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Between We Buy Houses and We Buy Wholesale

Abstract
The distressed residential real estate market has always depended upon the innovations of private, micro investors to reorganize the housing market and redistribute distressed properties for the benefit of homeowners, home buyers, and lenders alike. This Article asks whether recent trends in residential distressed real estate investing have created a new niche for operationally-sophisticated, yet small and nimble, private investors.

Keywords
Cornell University, real estate, distressed, residential, private, micro investors, housing market, redistribute, homeowners, buyers, lenders, foreclosure, auction, purchased, institutionalization, Fannie Mae, renting, hybrid, transactions, marries, scalability, sophistication, bulk, trapped equity paradox, sale, leaseback, buyback, Great Recession, market failure, equity, asset-rich, cash-poor, refinancing, regulations, borrowers, American Dream, repurchase, pre-foreclosure, foreclosure, pro-homeowner, jurisdiction, legal, legislation, wholesale, dominance, capitalization

Between *We Buy Houses and We Buy Wholesale*

By: Cori R. Harvey

Introduction

The distressed residential real estate market has always depended upon the innovations of private, micro investors to reorganize the housing market and redistribute distressed properties for the benefit of homeowners, home buyers, and lenders alike. This Article asks whether recent trends in residential distressed real estate investing have created a new niche for operationally-sophisticated, yet small and nimble, private investors.

Traditionally, small investors in the distressed market segmented themselves into *pre*-foreclosure investors, who found deals from dockets and *We Buys Houses* signs, and *post*-foreclosure investors, who bought properties at auction and from bank-owned REO inventories. These small, local investors have traditionally enjoyed the benefits of intimate market knowledge and, in the case of pre-foreclosure investing, early market access to the best deals in a given area.

Pre-foreclosure investors engage distressed homeowners in transactions designed to avoid individual foreclosures. Pre-foreclosure transactions come in many forms, but generally involve a distressed homeowner selling his home to a local investor, possibly leasing the home back from the investor, and possibly retaining an option to repurchase the home from the investor in the future. If the transaction involves all three steps, it is called a residential sale/leaseback/buyback (RSLB) transaction. Pre-foreclosure transactions are very sensitive to and dependent upon mobilizing the equity stored in the home and may involve short-sales where equity is insufficient.

Post-foreclosure investors traditionally have bid for and bought homes for cash at auction or purchased homes from banks after the foreclosure sale. These investors then resell or lease out the properties, depending on their individual exit strategies. One group rescues distressed homeowners from the foreclosure process and the other group relieves lenders of unwanted inventory. Therefore, both pre- and post-foreclosure investors provide valuable solutions and play a critical structural role in the larger foreclosure market.

Recent trends in the foreclosure market, especially the institutionalization of post-foreclosure investing, indicate that the size and nature of these investments groups has changed. Though individual and small groups traditionally dominated the post-foreclosure market, institutional buyers have begun purchasing foreclosed homes wholesale. After purchasing the homes from the foreclosing lenders and Fannie Mae, the institutional buyers have been renting the properties, creating housing opportunities for the newly displaced. Since 2012, institutional investors have purchased approximately 200,000 homes wholesale.[1] Large investors enjoy the benefits of greater capitalization and operational efficiency.[2]

This Article acknowledges that each transaction type is beneficial, but that, even taken

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1 Brian Louis, *Blackstone-Fueled Single-Family Home Boom Lifts Chicago*, Bloomberg News (Feb. 14, 2014).

2 The largest institutional firms in the foreclosure market are private equity firms such as Blackstone Group, LP, which already has spent $7.5 billion of a fund of almost twice that amount acquiring over 40,000 homes, making it the largest player, American Homes 4 Rent, which has purchased over 21,000 properties in 22 states, Colony Capital, Oak Tree, KKR, WayPoint, Och-Ziff, and others. These firms are financed by major international banks, such as Citigroup, Deutsche Bank, Wells Fargo, Bank of America, JP Morgan, and others. The Federal Reserve Bank has lauded the trend as a good strategy to move the inventory of foreclosed homes, which have kept the market depressed. (Craig Karmin, Robbie Whelan, and Jeannette Neumann, Housing Market's New Buyers: Private Equity, WSJ Online, http://online.wsj.com/news/articles/SB10000872396390443768804578034821658901916?). Some of these groups have started to securitize their rental pools into marketable rent-backed bonds.

together, they still leave a gap. To fill that gap, this Article envisions a hybrid of the two transactions, which marries the early market access and intimate market knowledge of one with the scalability and operational sophistication of the other. Current data shows that one quarter to one half of all homes in foreclosure have equity in them,[3] a fact which is especially relevant to pre-foreclosure investors as, presumably, an even greater percentage of homes *approaching* foreclosure would have equity in them, making this an ideal time to cherry-pick the best deals. This high-equity subset of homeowners in foreclosure may create a tremendous untapped opportunity to scale up and legitimize the pre-foreclosure marketplace with better-capitalized, formally-trained, local investors. This data highlights the existence of two overlapping phenomena that have converged to create the current foreclosure crisis: first, many homeowners are in foreclosure for reasons related to their having no or negative equity and, second, others are simply in foreclosure because they cannot pay their mortgages, even with great stores of equity. One is a supply and demand problem and the other is a cash flow problem – two distinct, but overlapping, phenomena. The latter, however, which characterizes pre-foreclosure investing, has and always will persist and explains why such investing is as old as mortgages. The latter also persists in both boom and bust markets; whereas, the negative equity problem, which drives the post-foreclosure market, creates opportunities primarily in market downturns.

The Article goes on to ask whether this hybrid opportunity is real. Can hybrid investors succeed in offering bulk pre-foreclosure options to high-equity homeowners before they lose their homes to foreclosure? To that end, Part I of this Article will describe the market failure, called the *trapped equity paradox*,[4] which gives rise to high-equity homeowners in foreclosure, and will introduce this homeowner. Part II will describe the market's current solution to this problem – the residential sale/leaseback/buyback - and will introduce the investors. Part III identifies the problems with the current market solution and raises the question: is there an unexploited opportunity for the newly-envisioned hybrid investor?

Home Foreclosure History

The Great Recession, highlighted by an unprecedented rise in home foreclosures, has given some the impression single-family foreclosure investing is a recent or short-lived opportunity. However, to the contrary, annual foreclosure rates before the recession indicate a more widespread investment market that will persist for the foreseeable future. The chart below shows the latest foreclosure rates in the United States over the past decade as provided by the Mortgage Bankers Association. The Great Recession significantly increased the number of foreclosed homes; but, in the years leading up to this period, home foreclosures tallied around 500,000 per year in the United States.

The Market Failure

Long before the most recent U.S. foreclosure crisis, there was a persistent market failure, called the *trapped equity paradox*, which will persist long after the current crisis abates. In the trapped equity paradox, a homeowner finds himself confronting the simultaneous conditions of having positive equity in his home, needing cash, and not being able to access that equity using traditional forms of financing to convert it to usable cash. As a result of the trapped equity paradox, this homeowner may be in default on his short-term cash obligations, such as credit-card and vehicle payments, and facing foreclosure on the very

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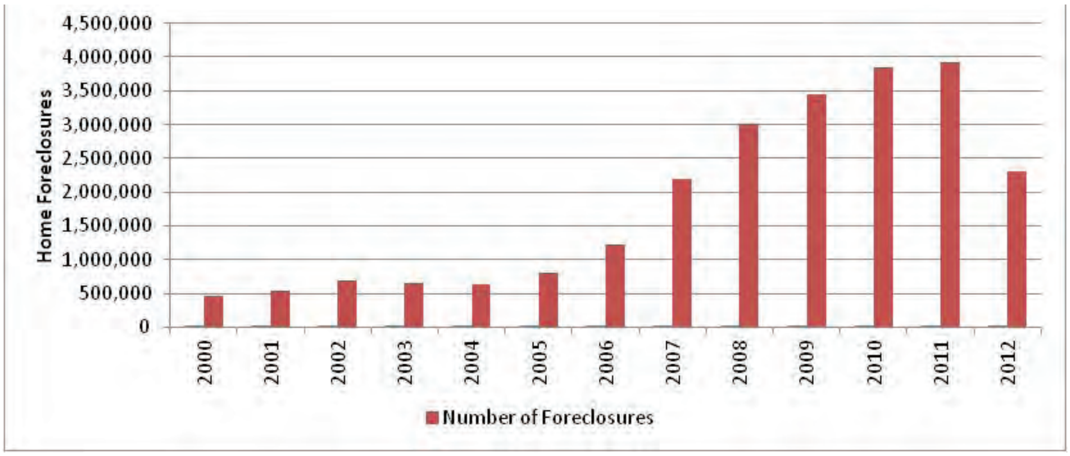
[3] RealtyTrac demonstrated in its most recent report, *US Home Equity & Underwater Report* (January 2014), that nationally 31% of homes in foreclosure had positive equity in them (defined as LTV of 100% or less). That number is significantly higher in some states and metro areas. For example, in OK, 62% of homes in foreclosure have positive equity (led by Oklahoma City with 63%), CO 54% (led by Denver with 64%), and NY 52% (led by Buffalo with 74%).

[4] Author coined the term "trapped equity paradox" in a previous article. *See* Cori Harvey, "*We Buy Houses": A Residential Sale/Leaseback/Buyback as a Solution to the Trapped Homeowner Equity Problem*, 79 Mo. L.J. (forthcoming Spring 2014).

Exhibit A

United States Home Forclosures



home with the equity trapped inside. A homeowner might normally be able to utilize ordinary banking and credit functions; however, in the trapped equity paradox, he cannot, due to lack of income or creditworthiness. This homeowner is best described as asset-rich and cash-poor[5] and exists within the northeast quadrant below. *See* Figure 1 *below.* If headed for foreclosure, this subset of homeowners will comprise the ideal pre-foreclosure candidates because the equity in their homes, once extracted, becomes the currency they can use when they lack actual cash or income.[6]

Figure 1

	Cash/Credit Sufficient	**Cash/Credit-Strapped**
Positive Equity (LTV<100%)	• Homeowner will stay put • May refinance or modify if he is in arrears[1]	• Trapped Equity Paradox • Asset-rich/cash-poor homeowner • Homeowner will want to avoid foreclosure and extract equity • Candidate for We Buy Houses or Sale/Leaseback/Buyback (RSLB) pre-foreclosure opportunities • Homeowner can stay in house & live off equity • Bank will push for foreclosure/ REO • This subset is the focus of this Article
No or Negative Equity (LTV≥100%)	• Strategic default likely • Home becomes REO • Short-sale possible • Homeowner can relocate & live off income/ savings	• Foreclosure • Home becomes REO

Local investors and other non-bank financial services providers have created ways to

5 A person is asset rich and cash poor if his wealth is primarily tied up in illiquid assets, yet he faces cash-flow problems or constraints.

6 In this regard, the pre-foreclosure transaction falls into a category of transactions known as home equity conversion products, which includes reverse mortgages, shared appreciation mortgages, and several similar products that allow homeowners to utilize the existing or anticipated equity within their homes for other beneficial purposes.

solve the trapped equity paradox and other cash flow problems using products such as title loans and pawn shops, among others. While the trapped equity paradox affects every area of a person's life, it is most problematic when the income- or credit-strapped homeowner is facing foreclosure because he cannot access any commercial means to stop it – despite the equity in the home. Therefore, in the housing market specifically, pre-foreclosure investors have designed transactions to help high-equity homeowners in foreclosure to bridge the gap while in the trapped equity paradox.

While new CFPB and mortgage refinancing regulations will ease some of the suffering of this particular group of homeowners, the regulations still permit lenders to refuse to modify or refinance certain homeowners - mainly those with cash-flow problems, regardless of their equity positions in the homes.[7] This problem can be exacerbated if the homeowner has multiple loans on the property or if the homeowner has any type of alternative or non-government-backed loan. Collectively, these factors may keep those homeowners where they were before the regulations – sans options.

Big Lenders, Small Borrowers

While the benefit of large-scale lenders is apparent at the origination stage of individual mortgage loans, the relationship gets precarious when things go wrong. Lenders have risk-related, operations-related, and profit-related reasons not to refinance certain homeowners. Because of the borrowing profile of the cash/credit-strapped homeowner, the banks will not lend to this group.[8] These homeowners are high-risk homeowners: they have demonstrated themselves willing to default on loans; they may have multiple second mortgages; and they may have no or limited income.

Operationally, the trapped equity paradox exists because it is inefficient for large lending banks to service this group of homeowners - whether they have equity in their homes or not. This group requires customized solutions and close monitoring, which large lenders are not equipped to do. Instead, lenders gravitate to transactions which reward scale, volume, and market power.[9] Rescue transactions require small, nimble, hands-on lenders who can manage individual relationships. From a profit standpoint, lenders have greater incentive to foreclose on properties with significant equity in them. At the time of foreclosure, a lender can extract much of that equity as foreclosure fees.[10] Adding to their incentives is the fact that lenders are now able to sell large batches of properties to post-foreclosure REO investors quickly and easily, especially in large markets.

Homeowner Options

Despite the unavailability of rescue financing from the lenders themselves, this high-equity homeowner often still wants to avoid foreclosure and remain in his home. Yet, in a situation where he cannot refinance his mortgage, this homeowner has very limited options – all of them problematic. He can try to save his home, using the credit of a friend

[7] In 2010, Congress and President Obama passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (called The Dodd-Frank Act), which is considered to be one of the toughest consumer protection acts in American history. Much of the legislation was drafted by consumer protection scholars Senator Elizabeth Warren and Professor Oren Bar-Gill. The Act created the Consumer Financial Protection Bureau (CFPB) as an agency of the Federal Reserve System, giving it the sole purpose to create and implement regulations in furtherance of the Act. The Consumer Financial Regulations ("CFR §§1024-1026"), are designed to preempt lender bad behavior. Generally, the CFR regulations specify how mortgage financing companies are to deal with homeowners who are delinquent on their mortgages. The goals of the rules are to increase transparency, encourage fair and expeditious dealing, and to keep homeowners informed of their options during the process. The regulations are considered to be the toughest because compliance is expensive for lenders, NOT because the regulations make lenders any more likely to refinance or modify home loans

[8] The cash/credit strapped homeowner in the northeast quadrant is the focus of this Article. If the one in the southeast quadrant can be helped, this Article can't do it.

[9] *See generally* Ronald J. Mann, *After the Great Recession: Regulating Financial Services for Low- and Middle-Income Communities*, 69 Wash. & Lee L. Rev. 729 (2012).

[10] National Consumer Law Center, Inc., *Why Servicers Foreclose When they Should Modify and Other Puzzles of Servicer Behavior* (Oct. 2009).

or loved one, which is illegal, may be a straw man purchase, and depends on his friends having more income and/or better credit than he does. He can find a lump-sum windfall to try to pay off the arrears on his mortgage, which is unlikely. He can try to lease out his property and relocate. However, he would need decent credit to find himself a new lease, cash for a security deposit, and the means of finding, and the existence of, a renter for his home. Further, that renter must be capable of paying rent at least equal to the debt-service required of the underlying mortgage.

Finally, this homeowner can try to sell the property in the traditional residential real estate market; but, state statutes often create very tight timelines for homeowners to avoid their foreclosures once lenders have initiated sale procedures. The last resort for this homeowner is to sell his home to a fast-moving, local investor and negotiate a transaction. The transaction may or may not involve the homeowner staying in the home after the sale, and may or may not involve the homeowner repurchasing the home from the investor in the future. This transaction is the focus of this Article.

Traditional WBH Solutions

Traditionally, the northeast quadrant (high-equity, cash/credit-strapped) homeowners have relied on small local neighborhood investors to resolve their trapped equity paradox. These investors often allow the homeowners to access their equity and avoid the foreclosure process. There are several versions of this pre-foreclosure transaction; but, they generally fall into three categories: an outright sale to the investor; a sale with homeowner leaseback; and a sale with both homeowner leaseback *and* optional buyback (a call option).

Specifically, just before losing it to foreclosure, the homeowner would sell his home to an investor (the "sale"), and possibly rent the home back from the investor (the "leaseback"), with or without the option to repurchase the home from the investor in the future (the "buyback"). If the transaction does include an option to repurchase, it is a residential sale/leaseback/buyback (RSLB) transaction. These transactions preserve for homeowners several options of which the traditional foreclosure process would deprive them – namely the economic, financial, psychic, and social benefits of not losing one's home to foreclosure (the sale), not having to relocate in an abrupt and disorderly manner (the leaseback), and the possibility of recapturing their American Dream in the near future (the buyback).

Traditional Foreclosure Investors

Traditional pre-foreclosure investors tend to be fast-moving, local micro-investors with nuanced knowledge of, or competitive advantage in, the marketplaces in which they operate. These "mom & pop" investors work outside of the traditional banking system and serve as an alternative to that system for homeowners who cannot access the traditional system. Often, these investors have some real estate or finance experience. If the investor engages in the leaseback and buyback stages of the transaction, he may also have construction and/or property management expertise as he effectively becomes the landlord. While these investors can be informal mom and pop operations, some can be larger.

Often, to move as quickly as possible to stop a pending foreclosure, a small investor uses hard money to execute the transaction. In that case, the investor then will resell the property to a second investor whose investment horizon is longer and whose cost of capital is lower. Problems with under-capitalization and specialization necessitate the separation of the primary and secondary investor functions. The role of the first investor is a more active deal-identification and sourcing function; the role of the secondary investor is a passive, cost-stabilizing function. The second sale lowers the cost of the transaction, which may allow the homeowner to pay a lower rent during the leaseback.[11] Whichever investor holds the property during the leaseback may be able to take advantage of economic, financial, and other tax benefits that accrue to owners of property.[12] The homeowner would be able to repurchase the property from the second investor as, ideally, the repurchase option would be recorded to run with the land.

The Pre-Foreclosure Transaction

The transaction with the homeowner begins when the investor and homeowner have identified each other. There are traditionally two ways the parties find each other. The least efficient way is for the homeowner to find and respond to a *We Buy Houses* sign in the neighborhood. The more efficient way is for the investors to find the homeowners through official publications and daily docket lists that are provided by subscription-based listing companies. Because lenders are required by statute to publish the names and other information of any homeowners they intend to foreclose upon, astute investors can easily and inexpensively find these homeowners each morning in jurisdictions all over the country. In this way, investors can find exactly the homeowners who would most benefit from a pre-foreclosure transaction and can do so as early in the process as possible. Once the investors have identified the homeowners, they can contact those homeowners, visit the properties, and negotiate terms which are mutually beneficial for the parties.

The pricing in these transactions is driven by the need for the property to change hands twice and still be below market value. For example, the original investor must purchase the home from the homeowner (sale #1) at a price that is well below market and must still be able to resell it to the second investor (sale #2) at a below-market price. The initial investor earns his money between the two sales. The second investor must be able to buy the home below market for several reasons. He must buy the property below market because, otherwise, he would be indifferent between this transaction and any other market-priced transaction, which wouldn't benefit the homeowner or either investor. In fact, if the second investor were choosing between two market-priced deals, he is more likely to choose the other one – the one that does not create time pressure, the one that does not come with legislation surrounding the sale of homes in foreclosure, and the one that does not require him to hold the property during the entire leaseback period. In this regard, the second investor bears the brunt of the risk in this transaction, in part because he pays the higher price for the property and, in part, because he must hold the property during changes in market price. Pricing the deal below market compensates him for this risk.

The Benefits of Pre-Foreclosure Transactions for the Homeowner

A well-negotiated pre-foreclosure transaction benefits all parties, while minimizing the inherent risks faced by the parties as well. The homeowner benefits in myriad ways from a pre-foreclosure sale. These benefits drive the demand for the pre-foreclosure transactions. First, he avoids the foreclosure and gets his name out of the negative public records. The data show that the foreclosure process suppresses a homeowner's credit rating by anywhere from 100-180 points.[13] Therefore, part of the cash value to the homeowner of foreclosure avoidance is that his cost of capital going forward remains lower. The homeowner also

[11] In some instances, when the homeowner cannot afford to pay any rent at all, he may negotiate with the investors to live off of the equity, meaning a portion of his equity would be consumed each month as rent.

[12] However, in some jurisdictions, the statutes which govern these transactions create a presumption of a mortgage arrangement and preclude the investors from benefiting as owners. That presumption can be rebutted and, in fact, these transactions should be structured carefully to avoid such presumptions.

[13] For example, *see* Meredith Miller, *Strategic Default: The Popularization of a Debate Among Contract Scholars*, Cornell Real Estate Review (Vol. 9, Art. 7, July 2011), at note 65 (*citing* Bob Tedeschi and Robert Calesch).

gets to extract whatever portion of his equity from the home he can successfully negotiate with the investors. Homeowners may use that cash payment to pay off other debts - often avoiding a bankruptcy. The homeowner also retains some control over the process. Unlike in the traditional foreclosure process, this homeowner is empowered to negotiate the terms, dates, and manner in which the transaction happens.

If the homeowner engages in the leaseback, he is spared the discomfort of having to relocate his family abruptly, having to uproot his children from their schools, and spared the cost and inconvenience of having to maintain a home as an owner. Given his limited options, a proactive, distressed homeowner would engage in a leaseback for the same reasons that a distressed commercial property owner would do a sale/leaseback: because the bundle of benefits he gets from owning the property in fee simple is overshadowed by the costs. Separating ownership from occupancy through a sale/leaseback allows such property owners to receive three primary benefits: being freed of the burdens of ownership[14] and liberating the value trapped inside the asset, while maintaining the benefits of occupancy and use.

If the homeowner further opts for the buyback transaction, he gets an even greater bundle of benefits. Indeed, the homeowner has an incentive to do the full buyback transaction regardless of whether he believes the home is rising or declining in value. A savvy homeowner can use the buyback feature as a hedge against real estate price risk. Had the homeowner been able to refinance his mortgage, he would still bear the risk of a market downturn. However, the RSLB transaction allows the homeowner to shift that risk to the investors, after having extracted his cash, having his debts paid off, and avoiding the foreclosure. If the market declines, the homeowner can walk away, let his option lapse and still be better off than had he never done the transaction. If, however, the market surges higher than the buyback price instead, he has an in-the-money call option that he can either exercise, if he's able, or resell for cash.

Benefits to the Investors

The benefit to the investor of pre-foreclosure investing is that he is able to use his intimate knowledge of his market - and his early access to that market - to cherry pick the best deals before the banks take the properties. This opportunity means that the equity is split only between the investors and the homeowner, in whatever ratio they can agree upon. The investor is also able to make money in smaller markets, which may be unfeasible for larger investment groups. The investor is able to get a below-market purchase price and the equity in the home will not have been exhausted by the lender's foreclosure fees.[15] Additionally, because the investors develop specific market knowledge and areas of concentration, they are able to build their brands and reputations in specific geographic areas. The homes also can come with a tenant (the original homeowner) in place, if the investor wishes, which lowers his tenant search costs. Many homeowners have income to pay rent, but not a lump sum payment for the arrears to have avoided the foreclosure on their own. Others can draw on their equity in exchange for rent.

The sale to the second investor is a critical piece of this marketplace.[16] The second investor contributes low-cost capital to the deal in exchange for capital gains, income, and tax-advantages.[17] The homeowner most likely would be unable to refinance his mortgage

[14] During the leaseback, the homeowner is relieved of the responsibilities of maintenance, taxes, insurance.

[15] The average US foreclosure is estimated to cost $78,000 and to take two years to complete; Associated Press, *Bank of America Starts Foreclosure Rental Program*, Mar. 23, 2012, *available at* www.suntimes.com/business/11489245-420/bank-of-america-starts-foreclosure-rental-program. S*ee also* Mortgage Lenders Association Policy Paper, *Lender's Cost of Foreclosure*, May 28, 2008 (putting the cost of foreclosure at 30-60% of the outstanding loan balance).

[16] The sale to the second investor is just a proxy for the original investor's access to long-term, low-rate capital, which many small, informal investors do not have.

[17] Again, some jurisdictions create a mortgage presumption and do not allow the investors to gain economic benefits of ownership. Cal. Civ. Code §1695.12, for example, creates the presumption of a mortgage when a homeowner retains both the leaseback and the buyback after the

at the rate at which the secondary investor can provide financing, which may make the homeowner's new rent payment lower than his total debt service was before the transaction. The second sale also frees up the original investor's funds to pursue other opportunities, to create scale and diversity. Finally, the sale to the second investor can shift underutilized property owner tax benefits from the low-income homeowner to the higher income second investor, who has more income to offset.[18]

Risks to the Investors

Clearly the period of pre-foreclosure creates many benefits for all of the parties. However, there are risks that need to be managed. One risk is homeowner moral hazard.[19] Once a homeowner converts his interest in the property from a fee simple estate to a leasehold estate, his incentives to care for the property may change, especially if he thinks he is unlikely to, or hasn't bargained to, regain ownership of the home. Then his incentive is that of a typical renter, which is to avoid any value-enhancing behaviors that occur at his expense and to extract as much value as he can during his leasehold.

Another problem is adverse selection, which is a risk because the very nature of this transaction may attract an adverse group of homeowners. In general, this transaction may draw desperate people who will resort to desperate and unpredictable measures when dealing with investors. Specifically, homeowners with no intent to regain the home might be drawn to this transaction just because they want to extract some of their equity before losing it all to foreclosure. It might attract homeowners who know of some latent defect in the home or some looming market decline and want to shift that risk to the investors before the defect or decline comes to light, while avoiding the foreclosure and extracting their cash. Another risk to the investors is market price risk. Because the investors may have difficulty selling the home during the leaseback period without the homeowner's consent, they may get stuck holding a home during an unexpected market decline.[20]

The investors face a legal environment that may be legislatively and judicially pro-homeowner, including creating strong legal presumptions in favor of the homeowners. Another risk, especially in strongly pro-homeowner jurisdictions is that courts may view the contracts as unconscionable and unbearably one-sided in favor of the investors. Further, because some jurisdictions do not provide strong relief to victims of unconscionability, the criminal courts may step in to find criminal fraud. These problems intensify as the size and sophistication of the investor increases relative to that of the homeowners.

Finally, the investors face extreme exposure due to operational inefficiencies and lack of capacity in financial modeling and economic analysis. For example, the inability to develop economies of scale in property management can be expensive. Also, investors need to develop financial modeling capabilities to track trends in homeowner mobility (a major source of risk for providers of home equity conversion products, such as the RSLB

sale. Traditionally, cases arising from these transactions have hinged on whether courts found the transaction to fit the characterization of a mortgage or not. Cal. Civ. Code §1695 et. seq. creates this as a burden-shifting presumption. If the courts find a mortgage loan instead of a lease, the investor and secondary investor may not be able to claim economic and tax benefits from the transaction.

[18] *See* Kyle Wells & Ryan Whitby, *Evidence of Motives and Market Reactions to Sale and Leasebacks*, Journal of Applied Finance – No. 2, 2011, p.2 (arguing that, under the US tax code, a lessee with a lower marginal tax rate can shift his tax allowances to a higher rate lessor through a sale and leaseback of an asset and that a property owner could negotiate a lower lease rate in exchange for the tax deductions). In the meantime, the homeowner is relieved of the responsibilities of maintenance, taxes, insurance.

[19] Robert J. Shiller & Allan N. Weiss, *Moral Hazard in Home Equity Conversion*, NBER Working Paper No. 6552 (May 1998).

[20] The investor may have difficulty reselling the property for several reasons. First, pursuant to Cal. Civ. Code §1695.6(e), for example, a homeowner with any repurchase rights to the property must approve the transfer of the property in writing. *Segura v. McBride*, 5 CA 4th 1028 (1992). This tenant may not willingly do so, especially since many jurisdictions do not require that the repurchase option be recorded, placing the burden on the renter to enforce his own repurchase and lease rights, which he likely cannot afford to do. Second, if the investor is trying to sell because the market is declining, the next investor to whom he's trying to sell the property likely will know that as well. Because the leaseback serves as a barrier to liquidity, the investor may not be able to get a market price for the property. Additionally, if the jurisdiction has a statutory right of redemption, which allows a homeowner, who sold his home in a foreclosure or foreclosure-related sale, to change his mind and repurchase the home, then the sale is never quite settled until that period has run and a subsequent buyer may avoid such a property. The statutory redemption period can be anywhere from ten days (NC) to three years (RI).

transaction) and subtle shifts in the second derivative of the housing price market curve (which reveals changes in the rate at which home prices are increasing or decreasing). Both pieces of data are imperceptible to the human eye,[21] even by those who are very experienced in their respective marketplaces, and can lead to expensive missteps.

The Hybrid Opportunity: Marrying Traditional Pre-Foreclosure Investing and Wholesale REO Buying?

Can pre-foreclosure investing provide opportunities for a new class of hybrid investors, especially for those who have greater sophistication than the traditional micro-investors, but who have smaller pools of capital than the bulk buyers? It is a marketplace that is easy to enter, and which can be scaled at whichever rate the investor chooses. Therefore, could marrying pre-foreclosure micro-investing with post-foreclosure bulk buying - in effect, institutionalizing the pre-foreclosure micro-investment - create a superior third transaction?

Figure 2

	PRE-FORECLOSURE • Labor intensive • Can get best deals • Negotiate directly with homeowners • Requires branding • True foreclosure rescue	**POST-FORECLOSURE** • One-stop shopping • Only get the deals the pre-foreclosure investors left on the table • Negotiate directly with banks
INDIVIDUAL TRANSACTIONS • Hard to get economies of scale • Good opportunities for small investors	• Traditional pre-foreclosure investing • Neighborhood investors • Risky and expensive	• Hard to compete with bulk buyers • May be OK in small markets without bulk buyers
BULK TRANSACTIONS • Rewards operational efficiency in acquisition, management, disposition	**OPPORTUNITY**	• Private Equity REO Purchases

Many of the problems faced by pre-foreclosure, micro-investors are due to size constraints and under-capitalization, which constrain scalability. While many of these problems can be avoided with better financing, better financing can be hard to find given the variety of risks involved – a classic chicken and egg problem. There are 14 million single-family rental units in the US and institutional investors own only 2% of them.[22] Therefore, there still is room for a better-financed, more sophisticated investor to take the best practices of each investment strategy and develop a hybrid investment category.

[21] Robert J. Shiller, *Historic Turning Points in Real Estate* (Cowles Found., Paper No. 1610, 2007), *available at* http://cowles.econ.yale.edu/P/cd/d16a/d1610.pdf ("By some accounts, the greatest challenge for economic forecasters is to predict turning points. . . [in the real estate market, and t]he housing market is populated mainly by ordinary folk who do not react with the speed of [economic] professionals.").

[22] Tom Barrack, Founder Chairman and CEO of Colony Capital, speaking on CNBC. *Looking to Play the Rental Market? Blackstone Wants You*, CNBC News (Dec. 16, 2013).

Access to Market.

Pre-foreclosure investors have access to the best deals and homeowners are hungriest for opportunities just before they lose their homes. Theoretically, bulk REO buyers expect that they are creating a portfolio that comprises a decent cross-section of whatever parameters they are trying to buy. However, pre-foreclosure investors will have picked over the deals already and should have identified and obtained the best ones. This cherry-picking leaves the bulk buyers with a portfolio that represents a cross-section of a less-desirable pool, even if they get it at low prices from banks eager to unload REO inventory. In this case, traditional investors have the advantage.

Market Knowledge.

Pre-foreclosure micro-investors generally have very specific knowledge of small geographic areas. Often they disperse property scouts into very small areas, often just a few square blocks to a few square miles. With scouts on the ground in neighborhoods daily, they can visit the homeowners published that day in the dockets and can also identify other homes that are falling into disrepair long before the homes end up on the foreclosure list. These investors report getting tips about homes that are vacant or beginning to look uncared for from postal workers, utility company workers, and others who are in the target neighborhoods daily.

On the other hand, because of their institutional background and approach, bulk REO buyers maintain access to and create macro-knowledge of the economy and large-scale trends that affect the housing market broadly. National bulk buyers, such as private equity firms and single-family REITs are good at identifying national and international trends and developing research capacity needed to take large, long-term positions. Potential pre-foreclosure investors must continue to generate and exploit local knowledge, while also investing in and developing macro-wisdom.

Search Costs.

Search costs are high for pre-foreclosure investors. Identifying and targeting potential deals, and negotiating with individual homeowners can be a labor intensive prospect. REO buyers, on the other hand, enjoy one-stop shopping and may negotiate only with banks, which presumably might be actively looking for the bulk buyers to help liquidate REO inventory.[23] To scale up, pre-foreclosure investors must develop ways to drive traffic to themselves. Traditionally, these investors have used *We Buy Houses* or *We Buy Ugly Houses* signs to draw traffic. These signs can be very prevalent in some neighborhoods and rarely, if ever, include any individualized branding. Indeed, pre-foreclosure investors must develop brand recognition and strength of reputation to draw business and break through the noise of these signs.[24] This requires consistency and fair-dealing.

Benefits to Homeowners.

Pre-foreclosure investing benefits homeowners in one way; converting bulk REO purchases into rentals benefits homeowners in another way. Pre-foreclosure investing prevents homeowners from going into foreclosure, which has very real economic and psychic benefits for the homeowners and their families. REO conversions create rental properties for the newly-displaced victims of foreclosure to call home. In fact, such schemes increase the supply of rental properties because the homes may not be available

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[23] However, Blackstone, the largest buyer of single-family foreclosures says that it individually negotiated 40,000 of its homes. John Gittelsohn and Heather Perlberg, *Blackstone Funding Largest U.S. Single-Family Rentals*, Bloomberg News, (Oct. 23, 2013) (quoting Blackstone's chairman: "You know how hard it is for you to buy a house?....I mean, you've got to negotiate with somebody, you've got all kinds of stuff, you've got the title. We did it for 40,000 houses.").

[24] Some investors interviewed state that they can draw more business from their handwritten signs than they can with their professionally printed signs. Unfortunately, homeowners are so distrustful of banks that the homeowners believe that, if they call the number on the handwritten sign, a real person might pick up who will talk to them.

for rent while they sit on the banks' balance sheets, which may create housing shortages and skew important market dynamics. Pre-foreclosure investing truly is foreclosure rescue for investors who wish to do socially beneficial investing.

Market Dominance.

Well-capitalized bulk buyers can establish dominance in their marketplaces and drive prices. Smaller investors, whether pre-foreclosure or post-foreclosure, cannot compete. Therefore, the rich get richer. However, larger buyers tend to gravitate towards the largest marketplaces, creating voids in smaller markets in which smaller firms with decent resources can prosper and gain a foothold. Additionally, it is possible that the absence of willing bulk REO buyers slows down the foreclosure process in a given marketplace. The option to sell foreclosed homes directly to bulk buyers creates artificial urgency on the part of lenders to foreclose. The lenders would not want to delay the foreclosure and risk the bulk buyer reaching capacity and/or reducing his footprint in that market, leaving the bank with that property. Therefore, the opportunity lies in bulk, pre-foreclosure buying in smaller markets.

The institutional investors may be running themselves out of the marketplace or struggling to get in. Two percent institutional ownership indicates that, despite the frenzy surrounding the bulk transactions, no institutional investor has been able to develop a meaningful foothold in the marketplace. This could be because they have become victims of their own success as they drive up the market prices in the very markets in which they want to invest. Another advantage for small investors is that post-foreclosure bulk buying will be a short-term play that will dry up when the market rebounds.

Operational Efficiency.

One of the main drivers of profit in this marketplace is operational efficiency. Operational efficiency would involve developing economies of scale, commoditization and systematization of the acquisition, management, maintenance, and disposition of properties. Micro-investors may not have the procedures in place to maximize operations. Potential investors would have to scale up their operations, including their hiring and procedure development, or outsource various functions, to effectively manage the various aspects of their operations. A micro-investor likely cannot do this. Gaining efficiency also requires finding ways to reduce homeowner and tenant individuality - the very problem that has driven the lenders away from this group of homeowners.

Legal Sophistication.

The legal environment surrounding the purchase and sale of homes in foreclosure is very complex and missteps can have dire consequences. Specifically, fairly harsh equity purchase statutes govern these sales in some states. Small investors are often under-represented or engage in DIY lawyering in their transactional and pre-litigation legal affairs, which can be detrimental – especially when various aspects of the transactions create presumptions against the investors and may carry criminal sanctions. However, along with sophisticated market research capabilities, potential investors must invest in sophisticated legal capabilities. In this case, the bulk buyers, often with in-house legal teams, have the advantage.

Under-Capitalization.

Most of the preceding problems are tied to under-capitalization in some form. "Mom and pop" investors own generally between 10-200 units apiece, but cannot get financing for what is a very capital-intensive business (due to buying and renovation costs).[25] Fannie Mae and Freddie Mac limit the number of investor loans an investor can get. Lack of funds also constrains the micro-investor's ability to diversify and maneuver if and when he sees shifts in his marketplace. In this regard, potential investors must maintain reserves to stay nimble. In fact, the lack of reserves and cash flow problems cause micro-investors to make bad decisions, which can get them into greater financial problems or even criminal charges. This requires sophisticated portfolio management skills. Lack of capitalization also forces the separation of the initial and secondary investor functions, which could be profitably combined. Specifically, the primary investor is on the ground sourcing deals and uses expensive short-term money, which enables him to move quickly on deals as they arise. The second investor has access to less expensive, longer-term money, but plays a more passive role in which he relieves the primary investor of his high-rate obligations so the primary investor can go find new deals to generate volume of deals. A better-funded group could combine those functions in the same pool of funds. Recently, one large bulk-buyer has started offering private funds to small entrepreneurial investors to purchase foreclosures to hold as rentals.[26] This creates an opportunity for sophisticated small players in their respective markets, while allowing the private equity firm to diversify into markets and deal sizes it could not otherwise get into.

Conclusion

Marrying traditional pre-foreclosure, micro-investing with bulk, post-foreclosure investing to promote the benefits of each, while mitigating the risks of each, democratizes foreclosure investing and creates opportunities for a new breed of investor. This Article has spelled out a particular investment strategy that presents tremendous opportunity for energetic investors (or investment groups) whose formal business, finance, and operations training makes them savvier than the "mom and pop" micro-investors. Because they can develop the resources to do a few dozen to several hundred transactions - more than their micro counterparts, but less than their bulk-buying counterparts - they can get into marketplaces that may be undesirable for the largest buyers.

Alternatively, this group of investors also could lend their skills to the needs of the other two types of investors. For example, they could lend their financial and operational skill and formality to the mom and pop groups who have the local knowledge. Or, they could lend their agility to the larger buyers, helping the larger players get into smaller marketplaces or into the pre-foreclosure space. Or, this hybrid investor could seek funding from the large bulk buyers, circumventing Fannie and Freddie's ten loan cap per investor. The sky is the limit and to whichever investor figures out how to institutionalize the pre-foreclosure market go the spoils.

25 Tom Barrack, Founder Chairman and CEO of Colony Capital, speaking on CNBC. *Looking to Play the Rental Market? Blackstone Wants You*, CNBC News (Dec. 16, 2013).

26 Diana Olick, *Looking to Play the Rental Market? Blackstone Wants You*, CNBC News (Dec. 16, 2013). (Blackstone has announced that it will provide funding to entrepreneurs to buy foreclosures. Minimum requirements are deals involving at least 5 properties and 25-30% "skin in the game." They will underwrite these bundles of single-family properties very conservatively, as they do multi-family transactions or commercial loans).

Sound Off #1 (Industry Professional Response)

THE INSTITUTIONALIZATION OF SINGLE FAMILY HOMES

Author

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Broadstone Net Lease is a private Real Estate Investment Trust (REIT) that invests in freestanding, single-tenant, absolute net-leased properties located throughout the United States. Broadtree Homes is a private real estate offering that invests in single-family homes for rent in multiple markets including New York, Florida, and Minnesota.

Tait holds a BS degree in Civil Engineering from Princeton University and an MBA from the Simon Graduate School of Business at the University of Rochester. She currently serves on the Board of Governors of the National Association of Real Estate Investment Trusts (NAREIT) and is the Director of M&T Bank's Rochester Regional Advisory Board.

The single family home rental market has always been a very significant part of our housing market and national economy; however, the fragmentation among "mom and pop" owners has resulted in little centralized data, research or attention focused on this sector. The recent recession has changed that. An emerging institutionalized market for rental single family homes is rapidly developing, and that genie is unlikely to go back into the bottle due to both cyclical and structural changes in our markets.

The crisis created both a glut of available houses at distressed prices and a surge in demand for rental housing. The homeownership rate in the US dropped from a peak of 69% to a current level of 65% as a result of foreclosures, lack of available mortgage financing and disillusionment about the "American Dream." That amounts to 5 million more rental families. As home prices went down and rents went up, opportunistic buyers were drawn into the sector to achieve higher returns than they could achieve on multi-family apartment investments, plus the possibility of outsized "HPA," or home price appreciation.

Now that the economy is beginning to normalize, many argue that the opportunity for high risk/high return investors looking to make a profitable short-term trade and high IRR may be fading. However, what is just starting, is the assemblage of stable portfolios for conservative, long-term investors seeking "core-like" returns.

Today, over 14 million families (representing 12% of all households in the US) live in rented, single family homes. Only 1-2% of these rental homes are currently held by investors that operate portfolios representing hundreds or thousands of homes. As these organizations continue to grow in scale, they can take advantages of operational efficiencies newly created through the use of technology and they can tap into emerging sources of capital. Their cost advantages, combined with the opportunity to offer more reliable customer service and improved marketing, will spur a huge consolidation wave from individual investors to institutional ownership, just as it occurred in the apartment industry in recent decades.

While specific market intelligence and entrepreneurial spirit may favor the local sharpshooter in acquiring and rehabbing properties, once stabilized, it makes sense to recycle capital and "flip" homes to an institutional owner that has the following advantages:

- Ability to access debt and equity capital efficiently
- Ability to purchase materials and contract labor at discounts
- Ability to use technology to efficiently underwrite large portfolios of homes
- Ability to diversify investments across different markets and neighborhoods
- Ability to effectively market their homes and communicate with residents using the internet and centralized call centers
- Ability to assure residents that their home will be properly maintained and will not be sold or foreclosed out from under them
- Improved compliance with applicable zoning and housing laws

Sound Off #2 (Industry Professional Response)

THE INSTITUTIONALIZATION OF SINGLE FAMILY HOMES

As the housing crisis has drawn considerable attention to the housing industry, "deals" are becoming more and more scarce, which is fine with me. The US housing market was never meant to be a speculator's bonanza. It is actually a very predictable and stable asset class for creating cash flow and capital appreciation. All the attention paid to finding deals loses sight of the fact that at its core, US housing is an accumulation play, not a flip.

It is true that housing investment has always been the domain of the small investor, and the entry of the large institutional investors crowds the market for the small guy. There is a silver lining though, and the institutional presence is a net positive for a few reasons.

First, the surge of demand institutional investors created in 2010 and 2011 gave us the bottom of the market. Owner occupant purchases of single family homes were down 15.5% in 2011, but investor purchases were up 65%. 2011 was the bottom of the market because of the actions of less than a dozen large scale investors. They showed much more confidence than the traditional home buying market—the mom and pops--at just the right time.

A few years have gone by and those institutions are providing the price stabilization that comes when new demand enters a market. Although other buyers, especially first time buyers, are being driven out of the market because of institutional competition, every homeowner in America is benefiting from the impact of this new demand in the form of price appreciation--not to mention the millions of people who can't own but still wish to live in a single family home.

Second, the single family market was always considered a great investment, but was never an institutionalized asset class. It had never been placed under the Wall Street microscope, nor was it organized with institutional quality data, management, and systems. That is taking place rapidly now, and what is being learned about the movement and behavior of single family real estate is very positive. It performs in a very dependable way when not manipulated, and is driven by one of the most reliable forces on earth - demand for housing in the US.

This new understanding, and all the new data and tools developed for investors buying thousands of homes, benefit investors at every level. My best analogy is this: The internet was invented for some very serious purposes. None of them involved me buying running shoes on line. But now I can buy running shoes on line.

In the end, this asset class still favors the little guy. Local presence, first-hand market knowledge and personal control over the property is not so easy with a national portfolio, but it is with a local one.

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Gregory Rand is a 20-year real estate industry leader and Managing Partner at Rand Real Estate Services, the parent company of Better Homes and Gardens Rand Realty, Rand Commercial Services, Rand Mortgage, Hudson Abstract and Hudson Group Insurance. As a foremost authority on housing patterns and emerging trends within the real estate market, Rand is guided by his proprietary 12-rule methodology that provides concrete, creative and pragmatic instructions on how to act ahead of the curve to gain wealth in real estate through all market cycles. He has since turned his attention to collaborating with a powerful coalition of political, civic, and business professionals to help solve the foreclosure crisis. His advice is followed by readers of his popular blog, "House Rich" and attains widespread viewership on real estate matters as a regular FOX TV news contributor. Rand was also the focus of "There's Value in Real Estate if you Find your Florida" by Paul Sullivan of The New York Times. Rand's firm is a family owned business that sells, finances and insures over 6,000 real estate transactions each year, so he has seen it all.