deposited into a broker's trust account, amounts may not be withdrawn on the broker's behalf until actually expended for the benefit of the principal or five days after a verified accounting as specified (see Question 25) has been mailed to the principal (Cal. Bus. & Prof. Code § 10146). Furthermore, if an advance fee loan modification agreement is cancelled before the rendering of all the services, or if not all of the advance is expended, the broker must refund the unused portion of the advance fee to the client ("Advance Fees and Loan Modifications" in DRE's Mortgage Loan Bulletin (Fall 2008) at http://www.dre.ca.gov/pdf_docs/mlb_fall08.pdf).

Q 25. What are the verified accounting requirements for an advance fee that has been placed in a broker's trust account?

A A broker who intends to collect an advance fee must submit the format of the verified accounting, along with the advance fee agreement, for DRE review before using the form or collecting an advance fee (10 Cal. Code of Reg. § 2970). The information that should be included in the verified accounting form for submission to the DRE is set forth in Question 26.

Furthermore, when a broker collects an advance fee, a verified copy of an accounting must be furnished to each principal at the end of each calendar quarter and when the advance fee agreement has been completely performed by the licensee (see also Question 24). A verified copy of the accounting must also be furnished to the DRE upon demand. (Cal. Bus. & Prof. Code § 10146.)

Q 26. What must be included in a verified accounting of an advance fee agreement that is submitted to the DRE for review?

A The DRE provides a sample form “Verified Accounting for Advance Fees” to be used in connection with its “Advance Fee Agreement for Loan Modification Services.” The “Verified Accounting for Advance Fees” form is available at http://www.dre.ca.gov/pdf_docs/AdvanceFeeSampleAccounting.pdf. A broker is not required to use the DRE sample form. If a broker prepares his or her own verified accounting form, the DRE requirements for the verified accounting form are as follows:

- Must state the agent's name.
- Must state the principal's name.
- Must describe the services rendered or to be rendered.
- Must state the amount of the advance fee collected.
- Must identify the trust account number and depository.
- For a loan modification, short sale, and similar service, the accounting format must include the lender name, address, and loan number.
- For arranging a loan secured by real property (or a business opportunity), the accounting must include a list of the names and addresses of persons to whom the principal's loan requirements were submitted and the submittal dates.
- Must include the amount allocated or disbursed from the advance fee for each of the following: (1) Providing each of the services rendered or to be rendered; (2) Commissions paid to field agents and representatives; and (3) Overhead costs and profits.
- Must be signed by the broker underneath the attestation, “I hereby represent and attest that this is a true and accurate accounting.”
- For disbursements made for advertising, the verified accounting must include a copy of the advertisement, the name of the publication, the number of advertisements actually published, and the dates they were carried. Note: This requirement is generally inapplicable to a loan modification transaction because a broker is unlikely to conduct any advertising on the homeowner's behalf.

(10 Cal. Code of Reg. § 2972; see also DRE's “The Essential Elements of an Advance Fee Agreement,” which is available at http://www.dre.cahwnet.gov/pdf_docs/adv_fees_essential_elements.pdf.)

Q 27. *If a broker does not intend to collect an advance fee for loan modification services, does the broker still have to submit a loan modification agreement, advertising materials, and a verified accounting form to the DRE for review?*

A No. If a loan modification service agreement does not involve an advance fee, the broker need not submit these materials for DRE review.

Q 28. *Is a broker who intends to collect an advance fee for loan modification services required to use the DRE sample forms?*

A No. A broker is not required to use the DRE sample forms, “Advance Fee Agreement for Loan Modification Services” and “Verified Accounting for Advance Fees.” The DRE drafted these sample forms to facilitate its review process of advance fee loan modification agreements. Brokers may submit their own forms instead, but, according to the DRE, the review process may be lengthy and involve several revisions causing delays before the forms can be used and advance fees collected. (See DRE’s “Introduction to Sample Advance Fee Agreement” at http://www.dre.ca.gov/mlb_intro_advfees_sample.html.)

Q 29. If a broker intends to use the DRE sample forms for an advance fee agreement, does the broker still have to submit them for DRE review?

A Yes. Even if a broker uses the DRE sample forms, “Advance Fee Agreement for Loan Modification Services” and “Verified Accounting for Advance Fees,” the broker must still fill in certain information and submit them for DRE review. However, using the DRE sample forms will facilitate DRE’s review process. The broker must also submit to the DRE all other materials to be used for advertising, promoting, soliciting, or negotiating an advance fee (10 Cal. Code Reg. § 2970).

For the DRE’s instructions for submitting the sample advance fee forms, go to “Introduction to Sample Advance Fee Agreement” at http://www.dre.ca.gov/mlb_intro_advfees_sample.html.

Q 30. If a broker intends to use the DRE sample forms “Advance Fee Agreement for Loan Modification Services” and “Verified Accounting for Advance Fees,” should the blank spaces on the forms be completed before they are submitted to the DRE for review?

A Yes, but only certain information (as specified below) must be completed prior to submission for DRE review. The remaining information on the “Advance Fee Agreement for Loan Modification Services” and “Verified Accounting for Advance Fees” sample forms is to be left blank until the broker enters into the advance fee agreement with a client.

A broker should complete the following information on the “Advance Fee Agreement for Loan Modifications Services” before submitting the agreement for DRE review:

- Broker’s (or corporate broker’s) name;
- Fictitious business name (DBA) if applicable;
- Trust fund bank account number and depository;
- Amount of the advance fee to be collected; and
- Dollar amounts equaling the respective percentages of the advance fees.

Furthermore, the broker should complete the following information on the sample form “Verified Accounting for Advance Fees” before submitting the form for DRE review:

- Broker’s (or corporate broker’s) name;
- Broker’s address;

- Trust fund account number and depository; and
- Amount of the advance fee to be received.

(See DRE's "Introduction to Sample Advance Fee Agreement," available at http://www.dre.ca.gov/mlb_intro_advfees_sample.html.)

Q 31. Can a broker submit an advance fee agreement for providing limited services, such as reviewing the borrower's financial condition, obtaining property information, or reviewing the borrower's documents?

A No. According to the DRE, an advance fee loan modification agreement must provide for the broker to submit to, or negotiate with, the lender or loan servicing agent a proposed modification or other solution. Services such as reviewing the borrower's financial condition, obtaining property information, or reviewing the borrower's documents are just some of the steps in a single transaction where the borrower seeks assistance on his or her loan. The DRE will not consider advance fee agreements that only provide for partial services with no requirement to contact the lender or servicing agent. (See "Advance Fees and Loan Modifications" in DRE's Mortgage Loan Bulletin (Fall 2008), available at http://www.dre.ca.gov/pdf_docs/mlb_fall08.pdf.)

Q 32. Can a salesperson submit an advance fee agreement for DRE review in the salesperson's name, instead of the broker's name?

A No. According to the DRE, an agreement submitted by the salesperson or an agreement for an unlicensed person, corporation or fictitious business name to provide the services will be returned without consideration. (See "Advance Fees and Loan Modifications" in DRE's Mortgage Loan Bulletin (Fall 2008), available at http://www.dre.ca.gov/pdf_docs/mlb_fall08.pdf.)

Q 33. Where does a broker submit a request for DRE's review of an advance fee agreement?

A A request for DRE's review of an advance fee agreement should be sent to:

Department of Real Estate
Mortgage Loan Activities Unit
Post Office Box 187000
Sacramento, California 95818-7000

Q 34. What is the penalty for violating the advance fees requirements?

A A violation of the advance fee requirements is subject to, among other things, disciplinary action by the DRE to revoke or suspend a real estate license. According to the DRE, many brokers are currently under DRE scrutiny for possible violations. (See "Advance Fees and Loan Modifications" in DRE's Mortgage Loan Bulletin (Fall 2008) available at http://www.dre.ca.gov/pdf_docs/mlb_fall08.pdf.)

In addition to disciplinary action by the DRE, a violation of the advance fee requirements may be subject to criminal and civil liability depending on the circumstances. The use or dissemination of any materials which the DRE has ordered not to be used is a misdemeanor punishable by six months imprisonment plus a \$1,000 fine for each violation (Cal. Bus. & Prof. Code § 10085). Furthermore, any failure to comply with the verified accounting procedures for handling advance fees is presumed to be embezzlement for which the principal may sue to recover, among other things, treble damages for amounts misapplied plus attorneys' fees (Cal. Bus. & Prof. Code § 10146 and Cal. Penal Code § 506).

III. LOAN MODIFICATION CONTRACTS

Q 35. *Instead of collecting an advance fee, are there other things a real estate broker could do to help make sure that he or she will be compensated for performing loan modification services?*

A Yes. Instead of collecting an advance fee, a real estate broker and homeowner may agree that the broker will perform a series of distinct loan modification services and be compensated once each service has been performed. For example, a broker and homeowner may agree that the homeowner will pay a certain dollar amount after the broker provides the homeowner with an initial consultation, another dollar amount after the broker prepares and submits a loan modification package to the lender, and another dollar amount after the broker has negotiated the loan modification with the homeowner's lender. Alternatively, the broker and homeowner may agree that the broker will charge a certain hourly rate for services rendered, and that the broker will collect that hourly fee after performing an hour of work.

Other things a broker could do to help ensure he or she will be compensated includes prescreening the homeowner to assess his or her creditworthiness upfront, entering into a written loan modification agreement (see Question 36), and following up with the client to collect payment once the broker's compensation is due.

Q 36. *Absent an advance fee, is a broker legally required to have a loan modification contract in writing?*

A No. The statute of frauds is a law that requires certain contracts to be in writing and signed to be enforceable. As an example, a real estate broker seeking to recover compensation for listing a property for sale must have a written agreement signed by the seller (Cal. Civ. Code § 1624). However, the statute of frauds does not cover an agreement to compensate a broker for providing loan modification services or mortgage broker services. Hence, if no advance fees are collected, a broker may sue to recover compensation for performing loan modification services absent any agreement in writing.

Even though a broker may pursue a claim for compensation absent a written loan modification agreement, the broker is nevertheless strongly advised to get the agreement in writing and signed by the homeowner. A written loan modification agreement can clearly delineate each party's rights and obligations to help avoid misunderstandings and disputes. Furthermore, if a broker elects to sue for compensation, a written loan modification agreement can serve as evidence of the broker's entitlement to compensation.

Q 37. *Does C.A.R. have a standard form loan modification agreement?*

A No. C.A.R. does not have a standard form loan modification agreement (with no advance fee). Decisions to draft or revise C.A.R. standard forms are made by the Standard Forms Advisory Committee. REALTORS® may submit any suggestions or comments about C.A.R. standard forms to carforms@car.org.

IV. LICENSING REQUIREMENTS

Q 38. *Is a real estate license required for providing loan modification services?*

A Yes, in most cases. A real estate broker's license is generally required when someone acting for profit performs loan modification services for a borrower. More specifically, unless an exemption applies (see Question 41), a real estate broker's license is required for someone who, for compensation or in expectation of compensation, does or negotiates to do any of the following acts on behalf of another:

- Negotiates loans secured by real property;
- Performs services for borrowers, lenders or note holders for loans secured by real property;
- Solicits borrowers or lenders for loans secured by real property; or
- Collects payments for loans secured by real property.

Cal. Bus. & Prof. Code § 10131(d). See also "Advance Fees and Loan Modifications" in DRE's Mortgage Loan Bulletin (Fall 2008) (stating that "Unless otherwise exempt, a real estate license is required to solicit, market, or provide loan modification, short sale and other loss mitigation services that involve the negotiation or renegotiation of the terms of a loan or sale of a property"), available at http://www.dre.ca.gov/pdf_docs/mlb_fall08.pdf.

Q 39. *Why is a real estate license generally required for loan modification services?*

A The purpose of a real estate license is to protect the public from dealing with incompetent or untrustworthy real estate practitioners (California Employment Stabilization Commission v. Morris (1946) 28 Cal.2d 812, 817). With the recent mortgage crisis, loan modification scams have exploded onto the real estate scene (see Question 40). REALTORS® who offer legitimate loan modification services often find themselves pitted against loan modification scam artists.

Q 40. *What is a loan modification scam?*

A There is a multitude of loan modification scams, and as soon as the public becomes savvy to one type of scam, the scam artists think up another. Scam artists also know how to take advantage of the vulnerability of distressed homeowners facing foreclosure. Ironically, one popular tactic scam artists use is to warn homeowners about loan modification scams, but hold themselves up as reputable businesses.

Scam artists dupe homeowners out of substantial sums of money by offering to provide loan modification services, pretending to work for the lender, or claiming to have a special rapport with the bank personnel. Many scammers charge homeowners upfront fees, ranging from a few

hundred to several thousand dollars. Yet, what in fact happens is they provide shoddy service or no service at all and abscond with the money.

Aside from homeowners, REALTORS® and other people involved in loan modifications may also be targeted by scam artists. One common scenario involves scammers who solicit REALTORS® for their leads and clients, often offering referral fees that may violate the law.

To safeguard against loan modification scams, REALTORS® and their clients should be knowledgeable about the laws pertaining to licensing and referral arrangements as discussed below. Knowing these laws will help REALTORS® and their clients distinguish between scam artists and legitimate businesses. For more information about foreclosure-related scams, C.A.R.'s Legal Department has a legal article entitled [Foreclosure Scams and the Foreclosure Consultant Law](#), available for members.

Q 41. *Are there any exemptions to the real estate licensing requirement for persons performing loan modification services?*

A Yes. Homeowners can perform loan modification services on their own behalf. Another exemption from licensing requirements is available for housing counselors who provide loan modification services free of charge (see Question 42). Attorneys are also exempt from the real estate licensing requirements, but only to a limited extent as discussed below (see Questions 43 to 44). For other exemptions to the licensing requirements, C.A.R. offers a legal article entitled [Licensing Chart for REALTORS®](#).

Q 42. *Is a real estate broker's license required for someone who provides loan modification services free of charge?*

A No. A real estate broker's license is not required if someone performs loan modification services on behalf of a homeowner without compensation or expectation of compensation (Cal. Bus. & Prof. Code § 10131). Indeed, various housing counseling agencies offer free assistance to distressed homeowners. A list of HUD-approved Housing Counseling Agencies in California is available at <http://www.hud.gov/offices/hsg/sfh/hcc/hcs.cfm?&webListAction=search&searchstate=CA>.

Q 43. *Is a real estate broker's license required for an attorney who provides loan modification services?*

A It depends. An attorney rendering legal services to a client is exempt from licensing requirements if the attorney is not using or attempting to use the exemption for the purpose of evading the licensing laws (Cal. Bus. & Prof. Code § 10133(a)(3)). Moreover, for loan modifications and other loan-related activities, the exemption from the real estate license requirement for an attorney only applies if all of the following conditions are met:

- The attorney is licensed to practice law in California;
- The attorney renders services in the course of his or her practice as an attorney;
- The attorney is not actively and principally engaged in the business of negotiating loans secured by real property;

- The attorney's disbursements are not charges or costs and expenses regulated by Article 7 loans (commencing with Cal. Bus. & Prof. Code § 10240); and
- The attorney's fees and disbursements are not shared, directly or indirectly, with the person negotiating the loan or the lender.

(Cal. Bus. & Prof. Code § 10133.1(a)(5).)

Q 44. Can a loan modification business circumvent the advance fee or licensing requirements by affiliating or associating itself with an attorney?

A No, in many cases. REALTORS® and their clients should be wary of unscrupulous people who claim that their affiliation or association with an attorney enables them to practice real estate without a license, to collect advance fees, or both.

One common scenario is a broker who claims the advance fee being charged is exempt from the advance fee requirements (see Question 14) because the broker has an in house attorney or an affiliation with a law firm to negotiate the loan modification with the lender. In truth, there is no such exemption from the advance fee requirements. Furthermore, although attorneys may not be subject to DRE requirements for advance fees, an attorney or law firm is generally prohibited from "fee splitting" or sharing legal fees with a person who is not an attorney (Cal. Rules of Prof. Conduct Rule 1 320(A)).

Another common scenario is for a loan modification business to claim exemption from both the real estate licensing laws and advance fee requirements due to its affiliation with an attorney or law firm. Yet, in truth, a loan modification business is not exempt from the real estate licensing merely because it is affiliated with an attorney or law firm. Furthermore, an attorney rendering legal services is not exempt from the real estate licensing requirements unless certain parameters are met as discussed above (see Question 43).

Other than these two scenarios, there are many other business arrangements involving attorneys. Some of them are legitimate enterprises, whereas others are not, depending on their specific facts and circumstances. The DRE is currently conducting a number of investigations of people who are attempting to affiliate with attorneys to circumvent the advance fee and licensing requirements (see "Advance Fees and Loan Modifications" in DRE's Mortgage Loan Bulletin (Fall 2008), available at http://www.dre.ca.gov/pdf_docs/mlb_fall08.pdf). For referral arrangements involving attorneys, see Question 45.

V. REFERRAL ARRANGEMENTS

Q 45. Can a real estate broker pay, or receive compensation from, an attorney in exchange for the referral of loan modification business?

A No, according to the DRE. REALTORS® may be propositioned by attorneys (or people who claim to be attorneys) to refer loan modification business in exchange for a fee. The DRE states that it has been advised by the Department of Housing and Urban Development (HUD) that "referral fees paid or received in a loan modification transaction would constitute a violation of the Real Estate Settlement Procedures Act (RESPA)." See "Advance Fees and Loan Modifications" in DRE's Mortgage Loan Bulletin (Fall 2008), available at http://www.dre.ca.gov/pdf_docs/mlb_fall08.pdf). Furthermore, an attorney or law firm is generally

prohibited under State Bar rules from paying a referral fee to a non-attorney (Cal. Rules of Prof. Conduct Rule 1 320(B)).

Under RESPA, a real estate agent is generally prohibited from giving or receiving anything of value in exchange for a referral for a transaction involving one-to-four residential units with a federally-related mortgage loan as defined (12 U.S.C. § 2607(a)). A federally-related mortgage loan includes first trust deeds, junior liens, purchase money loans and refinances (12 U.S.C. § 2602(1)(A)). However, RESPA specifically exempt, among other things, a loan conversion which is defined as any “conversion of a federally related mortgage loan to different terms that are consistent with provisions of the original mortgage instrument, as long as a new note is not required, even if the lender charges an additional fee for the conversion” (24 C.F.R. § 3500.5(b)(6)). The Fall 2008 DRE Mortgage Loan Bulletin does not address the RESPA exemption for loan conversions under 24 C.F.R. § 3500.5(b)(6).

Also exempt from RESPA is a payment for reasonable services actually rendered (24 C.F.R. § 3500.14(g)(1)(iv)). For more information about RESPA, C.A.R. has a legal article entitled *Referral Fees and Arrangements*.

Q 46. *Can a real estate broker pay, or receive compensation from, an unlicensed loan modification servicer or other unlicensed person in exchange for the referral of loan modification business?*

A No, according to the DRE (see discussion in Question 45).

Q 47. *Can a real estate broker pay or receive compensation from another real estate broker in exchange for the referral of loan modification business?*

A Probably not for RESPA transactions involving one-to-four residential units with a federally related mortgage loan. RESPA exempts referral arrangements between real estate agents and brokers, but not mortgage brokers (24 C.F.R. § 3500.14(g)(1)(v)). Because loan modification may be construed as mortgage brokerage activity, a broker-to-broker referral arrangement for loan modification may arguably violate RESPA.

VI. TAX CONSEQUENCES

Q 48. *Are there any potential tax consequences for obtaining a loan modification?*

A Yes. Any debt cancelled or forgiven by a lender, such as a principal reduction in a loan modification situation, may be taxable to the borrower as “debt discharge income.” As background, when a taxpayer obtains a new loan, the loan proceeds the taxpayer receives are not taxable income because there is an offsetting obligation to repay. However, if the debt is later cancelled, such as in a loan modification situation, the debt discharged may be taxable as ordinary income.

Q 49. *Are there any exemptions from debt discharge income tax?*

A Yes. Debt discharge income is not always taxable. Most notably, Congress recently enacted the Mortgage Forgiveness Debt Relief Act of 2007 which exempts from federal income tax any debt forgiven for a loan secured by a qualified principal residence (see Question 50). Yet, homeowners may qualify for other exemptions from debt relief income tax, including the following:

- Debt discharged through bankruptcy.
- When the owner is otherwise insolvent which means the owner's current liabilities exceed current assets. This exemption, however, only applies to the extent that the liabilities exceed assets.
- Forgiveness of a non-recourse loan resulting from foreclosure (see the IRS's Questions and Answers on Home Foreclosure and Debt Cancellation, available at <http://www.irs.gov/newsroom/article/0,,id=174034,00.html>). The IRS defines a non-recourse loan as a loan for which, in case of default, the lender's only remedy is to repossess the property and not the borrower personally.
- Purchase-money seller financing (but the discharged debt is treated as a reduction in the taxpayer's tax basis).
- Qualified real property business indebtedness (but the discharged debt is treated as a reduction in tax basis).
- Qualified farm indebtedness.

With many homeowners seeking loan modifications being upside-down on their properties, they are likely to qualify for the above insolvency exemption from debt relief income tax. However, because determining insolvency can be complicated, the assistance of a tax specialist is highly recommended.

Alternatively, homeowners are also likely to fall under the non-recourse loan exemption to debt relief income tax. For example, under California's anti-deficiency rules, a loan made to purchase owner-occupied, one-to-four dwelling units is a non-recourse loan (Cal. Code of Civ. Proc. § 580b).

For more tax information, C.A.R. provides members with a legal article entitled [Taxation of Foreclosures, Deeds in Lieu of Foreclosure, and Short Sales](#). Tax information is also available at the IRS website at www.irs.gov.

Q 50. What is the exemption from debt relief income tax under the Mortgage Forgiveness Debt Relief Act of 2007?

A The federal Mortgage Forgiveness Debt Relief Act of 2007 exempts from federal income tax any debt forgiven for a loan secured by a qualified principal residence. "Qualified principal residence" indebtedness is debt incurred in acquiring, constructing, or substantially improving a principal residence (up to \$2 million). This tax break applies to debts discharged in the calendar years 2007 to 2012. Any discharged debt excluded from income under the new law must nevertheless be subtracted from the tax basis of the taxpayer's principal residence for purposes of calculating capital gains. (Internal Revenue Code § 108(a)(1)(E).)

California law conforms to the federal Mortgage Forgiveness Debt Relief Act to a limited extent. The exemption from state tax only applies to debts discharged in 2007 and 2008. Furthermore, under California law, the maximum qualifying debt is only \$800,000, not \$2 million, and the maximum tax exclusion is \$250,000 for couples filing joint returns (and \$125,000 for individual taxpayers). (Cal. Rev. & Tax. Code § 17144.5.)

VII. ADDITIONAL INFORMATION

Q 51. *Where can I obtain more information?*

A This legal article is just one of the many legal publications and services offered by C.A.R. to its members. For a complete listing of C.A.R.'s legal products and services, please visit C.A.R. Online at www.car.org.

Readers who require specific advice should consult an attorney. [C.A.R. members](#) requiring legal assistance may contact C.A.R.'s Member Legal Hotline at 213.739.8282, Monday through Friday, 9:00 a.m. to 6:00 p.m. C.A.R. members who are broker-owners, office managers, or Designated REALTORS® may contact the Member Legal Hotline at 213.739.8350 to receive expedited service. Members may also fax or e-mail inquiries to the Member Legal Hotline at 213.480.7724 or legal_hotline@car.org. Written correspondence should be addressed to:

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