If the Seller Doesn't Really Pay Closing Costs, is it a Seller Concession?

By Marjorie E. Gross

After a home seller and buyer reach agreement as to terms, the buyer requests that the actual sale price be increased by 3% to cover the buyer's anticipated closing costs, and that the seller grant the buyer a "seller concession" in an equal amount. Is there anything wrong with this?

When I first came across this problem, it was not as a regulator of mortgage bankers, brokers and loan originators, but as a member of a bar association ethics committee (the "Ethics Committee"), and the question came from the seller's lawyer, not the buyer's loan originator. The Ethics Committee recognized that this situation posed some of the same problems that beset the rest of the housing market. In particular, seller concessions were designed to increase opportunities for homeownership to those who might otherwise not qualify for a mortgage. This can be both a good thing (increasing homeownership) and a bad thing (resulting in the extension of loans to persons who are less able to repay them). Seller concessions also may result in the terms of the loan being less transparent to the parties with an interest in the mortgage, who must make decisions on the value of the mortgage and the probability that it will be defaulted on. Two examples will help to explain our dilemma.

The Practice

Example 1. Suppose the seller is asking $310,000 for his house, but the prospective buyer will not bid more than $300,000. In order to close the deal, the buyer says he will pay the seller's price, but only if the seller agrees to pay his closing costs, which are expected to be $9,000. In that case, the contract price will be $310,000, and the HUD-1 will record a seller concession of $9,000. The mortgage can be up to $299,150 (assuming FHA's maximum loan to value ratio of 96.5%). The seller also could drop his purchase price to $301,000. He would be out of pocket the same $9,000. In either case, the seller has made a "concession" from his original asking price. But, in the latter case, the buyer's maximum mortgage amount would have been only $290,465 (96.5% of the lower purchase price).

Example 2. As noted above, in the question posed to the Ethics Committee, the original purchase price of the home was $300,000. Closing costs were expected to be $9,000. The buyer could not afford to pay the closing costs, and his banker suggested that he ask the seller to increase the purchase price of the home to $309,000, and simultaneously grant a seller concession of $9,000. The maximum mortgage amount could thus be $298,185 instead of $289,500 (96.5% of $309,000 rather than $300,000). The HUD-1 would show a sale price of $309,000 and a seller concession of $9,000, but would not indicate the fact that the originally agreed purchase price of the house was "grossed up" before application of the seller concession, so that the seller was effectively "conceding" nothing at all; rather, the lender was financing the closing costs.

The Applicable Rules

The rules on sellers' concessions are found in the policies on the amount of mortgage financing a lender will provide. HUD’s existing policy regarding sellers’ concessions is found in Handbook 4155.1, § 2.A.3 and Handbook 4155.2, § 4.8, which define seller concessions and provide that any concessions exceeding 6% of the lesser of the property’s “sales price” or appraised value must be treated as inducements to purchase, resulting in a reduction in the FHA mortgage amount. In a notice published in the Federal Register on July 15, 2010 [75 Fed. Reg. 135], HUD proposed to reduce the current 6% limit to
3%, because the Federal Housing Authority’s data indicate that borrowers who receive more than 3% in seller concessions have a higher risk of losing their homes. As a result of numerous comments that the proposal would have an undue effect on low-middle buyers with mortgage loans of $180,000 or less, HUD reproposed a standard of the greater of 3% or $6,000, but not more than the borrower’s actual closing costs. Conventional mortgage lenders have capped seller concessions at 3% of the sales price. Loans guaranteed by the Department of Veterans’ Affairs cap seller concessions at 4%.

The HUD handbook allows the seller and/or a third party to contribute to the buyer’s closing costs, prepaid expenses, loan discount points and other financing concessions, loan origination fees, condominium fees, builder incentives, and down payment assistance. Even under Example 2 above, the Seller is literally “contributing” to the borrower’s closing costs. But the Ethics Committee was concerned that the Seller was not actually paying such costs, since he/she is reimbursed for the outlay with a higher purchase price. In effect, the borrower is paying those costs with funds borrowed from the lender. (Although the lender clearly could grant a seller concession, in this case it is granting a loan.) Another way to phrase the problem is that the grossed-up sales price as recorded in the sales contract is not actually the “sales price.”

The New York Legal Ethics Opinion

The Ethics Committee interprets the ethical rules in New York’s Rules of Profession Conduct. Those rules prohibit a lawyer from engaging in “illegal” conduct, or from assisting a client in conduct the lawyer knows to be illegal or fraudulent. They also prohibit “conduct involving dishonesty . . . deceit, or misrepresentation.” The Ethics Committee did not take a position on whether the gross-up was illegal or fraudulent, since that is a question of law; but it did determine that failure to disclose the gross-up involved misrepresentation as a matter of ethics. It stated:

“The issue is whether the lawyer’s participation in such a transaction facilitates deception or misrepresentation. It seems obvious that there is potential deception implicit in the transactions. . . . Thus we hold that a lawyer may not ethically participate in such a “gross up” of the actual purchase price and concomitant seller’s concession unless . . . the gross-up (and not merely the grossed-up purchase price) [is] disclosed in the transaction documents.”

In other words, the Ethics Committee had no problem with the seller’s concession in example 1 above, but thought the circumstances in example 2 were deceptive. Two other lawyer groups have reached similar conclusions. See New Jersey Supreme Court Advisory Committee on Professional Ethics, Opinion 710 (2006)(participating in the gross-up of the purchase price and the subsequent sales concession violated New Jersey’s Rules of Professional Conduct since manipulating the sales price was potentially deceptive to the originating lender or secondary investors), North Carolina Formal Ethics Opinion 12 (2001), 2001 WL 1949450. In addition, at least one New York court has criticized the practice of grossing up the sale price, followed by a “seller concession.” See La Salle Bank, N.A. v. Shearon, 881 N.Y.S.2d 599, 603 (Richmond Co. Sup. Ct. 2009). The court in La Salle said:

The term seller’s concession implies that at the time of closing the seller is conceding a certain amount of the purchase price to enable the purchaser to complete the purchase. . . . But a seller’s concession as it is utilized in this transaction, is a misnomer with no foundation in logic or mathematics because the seller concedes nothing to the purchasers. In this case, the sellers inflated the price of their home from $335,000 to $355,100 to allow the Shearons to borrow additional funds to close the transaction. The sellers conceded nothing other than to act as co-
conspirators to circumvent the Banking Law restrictions on the closing costs to mortgage ratios and to manipulate the public records of the true sales prices and market data.

While the New Jersey opinion implied that the practice of grossing up the purchase price was inherently misleading, the New York opinion indicates that the potential to mislead could be cured with appropriate disclosure “in the transaction documents.”

My own view is that the gross-up is inherently misleading and that disclosure does not cure the problem. But, at a minimum, disclosure must be made.

Reactions of Real Estate Lawyers

The Ethics Committee’s opinion produced significant push-back by real estate lawyers, who believed that seller concession practices were beyond their control, and saw no reason why the seller’s lawyer in a mortgage transaction should police the terms on which the transaction are consummated.

The Ethics Committee heard a number of arguments about why there was nothing wrong with example 2. Here are the arguments [and my response]:

Everybody does it. The most frequent argument was that the practice of “grossing up” the sale price before applying the “seller concession” was absolutely standard. Do a Google search of “seller concession.” You will find numerous websites of real estate and mortgage brokers advising potential borrowers how to finance their closing costs through a seller concession. It must be OK, the argument goes, because so many people say it’s the thing to do. [As your mother used to tell you, just because “everybody does it” doesn’t make it right. Sometimes the morals of the marketplace are unreliable.]

The lender suggested it. Lenders may not care about a grossed-up sales price as long as the appraised value of the home covers the loan. If the gross-up matters to them, they should require their loan originators to disclose it to their loan underwriters. [This argument is attractive, since the lender has more to lose than anyone else if its loan-to-value calculations are incorrect. The underwriting policies and procedures of the lender should be clear about what is permissible, particularly since loan originators may have a financial incentive to get the loan closed by enabling the borrower to finance closing costs. Moreover, the lender and its underwriting staff should know whether, in a loan that purports to have a “seller concession,” the seller is financing closing costs, or the lender is. However, in order to ensure that the loan underwriters (and not merely the loan originator) is aware of the facts, disclosure is appropriate.]

If there were something wrong with grossing up the sale price, the GSEs would prohibit it. Given how widespread the practice seems to be, the GSE’s must be aware of it. If they didn’t want to it to happen, they could prohibit it in their Handbooks. HUD has published numerous Mortgagee Letters on the topic of seller concessions. For example, in Mortgagee Letter 2005-02, HUD makes clear that lenders and appraisers must identify and report sales concessions and properly address and/or adjust the comparable sale transactions to account for sales concessions. Since they have not prohibited gross-ups, they must be content for them to occur, as long as the appraisal covers the higher mortgage amount. [The proponents may have a point here. But it assumes that the GSEs know about the gross-up practice, while there is no evidence that this is so. As a former regulator, I believe the parties have an obligation to inform the regulator if they are using a term, such as seller concession, in a manner that is inconsistent with the regulator’s definition. And shouldn’t the parties inform the appraiser that there was a gross-up, and whether the seller is financing closing costs, or the lender is?]
If there were something wrong with grossing up the sale price, state regulators would prohibit it. [State regulators regulate mortgage bankers, mortgage brokers and their mortgage loan originators, as well as state-chartered banks. But most states eliminated their requirements with respect to the loan-to-value-ratio of mortgage loans in the early 1980’s after Congress passed the Depository Institutions Deregulation and Monetary Control Act and the Alternative Mortgage Transactions Act. Moreover, the existence of the gross-up is unlikely to be discovered in normal examinations unless it is disclosed in the sales contract or HUD-1.]

The Committee’s rule discriminates against less savvy borrowers. If the Borrower had known of the need to finance closing costs before finalizing the sales contract, then he or she wouldn’t have had to amend the sales contract and the lawyer never would have known that there was a gross-up. [Of course, this wouldn’t have made it any more appropriate – just less detectable.]

The seller concession is disclosed in the HUD-1. Consequently, the argument goes, the lender or subsequent purchaser of the mortgage knows that the borrower did not pay these costs. In any event, the HUD-1 is prepared by the lender. If the gross-up must be disclosed, the responsibility lies with the lender, not the seller or his counsel. [Although the documents currently indicate that the seller paid the closing costs, where there is a gross-up, the costs are not being paid by the seller, but financed by the buyer. Although the HUD-1 is prepared by the lender, shouldn’t the buyer’s counsel inform the lender of the gross up? If the lender agrees to finance closing costs, shouldn’t it report the gross-up on the HUD-1, and ensure that the appraiser is aware of the arrangement?]

As long as the appraisal supports the higher price, there is nothing wrong with the gross-up. The sales contract and HUD-1 disclose the existence of the seller concession. Thus the appraiser is on notice that the buyer is not paying the contract price for the home, even if the gross-up is not disclosed. Thus the appraiser should not use the sale price in determining “comparables” in future transactions. Moreover, the existence of a seller concession may not affect ability to repay. Although the borrower may need help financing closing costs because he/she does not have enough savings to pay both the down-payment and closing costs, the borrower’s income may be capable of covering the higher mortgage payments that result from financing closing costs. [Now it’s the responsibility of the appraiser. As noted above, I think this would be appropriate only if the appraiser were given complete information about the value of the house, including the price the seller was willing to accept.]

Purchasers of securitized mortgages are aware of this practice. [It is not clear how purchasers are supposed to know about the gross-up, if it is not disclosed. Prospectuses for securitized mortgages disclose underwriting practices, including loan-to-value ratios of the underlying mortgages. For example, one major issuer discloses that the lender permits an LTV ratio of up to 103%, including closing costs and prepaid items up to 3% of the value of the property, but only where income, assets and employment test are met, clearly indicating that the financing of closing costs is material information.]

Imperfect knowledge

Some service providers, such as mortgage brokers and lawyers, clearly believe their professional responsibility is to act only in the best interest of their client, which means achieving the goals established by the client – in this case, purchasing his or her desired home. However, the foreclosure crisis has caused many to question the validity is this goal. The original purpose of seller concessions was to make the home more affordable, i.e. because another party was paying some of the buyer’s costs – not to enable the buyer to take out a larger mortgage.
Without proper disclosure, the practice of grossing up the purchase price before applying the seller discount is inherently misleading. Of course, if everyone knew, the practice could not be misleading because no one would be misled. But does everyone really know? Often, the seller doesn’t know why he or she is being asked to accept a higher price and to grant a seller concession – only that “it’s part of the financing arrangements.” Does the lender really know? If the sale contract disclosed the gross-up, would the lender be lending as much money without compensating credit tests? If the appraiser knew about the gross-up, would he/she still appraise the house for the grossed up value? Shouldn’t the market value of the home be the price the seller was willing to accept? After all, is it really a seller concession if the seller concedes nothing?

And what if a loan originator, but not the lender’s underwriters or management, knows about the gross-up? A corporation may be the victim of a criminal fraud even if its high-level employees knew of or even participated in the crime. See United States v. Sun-Diamond Growers of California, 138 F.3d 961 (D.C. Cir. 1998). Moreover, there is no requirement of reliance, much less reasonable reliance, in the context of criminal fraud. See, e.g. Neder v. United States 527 U.S. 1, 24-25 (1999).

In the Addendum to the HUD-1, the Buyer certifies “I have no knowledge of any loans that have been or will be made to me . . . for purposes of financing this transaction, other than those described in the sales contract.” Is this statement true if the lender is financing closing costs, but the HUD-1 shows them being paid by the seller?

One of the persons whose knowledge of the sale price of the property is the most important is clearly the appraiser. As the HUD Handbook states:

“Sales concessions influence the price paid for real estate. For this reason, FHA requires that appraisers identify and report sales concessions and properly address and/or adjust the comparable sales transactions to account for sales concessions in the appraisal of all properties.”

In order to fulfill this requirement, the Handbook requires the lender to provide the appraiser with a complete copy of the ratified sales contract, including all addenda, as well as all financing data and sales concessions for the property granted by anyone associated with the transaction – even gifts or down payment assistance, which may or may not be included in the sales contract. Where the contract is amended, this includes all amendments. But what if the parties were smart enough to think about financing closing costs before the sales contract was entered into? Isn’t the appraiser equally entitled to know that the purchase price was grossed up before the sales concession was applied?

Conclusion

Despite the absence of a specific HUD rule prohibiting a gross-up of a sales price followed by a seller concession in an equal (or substantially equal) amount, I believe that the practice is inherently misleading, to the lender, the appraiser, the insurer and to subsequent purchasers of the loan, at least without adequate disclosure of its existence. The stated sale price is not really the sale price. The seller is not contributing to the borrower’s closing costs, since any amounts that purport to be contributed are immediately returned to the seller. The lender may be unwittingly financing closing costs. And it is unlikely that either the appraiser or a subsequent purchaser is adequately informed. Anyone with knowledge of the practice in a particular case should make sure that it is accompanied by full disclosure of the gross-up.

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2 HUD defines a "seller concession" as when a home seller pays all or part of the buyer's closing costs and other fees. See Federal Housing Administration Risk Management Initiatives: Revised Seller Concessions, 77 Fed. Reg. 10695 (February 23, 2012). The Ethics Committee's essential problem is that the seller is not paying these costs. According to the FHA, concessions are present in 65% of all FHA-insured home purchase loans.

3 At this writing, a final rule has not yet been adopted. HUD's most recent regulatory agenda estimates that the final rule will be published in October 2013, but this schedule may have been affected by the government shutdown.

4 The six percent limit also includes (i) third party payment for permanent and temporary interest rate buydowns and other payment supplements, (ii) payments of mortgage interest for fixed rate mortgages, (iii) mortgage payment protection insurance, and (iv) payment of the upfront mortgage insurance premium (UFMIP). HUD 4155.1(2.A.3.b). Under the HUD proposal, Could only include closing costs, prepaid expenses, discount points, UFMIP and interest rate buydowns. All other third-party contributions would be considered inducements to purchase, resulting in a dollar-for-dollar reduction to the lesser of sale price or appraised value, before applying the appropriate loan-to-value factor under current HUD rules.

5 HUD 4155.2(4.8[b]).

6 See NY Rules of Professional Conduct, Rule 8.4(b)("A lawyer or law firm shall not engage in illegal conduct that adversely reflects on the lawyer's honesty, trustworthiness or fitness as a lawyer"), 8.4(c) a lawyer or law firm shall not engage in conduct involving dishonesty, fraud, deceit or misrepresentation."