FLOPPING OR A VALID INCREASE IN MARKET VALUE?

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Disclaimer: As much as I hate to sound like a typical lawyer, there are times when I need to do so…. I am an Ohio licensed attorney whose practice includes real estate law, business law, estate planning, taxes, and asset protection. This article is for basic information purposes only and does not create any form of attorney-client relationship between the reader and me, nor does it constitute legal advice of any kind. Please seek competent legal counsel in your area if you have any questions about how the following information may apply to your situation.

Real estate agents and brokers are very wary of anything that resembles "flopping." This is perfectly understandable considering Freddie Mac and the Ohio Division of Real Estate & Professional Licensing have denounced flopping scams. Unfortunately many professionals do not understand what constitutes illegal flopping versus what constitutes perfectly legal flipping.

Many professionals believe investors who buy properties at a low price and then sell those same properties at a higher price on the same day (or within a few days of each other) are guilty of illegal flopping. Buying low and selling high is not illegal: this is the ultimate example of capitalism and the law of supply and demand. There is a difference between legal flipping and illegal flopping: Flopping is illegal because it is **fraudulent**. What exactly is fraud? A technical legal definition of fraud is "(a) a representation or, where there is a duty to disclose, concealment of a fact, (b) which is material to the transaction at hand, (c) made falsely, with knowledge of its falsity, or with such utter disregard and recklessness as to whether it is true or false that knowledge may be inferred, (d) with the intent of misleading another into relying on it, (e) justifiable reliance upon the representation or concealment, and (f) a resulting injury proximately caused by the reliance." *Cohen v. Lamko, Inc.* (1984), 10 Ohio St. 3d 167, 169, 462 N.E.2d 407.

Ok, I know many non-lawyers are starting to get a headache from reading that quote; so, what does that mean in plain English? Someone commits fraud when: (a) s/he states a "fact", or covers up a fact that is supposed to be disclosed, (b) the fact stated or covered up is crucial to a transaction, (c) the stated fact is false and is known to be false by the person making the statement (generally speaking), (d) the statement or non-disclosed information was designed to mislead the other party to a transaction (e.g., a buyer or a lender), (e) it was reasonable for the other party to rely on the statement or concealment, (f) and the other party was harmed because of her/his reliance on the misleading statement or concealment. Buying low and selling high is not fraud. Causing someone to act by making misleadingly false statements or by concealing information to mislead someone is fraud.

The Spring, 2010 edition of the Ohio Division of Real Estate & Professional Licensing Newsletter contains an article called "Property Flopping: An Emerging Problematic Trend in Real Estate". It state in part that "flopping… occurs when parties involved in a short sale **intentionally conspire** to purchase the property for **less than market value** and then quickly sell it… to turn a quick profit…. [There may be a **failure] to disclose** important information to a lender about the sale. As a result, the **lender may agree to finance** the short sale **before investigating all of the facts**…. [Realtors should] **seek legal counsel… to determine whether or not a potential sale is legitimate** or merely a fraudulent scheme." [Emphasis added.] Many real estate professionals read the headline or skimmed through the article and formed incorrect opinions based on what they thought they saw in the article. What does the article really communicate? 1) Flopping is an intentional conspiracy to not disclose certain information; 2) non-disclosure of certain information allows the flopper to buy a property at less than market value; 3) because one or more lenders do not have information that was supposed to be disclosed, the lender lends money, or releases the mortgage(s) when the lender would not have done so had the lender had all of the information; and finally, the article specifically recommends consulting a lawyer to determine if any given deal is illegal flopping or a legal flip.

Freddie Mac also published an article about flopping, although this term is not used in that article: Freddie Mac refers to this as "short payoff fraud." The article can be accessed (and was last accessed June 20, 2011) here: http://www.freddiemac.com/singlefamily/news/2010/0412_payoff_fraud.html?attr=EMC-SFNCAEFTSPF Freddie Mac defines short payoff fraud as "any misrepresentation or deliberate omission of fact that would induce the lender, investor or insurer to agree to the terms of a short payoff that it would not approve had all facts been known." Short payoff fraud, or flopping, is illegal because of the fraud involved with a willful withholding of information, or a failure to disclose information that must be disclosed.

So how can one be sure legal flipping is not illegal flopping when it comes to short sales? The investor must make very clear, in all communications and in all legal documents, that the investor is purchasing the property with the intention of selling it as soon as possible for the purposes of making a profit. Also, it is necessary for the investor to make perfectly clear to the purchase financer of a third-party buyer (e.g., a lender that lends purchase money to an end-buyer who will live in the home) that the investor intends to buy low and sell high, as soon as possible, for a profit. How does an investor accomplish this? There are ways – the best method is to make sure it is a matter of public record that will show up on a title search by the title company (one example is to record a notice of option contract.) This makes all the important information available to everyone who needs that information. It also makes it completely transparent as to how you operate as an investor.

Another method of protecting the investor is to require the seller to sign an affidavit of sworn testimony regarding certain things that can prove to be legal complications if they are not handled property. For example, will the seller receive any funds from the short sale, does the seller understand what a short sale is, does the seller understand the investor intends to make a profit from the purchase and sale of the seller's property, does the seller understand that the investor does not represent the seller, does the seller understand the investor has a legal means of backing out of the contract if the number don't make sense to the investor, and does the seller understand a number of other items that need to be in the affidavit, etc…?

Notwithstanding the above information, investors will still be asked to justify how the investor can justify buying a property for a low dollar amount and selling the same property for thousands of dollars more on the very same day? The law of supply and demand explains all.

Example 1:
Consider House 1 and House 2: they are adjacent identical properties. The seller of House 1 is selling via a "traditional" sale and the buyer can take possession after a closing period of about 30-45 days. The seller of House 2 insists on a six month closing because he's leaving the country, needs to get his affairs in order, and only wants to move once. Which house is worth more?

Most buyers would say House 1 is worth more Why? Because the buyer can move in right away (at least in terms of the standard time it takes to close.) Most buyers would not be willing to pay the same purchase price for House 2 because the Buyer has to wait six months to take possession. That would be an inconvenience to most Buyers, and most Buyers would expect a discounted purchase price as compensation for such an inconvenience. After all, most Buyers want to move in as soon as possible; therefore, most Buyers would be willing to pay more for House 1 because possession can be taken in a reasonable period of time. House 1 is worth more on the open market.

Example 2:
Consider House 3 and House 4: they are adjacent identical properties. House 3 is being sold in the "traditional" manner. House 4 is vacant and is in foreclosure. Which house is worth more? House 3 is occupied and the seller lives in House 3. The seller will continue to maintain and repair the house as is needed. The Buyer of House 3 can take possession after a traditional closing period. The Buyer of House 3 has no worry about losing the house because of a sheriff sale after a foreclosure judgment.

House 2 is vacant. The condition of a vacant house deteriorates much more rapidly than does the condition of an occupied house (there is something about the lack of an occupant that makes a house have more repair and maintenance costs over the same time period as does a house that is occupied. The Buyer of House 4 could lose the house to a sheriff sale it at any time before closing; and, the Buyer of House 4 will likely have to spend more money to make repairs. Wouldn't the average Buyer be willing to pay more for House 3 than they would be willing to pay for House 4? House 3 is worth more on the open market.

Example 3:
While having nothing to do with houses, this is a perfect example of supply and demand in action. In the late 1990s the Harley-Davidson Motor Company did not manufacture enough motorcycles to meet consumer demand. Buyers of new motorcycles had to place their names on a waiting list to purchase a new motorcycle. Buyers on the waiting list had to wait up to two years before they had a chance to take delivery of their motorcycle. Buyers also had to pay full MSRP (Manufacturer Suggested Retail Price). However, buyers had an alternative if they did not wait so long to acquire a Harley-Davidson motorcycle. Buyers could purchase a used Harley-Davidson motorcycle immediately, on two conditions: Buyers had to be willing to 1) forego ownership of a new motorcycle; and, 2) Buyers had to be willing to pay a premium for immediate satisfaction of their desire for a Harley-Davidson motorcycle. Buyers could get a motorcycle immediately if they were willing to pay a few to several thousand dollars more for a used motorcycle that had been driven for several thousand miles worth of wear and tear. Why would a Buyer pay significantly more money for an inferior (inferior because of age, wear and tear) product? The Buyer attached MORE VALUE to acquiring a motorcycle NOW, even if the motorcycle was used and a few years old, than the Buyer did to acquiring a new motorcycle after waiting two years even though it would cost less money.

Example 4:
Consider two homes, as above in Examples 1 & 2. House 5 is being sold by the "traditional" method. House 6 is a short sale being sold by a distressed seller who is in, or about to go into, foreclosure. Nobody knows exactly what price the lender will accept to release the lien(s) on the property. A Buyer must make an offer on House 6 before the lender will even consider negotiating price it will accept to release the lien(s). It will usually take months of negotiating before the lender agrees to the lowest release price. What will the average Buyer of House 6 do during those months of uncertain waiting? The Buyer usually walks away from the deal and buys House 5 instead at a higher price (if House 5 is still available.) Or, maybe the Buyer decides to stick it out and wait for House 6, but loses the house to a sheriff sale because the foreclosure was finalized before a short sale was negotiated. Then the Buyer buys House 5 at a higher price (if it's still available). Which house could be sold for a higher price? House 5. Why? Because the Buyer could take possession of House 5 much more quickly and would not have to worry about

losing the house to a foreclosure sale or without having to worry about the bank refusing to accept a reasonable release offer on the House 6 short sale.

What else can be said about the value of House 5 compared to the value of House 6? Marketable title for House 5 was easily conveyable with no problems. Whether or not a Buyer could acquire House 6 with marketable title is a uncertain. A Buyer of House 6 – assuming the Buyer is able to get the house in the 1st place – may have to contend with issues of unmarketable title. How do we determine the actual purchase orice of House 5 compared to House 6? The purchase price of House 5 should be determined pretty quickly: it should only take an offer or two back and forth before a purchase price is agreed on within a matter of days. What about determining the purchase price of House 6? How many offers and counter-offers will it take to get an amount the lender is willing to accept to release the lien(s)? How long will negotiations go on before a release amount is acceptable to the bank – will it be acceptable to the Buyer? Who controls the price at which House 6 will sell? BOTH the owner(s) AND the lender. Which house is worth more? House 5.

While an investor cannot guarantee success investors will do their best to negotiate a release amount from the lender. Investors also will work to clear all liens from the title. Investors work hard to clean up the marketability of the title to the house they purchase. The investor puts in all the time and effort to deliver marketable title to the end-buyer. The investor provides a house that the Buyer can take possession of after a traditional closing period. The investor did all the hard work to ensure the as much success of transferring the house to the Buyer as the Buyer would have at a traditional closing The ultimate Buyer put no effort into making the title marketable, had no worries about the title being marketable, had no worries about whether the house would be sold at sheriff sale, had not waiting period while the bank delayed negotiation of a release amount, had no uncertainty about what the price would be, and had no less chance of success in taking possession of the house than if the Buyer purchased House 5. The investor took ALL of the risk, all of the work, all of the time, and converted a distressed house and made it a "typical" house for the ultimate Buyer: the investor added a tremendous value to the ultimate Buyer. The investor did this over a period of time, but the payoff is only realized at closing. Therefore, if the investor closes, then turns around and immediately transfers it to another Buyer, it looks like the investor could be "scamming" someone to make a profit whereas the investor EARNED the profit through a lot of hard work, through a lot of time invested, and through a lot of money invested.

House 6 started out with many defects. These defects lowered the market value and the purchase price of House 6. After the defects of House 6 have been corrected, both the market value and the purchase price of House 6 IMMEDIATELY increases. Because the increase in value/price is not realized until closing of the transfer of House 6, House 6 can have 2 different values on the same day: value 1 is the value of House 6 as the original distressed owner presented it to the investor; and, value 2 is the value of House 6 as the investor presents it (in better condition) to the ultimate Buyer. The lower price reflects the value of the house with problems. The higher price reflects the value of the house without problems. This is how capitalism and the law of supply and demand work.