

REAL ESTATE PRACTICE

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REAL ESTATE PRACTICE

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Real Estate agents are urged to refer to two indispensable reference sources: ***“Real Estate Law”*** and ***“Real Estate Reference Book”*** published by California Department of Real Estate. Please visit DRE’s website, www.dre.ca.gov. Or you may order via our school.

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PREFACE

Real Estate Practice is an introduction to the many interesting aspects of the real estate business. This book has been written primarily for the prospective real estate broker or salesperson, but it will also be of interest to the people who want to become a real estate professional.

How to Use This Book

Read the text of each chapter. At the end of each chapter there are chapter quizzes that will require you to use what you have learned to solve problems involving practical applications of the topics covered. After you complete a test, you can check the answer key by looking at the back of the book.

It is difficult to overestimate the growing importance of the Internet to the real estate industry. The resources available there have brought together the interests of agents, consumers and investors. Throughout this book you will find addresses on the World Wide Web, a collection of computer sites referred to in this book as the “ **web.**”

The web has made the Internet easily accessible to anyone with a computer and modem or, in some cases, a television set coupled with a phone line and wireless keyboard. There are web sites sponsored by government agencies, sites run by private trade groups and others that are commercial enterprises yet offer a great deal of free information that is both interesting and useful.

We encourage you to explore the sites mentioned in this book to expand on what you read here. To make it easy to find site references, they are highlighted in the margins of the text. There is also a complete list of all site references in the Internet Appendix at the back of the book. As with any resource, you are cautioned to use good judgment when considering the validity of the information you find on the Internet.

Research and written by Timothy Lu, CPA.

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CHAPTER 1: REAL ESTATE MARKETS



Preview

Real estate transactions are taking place all around you, all the time. When a commercial leasing company rents space in a mall or the owner of a building rents an apartment to a retired couple, it's a real estate transaction. If an appraiser gives an expert opinion of the value of farmland or a bank lends money to a professional corporation to purchase an office building, it's a real estate transaction. Most common of all, when an American family sells its old home and buys a new one, it takes part in the real estate industry. Consumers of real estate services include buyers and sellers of home, tenants and landlords, investors and developers. Nearly everyone at some time is involved in a real estate transaction.

All this adds up to really big business complex transactions that involve billions of dollars every year in the United States alone. The services of millions of highly trained individuals are required: attorneys, bankers, trust company representatives, abstract and title insurance company agents, architects, surveyors, accountants, tax experts and many others, in addition to buyers and sellers. All these people depend on the skills and knowledge of licensed real estate professionals.

REAL ESTATE BUSINESS

BROKERAGE

Brokerage is the business of bringing people together in a real estate transaction. A broker acts as a point of contact between two or more people in negotiating the sale, purchase or rental of property. Despite the size and complexity of the real estate business, many people think of it as being made up of only brokers and salespersons. Actually, the real estate industry is much bigger than that. Appraisal, property management, financing, subdivision and development, counseling and education are all separate businesses within the real estate field. To succeed in a complex industry, every real estate professional must have a basic knowledge of these specialties.

A broker may be the agent of the buyer or the seller (or both), or the broker may not be anyone's agent. The property may be residential, commercial or industrial. A salesperson is a licensee employed by or associated with the broker. The salesperson conducts brokerage activities on behalf of the broker. The broker, however, is ultimately responsible for the salesperson's acts.



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APPRAISAL

Appraisal is the process of estimating a property's market value, based on established methods and the appraiser's professional judgment. Although their training will give brokers some understanding of the valuation process. Lenders generally require a professional *appraisal*, and property sold by court order requires an appraiser's expertise. Appraisers must have detailed knowledge of the methods of valuation. In many states, appraisers must be licensed or certified to carry out local transactions. Appraisers must be licensed or certified for any federally related transactions. Appraisal is covered in later chapter.

PROPERTY MANAGEMENT

A **Property Manager** is a person hired to maintain and manage property on behalf of its owner. By hiring a property manager, the owner is relieved of such day-to-day management tasks as finding new tenants, collecting rents, altering or constructing new space for – tenants, ordering repairs and generally maintaining the property. The scope of the manager's work depends on the terms of the individual employment contract, known as a *management agreement*. Whatever tasks are specified, the basic responsibility of the property manager is to protect the owner's investment and maximize the owner's return on his or her investment. Property management is discussed in later chapter.

FINANCING

Financing is the business of providing the funds that make real estate transactions possible. Most transactions are financed by means of mortgage loans or trust deed loans secured by the property. Individuals involved in financing real estate may work in commercial banks, savings associations and mortgage banking and mortgage brokerage companies. A growing number of real estate brokerage firms affiliate with mortgage brokers to provide consumers with "one-stop-shopping" real estate services. Financing issues are examined in later chapter.

SUBDIVISION AND DEVELOPMENT

Subdivision is the splitting of a single property into smaller parcels. Development involves the construction of improvements on the land. These Improvements may be either on site or off site. Off-site improvements, such as water lines and storm sewers, are made on public lands to serve the new development. On-site Improvements, such as new homes or swimming pools, are made on individual parcels. While subdivision and development normally are related, they are independent processes that can occur separately. Subdivision and development were discussed in our real estate principles course and will not be discussed further in this course.

COUNSELING

Counseling involves providing clients with competent independent advice based on sound professional judgment. A real estate counselor helps clients choose among the various alternatives involved in purchasing, using or investing in property. A counselor's role is to furnish clients with the information needed to make informed decisions. Professional real estate counselors must have a high degree of industry expertise.

EDUCATION

Real estate education is available to both practitioners and consumers. Colleges and universities, private schools and trade organizations all conduct real estate courses and

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seminars, from the principles of a prelicensing program to the technical aspects of tax and exchange law.

REAL ESTATE MARKET

The market for each of these types of property can be subdivided into the sales *market*, which involves the transfer of title and ownership rights, and the *rental market*, in which space is used temporarily by lease.

☞ *Although it is possible for a single real estate firm or an individual real estate professional to perform all the services and handle all classes of property discussed in this chapter (unless restricted by a state's license law), this is rarely done. While such general services may be available in small towns, most firms and professionals specialize to some degree, especially in urban areas. Some licensees perform only one service for one type of property, such as residential sales or commercial leasing.*

A **market** is a place where goods can be bought and sold. A real estate market is a vast, complex economic system. The function of a market is to provide a setting in which supply and demand can establish market value, making it advantageous for buyers and sellers to trade.

SUPPLY AND DEMAND

☞ *When supply increases and demand remains stable, prices go down. When demand increases and supply remains stable, prices go up.*

Uniqueness and immobility are the two characteristics of land that have the most impact on market value.

The operation of **supply and demand** in the market is how prices for goods and services are set. Essentially, when supply increases and demand remains stable, prices go down; when demand increases and supply remains stable, prices go up. Greater supply means producers need to attract more buyers, so they lower prices. Greater demand means producers can raise their prices because buyers compete for the product.

Supply and demand in the real estate market

Two characteristics of real estate govern the way the market reacts to the pressures of supply and demand: *uniqueness* and *immobility*. **Uniqueness** means that, no matter how identical they may appear, no two parcels of real estate are ever exactly alike; each occupies its own unique geographic location. **Immobility** refers to the fact that property cannot be relocated to satisfy demand where supply is low. Nor can buyers always relocate to areas with greater supply. For these reasons, real estate markets are local markets: each geographic area has different types of real estate and different conditions that drive prices. In these well-defined small areas, real estate offices can keep track of both what type of property is in demand and what parcels are available.

☞ *Technological advances and market changes have widened the real estate professional's local market. No longer limited to a single small area, brokers and salespersons must track trends and conditions in a variety of different and sometimes distant local markets. Computers-including information networks and laptop PCs, cellular phones, fax machines and a growing arsenal of other technologies-help real estate practitioners stay on top of their wide-ranging markets.*



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Because of real estate's uniqueness and immobility, the market generally adjusts slowly to the forces of supply and demand. Though a home offered for sale can be withdrawn in response to low demand and high supply, it is much more likely that oversupply will result in lower prices. When supply is low, on the other hand, a high demand may not be met immediately because development and construction are lengthy processes. As a result, development tends to occur in uneven spurts of activity.

Even when supply and demand can be forecast with some accuracy, natural disasters such as hurricanes and earthquakes can disrupt market trends. Similarly, sudden changes in financial markets or local events such as plant relocations or environmental factors can dramatically disrupt a seemingly stable market.

Factors Affecting Supply

Factors that tend to affect the supply side of the real estate market's supply and demand balance include the labor force, construction and material costs, and government controls and financial policies.

Factors that affect the supply of real estate are:

- ⇒ *Labor force;*
- ⇒ *Construction costs;*
- ⇒ *Government controls; and government financial policies.*

Labor Force and Construction Costs

A shortage of skilled labor or building materials or an increase in the cost of materials can decrease the amount of new construction. High transfer costs (such as taxes) and construction permit fees can also have discouraged development. Increased construction costs may be passed along to buyers and tenants in the form of higher prices and increased rents, which can further slow the market.

Government Controls and Financial Policies

The government's monetary policy can have a substantial impact on the real estate market. The Federal Reserve Board establishes a *discount rate* of interest for the money it lends to commercial banks. That rate has a direct impact on the *interest rates* the banks in turn charge to borrowers. These interest rates play a significant part in people's ability to buy homes. Such government agencies as the Federal Housing Administration (FHA), the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) can affect the amount of money available to lenders for mortgage loans.

Virtually any government action has some effect on the real estate market. For instance, federal environmental regulations may increase or decrease the supply and value of land in a local market.

Real estate taxation is one of the primary sources of revenue for local governments. Policies on taxation of real estate can have either positive or negative effects. High taxes may deter investors. On the other hand, tax incentives can attract new businesses and industries. And, of course, along with these enterprises come increased employment and expanded residential real estate markets.

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Local governments also can influence supply. Land-use controls, building codes and zoning ordinances help shape the character of a community and control the use of land. Careful planning helps stabilize and even increase real estate values. The dedication of land to such amenities as forest preserves, schools and parks also helps shape the market.

Factors Affecting Demand

Factors that tend to affect the demand side of the real estate market include population, demographics and employment and wage levels.

Factors that affect the demand for real estate are:

- ⇒ *Population*
- ⇒ *Demographics*
- ⇒ *Employment and wage levels*

Population

Shelter is a basic human need, so the demand for housing grows with the population. Although the total population of the country continues to rise, the demand for real estate increases faster in some areas than in others. In some locations, however, growth has ceased altogether or the population has declined. This may be due to economic changes (such as plant closings), social concerns (such as the quality of schools or a desire for more open space) or population changes (such as population shifts from colder to warmer climates). The result can be a drop in demand for real estate in one area, matched by an increased demand elsewhere.

Demographics

Demographics is the study and description of a population. The population of a community is a major factor in determining the quantity and type of housing in that community. Family size, the ratio of adults to children, the ages of children, the number of retirees, family income, lifestyle and the growing number of single-parent and empty-nester households are all demographic factors that contribute to the amount and type of housing needed.

Employment and wage levels

Decisions about whether to buy or rent and how much to spend on housing are closely related to income. When job opportunities are scarce or wage levels low, demand for real estate usually drops. The market might, in fact, be affected drastically by a single major employer moving in or shutting down. Licensees must be aware of the business plans of local employers.

As we've seen, the real estate market depends on a variety of economic forces, such as interest rates and employment levels. To be successful, licensees must follow economic trends and anticipate where they will lead. How people use their income depends on consumer confidence. Consumer confidence is based not only on perceived job security but also on the availability of credit and the impact of inflation. General trends in the economy, such as the availability of mortgage money and the rate of inflation, will influence an individual's decision as to how to spend his or her income.

Summary



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Although brokerage is the most widely recognized real estate activity, the industry provides many other services. These include appraisal, property management, property development, counseling, property financing and education. Most real estate firms specialize in only one or two of these

CHAPTER QUIZ

1. In general, when the supply of a certain commodity increases,
 - A. Prices tend to rise.
 - B. Prices tend to drop.
 - C. Demand tends to rise.
 - D. Demand tends to drop.
2. All of the following factors tend to affect supply **except**:
 - A. The labor force.
 - B. Construction costs.
 - C. Government controls.
 - D. Demographics.
3. Factors that influence the demand for real estate include:
 - A. The number of real estate brokers in the area.
 - B. The number of full-time real estate salespersons in the area.
 - C. The wage levels and employment opportunities.
 - D. The price of new homes being built in the area.
4. Commercial real estate includes all of the following **except**:
 - A. Office buildings for sale.
 - B. Apartments for rent.
 - C. Retail space for lease.
 - D. Fast-food restaurants for lease.
5. Property management, appraisal, financing and development are all examples of:
 - A. Factors affecting demand.
 - B. Specializations within the real estate industry.
 - C. Non-real estate professions.
 - D. Government regulation of the real estate industry.

Answers: 1-B, 2-D, 3-C, 4-B, 5-B

CHAPTER 2: REAL ESTATE ECONOMICS



Preview

To understand real estate market, we need to understand how the real estate economics are about. Real estate market is primarily driven by our local economy. In this chapter we will discuss both national and regional, city and neighborhood trends in an effort to interpret what effect these trends will have on the real estate market. We will discuss economic systems, basic economic theories, tools to measure economic activities.

BASIC ECONOMIC CONCEPTS

Economics is a science concerned with how individuals and societies choose to use scarce resources to produce, distribute, and consume goods and services. A science that is concerned with human behavior is frequently called a social or behavioral science. Therefore, economics is a social or behavioral science that studies how people allocate scarce resources in order to satisfy their need for food, clothing, housing, and recreation.

The desire for material goods and services usually exceeds the supply available, and economics attempts to determine how scarce goods and services can be distributed efficiently. For example, imagine how many families would like to live on a 10- to 15-acre ranch within an easy 15-mile drive of their jobs in a large city. When such a miniranch becomes available, who gets it? Who decides which family gets the land and the opportunity to enjoy a rural setting and which families must continue to live in the congested city? Should names be drawn out of a hat? Should it go to the highest bidder? Should the land be subdivided? Should the government make it into a park? As you can see, this is a problem involving scarcity. There is simply not enough land to satisfy all of the families who wish to live on miniranches.

CHOICE AND OPPORTUNITY COST

A key concept in economics is choice and opportunity cost. Resources are scarce, and individuals and societies must choose among competing uses of limited resources. Once a choice is made, that which is given up or not selected is the trade-off, or *opportunity cost*, that one must pay for a particular choice. For example, if a person works in a large city but chooses to live in a quiet suburban area, the trade-off or opportunity cost of living in the suburbs is the expense, time, and frustration of a long daily commute. In short, every choice incurs a cost; there is no free lunch. It is the role of the economist to examine alternate



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solutions to scarcity problems, pointing out the advantages and opportunity cost of each solution.

ECONOMICS IS AN INEXACT SCIENCE

As a social science, economics is concerned with human behavior, not with mere physical objects. A chemist can predict with great accuracy what will occur when certain chemicals are mixed. But an economist cannot always predict accurately what will occur when certain economic ingredients are mixed.

For example, if a country is in a recession, reducing income taxes should stimulate the economy because people will have extra dollars to spend. But a tax cut will not immediately stimulate the economy if people decide to save rather than spend their newfound dollars. The key point is that people can change their behavior patterns, and these changes add uncertainty to economic predictions. However, by constantly studying human behavior and upgrading their analytical tools, economists are continually attempting to improve the accuracy of their forecasts.

ECONOMIC SOLUTIONS MAY CONTAIN VALUE JUDGMENTS

Frequently, economists can agree on the nature of an economic problem but because of data interpretation and their own personal beliefs, can differ as to the best solutions. For example, if a nation is suffering rapid inflation, caused by too much spending driving up prices faster than businesses can increase supply; most economists would agree that inflation should be reduced. But what actions should be taken to stop inflation? Should the government increase taxes to cut consumer spending? If so, whose taxes should be increased? Or should the government cut back on its own spending? If so, which government programs-welfare, defense, highways, low-income housing-should be cut?

Students should not become bewildered by disagreements among economists. Disagreements among experts exist in most fields of study. How can two equally qualified real estate brokers arrive at different conclusions as to the ideal use for the same parcel of land? Is there not just one ideal land use? Or does the interpretation of an ideal land use depend on the circumstances, interests, and experiences of the person proposing the solution?

As trained social scientists, economists attempt to minimize the number of personal value judgments that enter into their analyses, but students should recognize that some bias does exist. When disagreements arise among experts, students should carefully listen to all sides and then form their own opinions.

DIFFERENT ECONOMIC SYSTEMS

What will be produced? How will it be produced? For whom will it be produced? These are the economic questions that every society must answer, and economists have agreed that there are three general types of answers to these questions.

TRADITIONAL ECONOMY

If the society chooses to continue doing things as they have been done before, we call its system a **traditional economy**. A child follows the parent's trade, a farmer uses age-old methods, social stratification remains fixed-these are the hallmarks of a traditional economy like that of medieval Europe and found today in some underdeveloped countries.

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If the great majority of decisions about production and distribution are made by private individuals in competitive markets, the system is called a **market economy** or *capitalism*.

If it is the government that makes most of the economic decisions in society, the system is a **command economy** more commonly known as *socialism* or *communism*.

Although some of the underdeveloped world still has a traditional economy, our concern will be with the market and command solutions to the basic questions of production and distribution. The major distinction between these two systems is the role of the government. In a “pure” market-or capitalist-society, the government provides only defense needs and a judicial system that will protect the rights of individuals and foster competitive markets. Private individuals own the property and resources of the society. They produce goods and services and distribute them according to supply and demand using a competitive market system. It is the ability to pay, not the need to have, that determines who gets what in this system. In a “pure” commander socialist-society, the government owns the major resources as a trustee for the people. The government produces and distributes goods and services according to its interpretation of its citizens' needs.

In the real world, there is no such thing as pure capitalism or pure socialism. Although in recent years there has been a worldwide decline in socialism, all large economies have some mixture of the two systems. The United States is primarily a capitalistic country, but its economy has many features of the command system: Just look at the uses the government makes of tax dollars. Whether citizens like it or not, the U.S. government builds missiles, supports various social services, builds roads, and gives food to developing nations. On the other hand, countries with more socialistic economies allow their farmers to have private plots of land, encourage some individuals to own and operate businesses, follow public buying patterns to determine what consumer goods to produce, and create profit incentives for some categories of workers.

MARKET ECONOMY

Capitalism, also known as *market system* prevails in the United States, and most democratic countries in Europe and Asia. Therefore, we will concentrate on this economic system.

☞ ***The United States was founded by capitalists who came here for economic gain.***

While some immigration was the result of people looking for refuge from persecution the majority came to our shores in the hopes of a higher standard of living. There were no class or religious barriers to economic advancement in the United States. The freedom that was sought in America was primarily economic freedom.

Capitalism and socialism are economic systems, not political systems. Terms like democracy, monarchy, and anarchy describe political systems.

☞ ***Capitalism occurs in a “demand” economy, whereas socialism takes place in a “command” economy.***

If the majority of decisions are made by private individuals demanding land, goods, or services in competitive markets, the system is called **capitalism**. If the government makes the majority of decisions, the system is called a command economy, more commonly known as **socialism**. In other words, a capitalist economy is based on consumer demand and how



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much the consumer is willing to pay. In a socialist economy, the government dictates both production and prices for basic goods and services.

PURE CAPITALISM (WHAT, HOW, AND FOR WHOM)

In a pure capitalistic economy, society needs to answer the critical questions of what, how, and for whom to produce? The answers are determined by the interaction of supply and demand-what Adam Smith, the famous capitalist, called the “invisible hand.”

What to produce is determined by businesses as they produce goods and services to satisfy the demands of buyers.

How to produce is answered by the lowest possible production cost.

To remain competitive, a manufacturer must constantly seek ways of producing at lower costs. According to pure capitalistic theory, these lower costs should ultimately results in lower consumer prices.

For Whom shall the items be produced? Who gets the goods and services, and who must do without? According to the theory of capitalism, goods and services will go to those who have something of value to exchange. Usually the medium of exchange is money. In short, goods and services go to those who can pay for them.

BASIC PRINCIPLES OF PURE CAPITALISM

The basic principles of capitalism form the backbone of America. Although the United States has drifted away from pure capitalism, the basic principles remain central to our way of life.

- ♦ **Private Property** – The right of Individuals to own, dispose of, and control real and personal property.
- ♦ **Private Enterprise** - The major sources and businesses are owned and controlled by private citizens, not by the government. These private enterprises have freedom of choice in the use of these resources.
- ♦ **Competitive Markets** – Markets in which numerous buyers and sellers negotiate for the exchange of goods and services. No one person can manipulate prices. Ultimately, the bargaining process results in good being allocated at the lowest possible price.
- ♦ **Profit Motive** - The desire for personal gain motivates individuals to take risks and form businesses to produce the goods and services demanded by society. Failure to produce what society wants, as the correct price will cause personal bankruptcy, where success will generate profit and personal wealth.
- ♦ **Laissez-Faire** (“*Let people do as they please*”) – A theory that the government should not interfere in the basic private economic affairs.

CAPITALISM IN UNITED STATES (MIXED CAPITALISM)

America’s economy is a “*mixed economy*,” in which both public (government) and private (individual) institutions exercise economic control.

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This system evolved as a result of public pressure - to correct what the majority believed were serious faults in a “pure” capitalistic economy. Consequently, the government became active in many areas of the private economy.

⇒ *The United States is basically a free market economy, but the government purchases about 20 percent of everything produced, employs about 17 percent of all workers, and collects taxes worth about 35 percent of all income.*

A **capitalist society** exercises private control over production and distribution through individuals working for individual gain. In such a free enterprise system, goods will not be produced unless there is a market for the goods. Demand must be coupled with purchasing power in order for a market for goods to exist.

Demand is determined by taste, income, and prices of related goods among others. Demand is inversely related to price.

At higher prices, fewer goods are demanded, while lower prices increase demand.

The sources of production under capitalism are land, labor, capital, and management.

☞ ***The catalyst for capitalism is “profit.”***

Only for profit will people start businesses and risk their capital. Increased risk must be balanced by the possibility of increased profit.

An **entrepreneur** is a risk-taker who combines land, labor, capital, and management to provide a market-desired good or service that can be sold for more than the cost of producing it-hopefully, for a profit.

In a pure capitalist society¹ wherever extraordinary profits are being made, other businesses will enter the marketplace and competition will result in lower prices.

☞ ***Capitalism is the only economic system that gives consumers a say in what is produced.***

Capitalism is the system that is most efficient at meeting the needs and wants of its citizens. In a capitalist society, citizens are free to vote for what they want. They vote with their dollars.

In a pure laissez-faire economy, the marketplace would be supreme. There would not be any government control or regulation. Our capitalist system is not pure capitalism because we have governmental controls of many types. As an example, federal, state and local governments regulate real estate activity.

Federal statutes, which control or regulate the real estate industry, include the following:

1. Real Estate Settlement Procedures Act
2. Truth in Lending Act
3. Equal Credit Opportunity Act
4. Fair Credit Reporting Act



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5. Civil Rights Act of 1866
6. Civil Rights Act of 1968
7. Americans with Disabilities Act
8. Interstate Land Sales Act
9. Sherman Anti-trust Act

Every state regulates the licensing and conduct of real estate brokers and salespersons, as well as appraisers and lenders.

California Contractor Licensing Board regulates contractors. For its website please visit www.cslb.ca.gov. States regulate subdivisions and set minimum construction and health and safety standards. Local governments control land use and set their own local health, safety and construction standards. We have, therefore, what is known as a modified, or mixed, capitalist system.

Progressive state and federal income taxes, inheritance taxes, and social programs all tend to redistribute wealth in our society. One purported purpose is to reduce the danger of our society developing rigid class lines.

SOCIALISM

Karl Marx is the father of socialism. Marx believed dramatic economic change was possible only through revolution. He is considered the prophet of socialism.

Marx maintained that the value of goods should be computed simply as the sum total of the wages and equipment necessary to produce the goods. He believed there should be no rent for land since land should not be privately owned, no interest for the use of capital, and no profit for management non risk-takers.

Under **socialism**, major industries are owned by the government.

☞ ***Under socialism, private ownership of the means of production is replaced by state ownership.***

Socialists believe private ownership and competition lead to an inefficient use of the means of production and the benefits of such a system go to only a few.

In a socialist state, economic decisions regarding what and how much should be produced, as well as prices, are determined by leaders, not its consumers. Under socialism there is no incentive to meet society's needs, nor is there any motive to improve production. Socialism requires a *command economy* with economic decisions mandated by governmental Leaders rather than a *demand economy*, such as exists under capitalism, where the demands of the marketplace determine what is produced. Russia has realized that pure socialism does not work and they are moving toward a market economy.

⇒ ***Even China, which formerly followed rigid rules against private ownership, has allowed individuals to produce and compete in the marketplace.***

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In the remaining communist countries there is an active “black market” for Western style goods.

This black market illustrates the inability of state decisions to meet market demands. In state-controlled factories operating without competition, there is no incentive to improve quality or design.

In the U.S. we realize that even our government programs, such as are, require incentives for individuals to end their dependence on such programs.

Incentives are the key to motivating people in a mixed capitalist society. Socialism does not have a way to motivate efficient economic activity.

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 ***Real Estate Economics, simply stated, is the application of these economic principles to the real estate marketplace.***

Our desires for goods and services frequently exceed the supply available, and economics attempts to determine how these limited goods and services can be utilized efficiently without waste. Real estate economics is a field of study that uses economic principles to help solve real estate problems. Like general economics, real estate economics is concerned with the allocation of scarce resources, but the main focus is on the use of real property.

In other words, how does a society create a mechanism for the allocation of different types of land among individuals?


Economics is primarily concerned with the efficient allocation of scarce resources.

In economics our goal is to determine how the market system prices and distributes goods and services throughout the economy.

It is the study of the divergent forces that determine the use and value of real estate, our nation's most valuable physical asset. Not only is an estimated two-thirds of our national wealth in real estate but also, after the government, more people make their livelihood directly or indirectly through real estate development and marketing than any other American industry. The largest investment the average person ever makes is in real estate: a home. It could take 30 years to pay for making such a decision.

Buildings have a long life, far longer than depreciation periods used for tax purposes. Many structures, if reasonably maintained, could have physical lives of a hundred years. The wrong use, the wrong location, or even the wrong design could have a lasting effect on future owners and users. Therefore, decisions in real estate should be made utilizing the resources that are available.

Every real estate decision has an effect on other decisions. The type of structure built could affect what is built in the area in the future. Even the rent policy will have an influence outside of the structure itself. Every transaction can have a ripple effect on others.

 ***In economics, we study what has happened in the past in order to formulate explanations to predict what will happen in the future.***



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By gaining an understanding of basic real estate economic principles, we have the tools that enable us to make the economic decisions of the future.

Real estate economics has long been treated as a stepchild of economics. Until recently, traditional economists have largely ignored the field of real estate, despite the fact that real property offers true utility value, that real property value far exceeds the value of our supply of gold and greenbacks combined, and that the value of mortgages, trust deeds and land contracts exceeds the value of all stocks and bonds.

Economists avoided applying their principles to real estate, possibly because there were just too many different factors influencing value. External influences and interrelated theories make forecasting difficult, but not impossible. Economic theory in relationship to real estate cannot be studied in a vacuum; hence it is more of an applied science than a pure science.

The real estate marketplace is vibrant with change and interacting factors that influence economic trends. A danger to avoid is oversimplification. Economic change results from many factors, sometimes working together, sometimes in different directions. Every aspect of our economy, from national debt to unemployment changes, can be significant. Even local changes of a new road or a changed use can have a lasting effect on other property.

As a professional you are expected to advise clients. That advice should be based upon an understanding of economic principles as well as trends and factors influencing value.

Understanding real estate economics will not guarantee your success, but it can certainly reduce your chance of failure. Hopefully you will gain a framework for economic decision-making. Will Rogers said, "Who can predict what is going to happen in the future is entitled to the spoils."

REAL PROPERTY

There are two types of property: *real property* (immovable) and *personal property* (movable).

Real property is the land and buildings or improvements attached to land. Real property consists of:

- ♦ Land;
- ♦ Anything permanently attached to the land;
- ♦ Anything incidental or appurtenant to the land; and
- ♦ That which is immovable by law.

Any tangible items that are not permanently attached to real estate, and thus are not considered fixtures, are classified as *personal property*.

U.S. ECONOMIC HISTORY

United State's early economic growth was fueled by a seemingly unlimited supply of free or low cost land. In early days, "Go West Young Man" was based largely on land opportunities. With the advent of the railroad came access to markets as well as an aid to *westward movement*. Besides crops, early economic growth was stimulated by what the

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land could support, including fur, game, and domestic animals, as well as the mineral wealth the land contained.

The industrial revolution resulted in factories for the goods needed by Westward expansion and a growing population. Immigration was encouraged to provide workers for industry as well as consumers for its goods.

Our nation's economic base changed from agricultural fur and mineral to manufacturing and now towards technology and service related industries. However, agriculture, mining and traditional manufacturing industries still play a significant role in our nation's economy.

The days of the wide-open frontier are long gone. The larger the population, the scarcer and more valuable the land became. The highest priced land is now concentrated in the most populated areas - urban areas-because that's where the jobs are.

LOCAL ECONOMIES

Many factors affect our national economy as well as local economies. The local economy could be based upon an industry or even a single employer and the growth or contraction of that industry or employer could affect the local economy and the local real estate marketplace.

☞ ***A local economy could be far different from the regional or national economy.***

The economic base of a community can change. A new plant, a closed plant, government decisions, and new recreational opportunities are just a few factors that could change a community's economic base.

REAL ESTATE ECONOMICS (ANALYSIS OF TRENDS)

Real estate economic analysis is inductive in nature. It is a logical process that begins by looking at the neighborhood and the site itself. We start all analysis by looking at the economy on the following levels:

1. National
2. Regional
3. City
4. Neighborhood

MARKETS AND PRICES

WHAT DETERMINES PRICES AND OUTPUT?

This section defines the term *market* and describes how prices and output are established in competitive markets. Special emphasis is placed on the factors that cause prices and output to change.

What determines the rent charged for land? The interest rate charged for capital? The wage level charged by labor? The price of goods and services? The amount of goods produced? In the U.S. economy, most of these questions are answered in the marketplace. A market is defined as a place where buyers and sellers meet to bargain and exchange items of value at negotiated prices.



REAL ESTATE PRACTICE

The characteristics of a market can influence the level of output and the prices paid for goods and services. Markets can be broken down into two broad categories: markets with perfect competition and markets with imperfect competition.

When conditions of perfect competition prevail in a market, there are many buyers and sellers bidding against each other for available goods and services. No one buyer or seller can exert influence over the market or control prices. The goods or services being offered are similar enough so that the buyer will select the lowest-priced offering. The bargaining between buyers and sellers establishes prices.

If either the buyer or the seller exercises some control over the market, then conditions of imperfect competition prevail. If there are several sellers and one buyer, a lower price will result. If there are several buyers and one seller, a higher price will result. Consider the previous example of the miniranch in the suburbs: If there is just one property for sale and demand is strong, the many prospective suburbanites will drive the price up by bidding against each other. But if 500 miniranches suddenly came on the market, the price of most miniranches in the area should level off or fall.

DEMAND AND SUPPLY

The U.S. economy has become so complex that it is difficult to find examples of perfect competition, but people tend to understand the market forces that influence prices more clearly by viewing them under conditions of perfect competition. Therefore, the following discussion assumes a perfectly competitive market. Later, the principles discussed below will be modified to analyze prices in the imperfect real estate market.

Prices in a market economy are determined by the interaction of buyers and sellers as they compete against one another for goods and services in the marketplace.

☞ ***The total quantity that buyers are willing to buy at a given time at certain prices is called demand.***

The total quantity that sellers are willing to sell at a given time at certain prices is called supply

People must be careful not to confuse desire or need with demand. Demand is desire or need coupled with the ability and the willingness to spend. For example, Family A wants a \$400,000 home but cannot afford it. Family B wants the same home and can afford it, but Mr. and Mrs. B do not want to make the necessary high monthly payments. Family C wants the house₁ can afford it, and will make high monthly payments. Only Family C exercises real demand for this house. Families A and B are lookers, not buyers. Some economists use the term *demand* for desire or need, and when ability to pay is joined to desire or need, they use the term *effective demand*. Regardless of which term is used, it is effective demand, not wishful desire or need, which is the key to understanding demand in the marketplace.

2: REAL ESTATE ECONOMICS

THE LAW OF DEMAND

As stated earlier, economists do tend to agree on some things. One of these common points is the existence of a few economic laws. An important law is the *law of demand*, which states:

☞ ***The lower the price, the more consumers will buy. The higher the price, the less they will buy.***

At lower prices, consumers will buy more goods because they can afford more and because a lower price may entice them to buy more after their initial purchase. For example, you may buy one can of Brand A for \$1.00, but to entice you to buy more, the grocer may lower the price to two cans for \$1.75. At higher prices, consumers will buy fewer goods because they cannot afford as much and because each additional unit purchased will give less satisfaction than the original unit.

Changing circumstances may change demand by causing an increase or decrease in the number of available buyers. Some of the causes of a change or shift in demand are listed below:

1. *An increase or decrease in population.* Demand rises or falls with population: As the number of people increases, demand increases; as the number of people declines, demand declines. More people increase the demand for housing, whereas fewer people decrease the demand for housing.
2. *An increase or decrease in per capita income.* Demand also rises and falls with the level of per capita income: The higher the level of income, the greater the demand; the lower the level of income, the smaller the demand.
3. *Changes in consumer taste and substitute products.* If consumers favor smaller cars over large sedans, demand for the former grows and demand for the latter diminishes. The same is true in housing: If city dwellers create a trend to move to the suburbs, then the demand for city apartments will decline and demand for suburban homes will grow.
4. *The amount of credit available.* Easy credit tends to increase demand, whereas tight credit tends to reduce it. Of course, you must pay back later what you borrow now, and this will affect future demand.
5. *The effect of advertising.* The well-written newspaper ad or the catchy TV commercial can create desires that eventually lead to purchases and increased demand.

SUPPLY

Demand represents the buyer's side of the market. Supply represents the seller's side of the market. The total quantity that sellers are willing to sell at a particular time and at a certain price is called supply.

THE LAW OF SUPPLY

The *law of supply* states: *Producers will offer more products for sale as prices increase and fewer as prices decrease.* Higher prices may mean higher profits, so businesses increase output. As prices decline, profits usually decline, and businesses cut back on output.



REAL ESTATE PRACTICE

Supply, like demand, reflects changing circumstances. Some of the causes of a change or shift in supply follow:

1. *Changes in the cost of the factors of production.* If land, labor, or capital gets more expensive, some producers will be unable to make a profit and may have to drop out of business, thereby reducing the supply. If the factors of production become cheaper, perhaps because of better technology, some producers might seek a profit by moving into that particular business, thereby increasing supply.
2. *A change in demand for one product can cause a change in supply of another product.* For example, if people decided to live in tents instead of houses, you could expect to see a cutback in the supply of homes and an increase in the supply of tents.
3. *Business anticipation of future prices and profits can change the amount of goods supplied.* Sellers will increase output if they think future prices and profits will increase; they will decrease output or even go out of business if they think future prices and profits will decrease.

SUPPLY AND DEMAND VS. OUTPUT AND PRICE LEVELS

If all the sellers and buyers of goods and services were to come together, there would eventually be an auction-like agreement among them, which would determine the selling (buying) price of the goods and services. If sellers were to insist on prices that are too high, some buyers would refuse to purchase. Not wanting excess goods on hand, sellers would then lower prices until they sold the merchandise. If prices were too low, sellers would not be able to make a profit. They would stop production, and the buyers, not wanting to do without the products, would gradually increase their bids until sellers were enticed back into production.

After much movement back and forth, prices settle at the point where the quantity that buyers are willing to purchase equals the quantity that sellers are willing to sell. This is called the *equilibrium point*; here buyers and sellers are matched, and the goods and services for sale in the market are sold. Rents, wages, interest rates, and prices of goods and services in a perfectly competitive market are established by this interaction of supply and demand.

But in a dynamic economy, things never stay the same for very long. The changes noted above cause both supply and demand to shift, and these shifts change the equilibrium point. For example, if supply remains the same while demand increases, would you expect prices to increase or decrease? Would supply remain at the same point or would it change in response to the increase in demand? Prices would of course increase: More buyers are after fewer goods. Suppliers would then increase production and the quantity supplied to take advantage of the higher prices. Then the increase in demand and supply would create a new equilibrium point to clear out the market.

And what would happen if demand remained constant while supply increased? Prices would go down as sellers tried to liquidate their stocks, but this trend might force some sellers out of business. Soon the supply would decrease to reach a new equilibrium point with demand.

2: REAL ESTATE ECONOMICS

EQUILIBRIUM (POINT AND PRICE)

In a free market, equilibrium will be established at a price which will result in a supply that will satisfy the demand of buyers.

☞ ***Equilibrium, more simply stated, is the point where the demand and supply curves cross, establishing the market price.***

At any other price, the demand and supply would be different. In an equilibrium market, there is no shortage or oversupply at a particular price. Equilibrium is the price obtained when the supply and demand curves intersect by clearing the market of excess goods.

☞ ***Since the marketplace is constantly changing with new sellers and buyers, the equilibrium point does NOT remain constant.***

When supply and demand are not at an equilibrium point (or price), there will be either a shortage or an oversupply. In many markets, the price will react to either of these situations by eventually reaching equilibrium.

In understanding the forces leading to equilibrium, you should consider these points:

1. When supply increases, the price will decrease, which in turn will increase demand. At a price above the equilibrium price, the quantity supplied would exceed the quantity demanded. Producers will lower the price to deplete unwanted inventory. As the price falls, the quantity demanded will rise, and the quantity supplied will fall. The price will eventually settle at PE, the equilibrium price.
2. When supply decreases, the price will increase to reduce demand. At a lower price, the quantity supplied is less than the quantity demanded, creating a shortage. Consumers would bid up the price. As the price increases, producers will supply more. The price would then settle at the equilibrium price, PE.

THE REAL ESTATE MARKET IS AN IMPERFECT MARKET

Real estate does not lend itself to perfect economic supply and demand models.

To begin with, there is product differentiation. **Product differentiation** is the deliberate attempt by suppliers to make their products (buildings or developments) unique and distinct from those of their competitors. This helps to avoid price competition. Because of different locations, designs, construction methods, and even decorating, no pure price competition exists. In addition, emotion also plays a great part in purchase decisions.

Real estate requires a lengthy process to increase supply. It can take a number of years for a developer to purchase land, obtain the necessary building permits, construct the properties and sell or lease them. The developer usually does not know what the competition is doing until it is too late to make any changes in plans. This is what is meant by **“imperfect knowledge”** of the market. Because of the time lag and imperfect knowledge of the market, we often overproduce or fail to produce.

Real estate purchases usually require financing, and the government, through the Federal Reserve Board, controls the money supply and interest rates. As a result, we do not have a completely free market. It is not just prices that affect supply and demand in real estate; it is the availability and cost of financing as well. As we know, housing demand is relatively



REAL ESTATE PRACTICE

sensitive to rents and prices; therefore increased costs of renting or buying will tend to decrease demand.

Demand is meaningless unless it is coupled with purchasing power and/or financing ability.

Demand without the ability to complete a purchase is merely a wish that, by itself, does not affect the marketplace.

Supply and demand forces are so strong that they have resisted government attempts to control prices. During World War II the Office of Price Administration (OPA) set price controls by rationing goods. The result in many areas of the economy was that products disappeared from the conventional marketplace and a vast black market developed.

☞ ***In a market system, items will NOT be produced if there is no market. If there is demand, there will be production.***

Will Rogers said, "If you want to make money in real estate, find out where the people are going and get there first." What Will was talking about was basic supply and demand economics: Increases in demand will increase value.

ELASTICITY OF SUPPLY AND DEMAND

Elasticity is the size or magnitude of a reaction to a change in price. The *Elasticity of Supply* is the measure of the response of the quantity of a good supplied to a change in price. Demand and supply are each either elastic or inelastic.

An **elastic supply** means that a small change in price will greatly affect the quantity supplied.

An **inelastic supply** means that a change in price will have little effect on the quantity supplied.

☞ ***The total supply of land is relatively inelastic.***

Although some land can be created (reclaimed) from the sea and swamps have been drained, we generally regard land as being an asset of fixed dimension. It is difficult to create more land.

The supply of land for a particular use is fairly elastic in that higher prices will make more land available for that use. As an example, an increase in agricultural prices would result in more land being placed in production. Marginal land would be farmed, land would be reclaimed, and desert land would be irrigated. Similarly, higher prices will make more farmland available for sale on the marketplace.

The **elasticity of demand** is the ratio of the percentage change in quantity demanded to the percentage change in price. An **elastic demand** means that a small change in price will greatly affect the quantity demanded. An **inelastic demand** means that a change in price will have little effect on the quantity demanded. An example of an item with a relatively inelastic demand is table salt. If the price were cut in half, people would not use more salt as seasoning. Similarly, doubling the price would likely have little effect on demand.

2: REAL ESTATE ECONOMICS

The difference between elastic and inelastic demand is the degree to which a price change affects the quantity purchased. The importance of this measurement cannot be overstated. Without this ability to measure and predict how people are likely to respond to economic changes, all the economic theory in the world would be of little help to us.

☞ ***The demand for real estate is elastic.***

The demand for real estate is elastic because of:

1. Available alternatives. Where two similar houses are available, the lower priced house will lower the demand of the other. Consumers will substitute lower priced goods for more expensive goods.
2. Relative high price of real estate.
3. Long time dimension of the purchase decision.

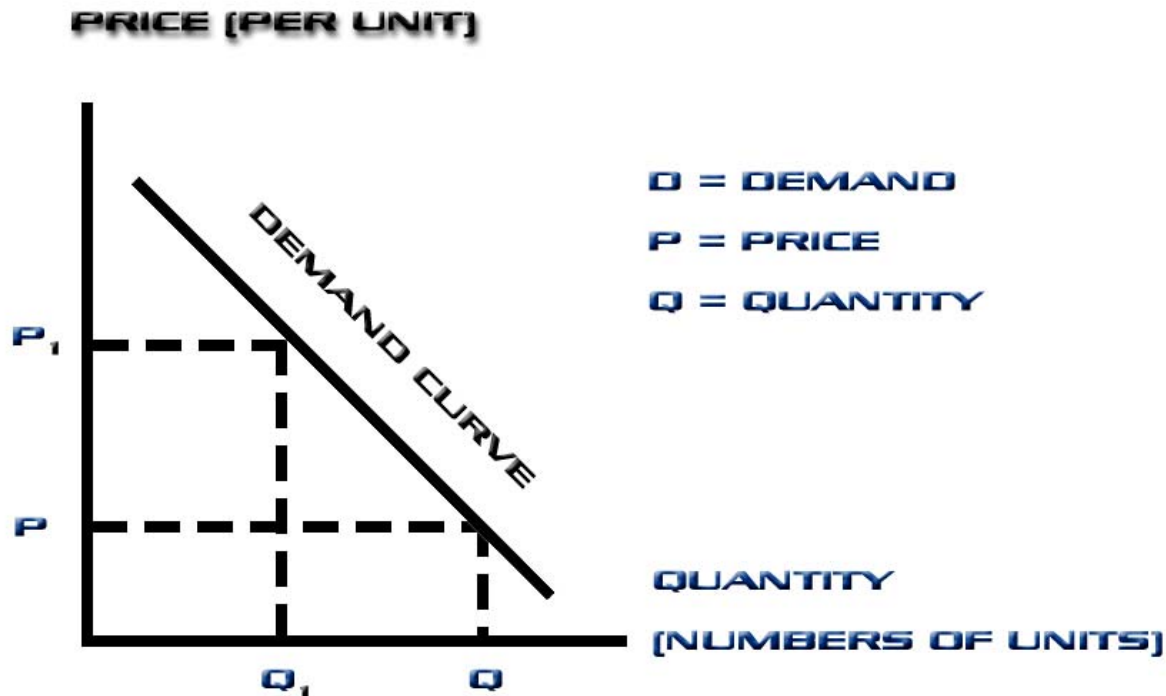
Within the housing market there is even supply elasticity. Alternatives to buying are renting, commuting from other areas, relocating or moving in with others.

A demand curve that is straight up and down would indicate a completely inelastic demand. In such a situation, lowering prices would not affect the demand. (See next figure.)

Figure 2-1 Inelastic Demand



REAL ESTATE PRACTICE



REAL ESTATE SUPPLY AND DEMAND

If sellers believe prices will rise, they will not sell their property or, if they do sell, they will ask for a higher price. As sellers hold back property (decrease supply), prices will rise. Sellers who believe prices will fall will list their properties for sale as soon as possible. Because many people place their property on the market at the same time, the oversupply will lead to lower prices. As more properties are put on the market (supplied), prices fall because there are more properties for sale at the time than buyers. When buyers believe real estate prices will rise, or that there will be a shortage of property for sale, they buy as soon as possible. Many buyers entering the market at the same time tend to bid up property prices. When buyers believe real estate prices will fall, they try to postpone purchases.

☞ ***Informed sellers and buyers will act upon changes they anticipate in the marketplace.***

A **seller's market** exists when there are few sellers and many buyers, who keep real estate prices up because less property is available for sale or rent. In a seller's market a buyer has few alternatives and must either pay the price required or do without.

☞ ***The exodus of buyers from the market will cause property prices to fall.***

A **buyer's market** exists when there are many sellers but few buyers, who keep real estate prices down because there is an abundance of property for sale or rent. In a buyer's market buyers have far more power to negotiate prices and terms. They also have more choice in selecting an ideal location within a neighborhood.

2: REAL ESTATE ECONOMICS

Both buyer's and seller's markets can exist at the same time within a metropolitan area because there are many neighborhoods within a city. The real estate is primarily a local market.

☞ *The party who is ready, willing and able to buy property now will obtain it by offering the highest price.*

INFLATION AND DEFLATION IN REAL ESTATE

DEFLATION

A **deflationary economy** exists when there are more goods than there is purchasing power.

After World War II, we had some periods of high inflation, but practically no deflation. We also had some short-term periods where regional real estate values declined, despite a generally inflationary economy.

☞ *In a deflationary period the dollar buys more.*

INFLATION

Since the late 1980s, inflation has been in check and consumer price increases have been relatively modest. On the other hand, since the early 1990s and into the 2000s, we have seen a dramatic increase in real estate prices.

☞ *The dollar buys less in an inflationary period.*

Inflation is either pulled by demand or pushed by costs. Inflation in real estate aids trustors and mortgagors (borrowers). They benefit by the increase in value of the underlying real estate (security). In addition, lenders get to pay back their loans with dollars having less purchasing power (inflated, cheaper dollars).

Inflation - Demand Pull vs. Cost Push

Demand Pull

Demand-pull inflation has nothing to do with cost. It relates simply to the interaction of supply and demand in the marketplace. *Demand Pull inflation occurs when the price of goods is bid up due to demand increasing above supply.*

An increase in unemployment should logically stem inflation, as unemployment will decrease the number of dollars available to purchase goods. Unemployment has a tremendous effect on controlling inflation, both through the reduction in wages and reduction in worker bargaining power.

During much of the 1970's, the purchasing power of the dollar was falling. People were afraid that the value of their savings would be eroded by inflation. This resulted in a tremendous interest in buying assets such as real estate. Real estate was considered a hedge against inflation in that real estate values had generally increased at a rate in excess of inflation.



REAL ESTATE PRACTICE

Coupled with the idea that real estate was a safeguard against inflation, real estate profits were formerly taxed advantageously at a lower capital gains rate. This made real estate a very attractive investment during the '70s. During this era, the price of real estate was driven up to unrealistic levels.

☞ ***Housing inflation has an effect on the entire economy. As the proportion of income allocated for housing increases, other purchases suffer.***

Real estate purchases by syndicates and corporations, as well as by individual investors, fueled the inflation. Many of these purchases were based more on the “bigger fool theory” than on economic reasoning. Speculators were rushing to buy on the expectation that someone (a bigger fool) would come along and pay them more than they had paid. In the early 1980s, speculators had largely left the market. By 2002, inflation was under 2% a year.

Cost Push

Cost Push inflation occurs when increasing costs push up prices. When the costs of production increase, producers are able and willing to supply less at each price level.

☞ ***When production costs increase, the increase is largely passed on to purchasers in increased costs. In real estate, when costs of new units rise, it generally causes prices of existing units to rise.***

Inflation can be self-perpetuating so that it continues despite other trends in the economy. Workers whose wages are tied to the cost of living get raises during inflationary periods. Pension benefits are often tied to the cost of living. Their increased wages help drive up the price of goods. This in turn causes the cost of living to increase so that wages increase further. This cost-push inflationary-spiral effect was very evident in Israel where workers' wages are customarily tied to the cost of living. The only way to break this spiral is to break the psychology of inflation. One way to do this is to impose strict wage and price controls. Former President Nixon attempted to freeze wages, although with very limited success.

STAGFLATION (INFLATION DURING RECESSION)

Traditional fiscal and monetary tools were designed to fight economic problems such as rising prices and over-employment during periods of excessive prosperity and declining prices and unemployment during periods of recession. But in the 1970s, a new economic phenomenon was identified-inflation during recession-and the term *stagflation* was coined to label it.

Stagflation is the name given to the phenomenon of inflation during a recessionary or no-growth period. This unusual condition was at its greatest following President Nixon's resignation, during the Ford and Carter Administrations.

How do you fight stagflation? If you attempt to fight recession by increasing spending, you add to inflation. If you attempt to fight inflation by reducing spending, you prolong the recession. Stagflation disappeared in the 1980s, but economists are currently debating whether stagflation will return in the 1990s.

During a recession, the increase in unemployment should reduce the purchasing power for goods and stem inflation. This did not work because the market cannot always quickly adjust to changes in supply and demand. Many costs, such as labor cost, are fixed by contract. Wages cannot be lowered unilaterally to meet market conditions. In addition,

2: REAL ESTATE ECONOMICS

government unemployment benefits, welfare benefits and employer supplemental unemployment benefits tend to reduce the dampening effect of unemployment on inflation.

AUTOMATIC STABILIZERS

Our economic system has some built-in stabilizers that tend to dampen large swings in the business cycle without waiting for governmental action. Two prime examples are the progressive income tax and unemployment insurance. During periods of prosperity, the amount of income taxes you pay could rise faster than your increase in wages. This reduces your ability to spend, while building up a surplus of money for the government. Also during prosperity, contributions to the unemployment insurance program increase, while unemployment claims fall, creating a larger surplus.

When the business cycle is heading for a recession, the process reverses itself. As your income declines, the amount of income tax you pay drops, leaving you with proportionately more money to spend. Also, those left unemployed by the recession can obtain money by filing unemployment claims.

Both of these processes move opposite to the business cycle and are called *automatic stabilizers*, meaning that they work without requiring direct government action.

CYCLICAL UNEMPLOYMENT

Cyclical unemployment is caused when the economy slips into a recession and jobs are lost because of this slow-down. Once the business cycle recovers, the jobs are regained.

STRUCTURAL UNEMPLOYMENT

Structural unemployment occurs when there are some fundamental changes in the economy that are not related to the normal ebb and surge of the business cycle. Recent examples include the elimination of defense jobs attributable to the end of the cold war, cuts in employment because of technological innovations, and certain U.S. jobs made obsolete by foreign competition resulting from globalization of the economy.

Structural unemployment does not recover as the economy grows. Thus, structurally unemployed workers must shift to tomorrow's new jobs or run the risk of being chronically unemployed.

LEVERAGE

☞ **Leverage is obtained by using other people's money (borrowed capital) to purchase real property.**

The advantage of leverage is that, for a relatively low capital outlay, a person can control real estate of high value. In periods of rapid inflation, leverage can make millionaires from those who have placed relatively small amounts of capital at risk in real estate.

It was commonly believed that sophisticated investors should purchase with as low a down payment as possible. While leverage makes economic sense in a rising market, it can be disastrous in a falling or stagnant market. Many highly leveraged real estate syndicates (partnerships) managed by skilled professionals have lost their property to foreclosure when anticipated occupancy rates and increases in revenue were not forthcoming and the properties could not be sold at a profit.



REAL ESTATE PRACTICE

“Real estate values always go up” is not an economic principle or truth. Values do decline. Conservative real estate investors increase the percentage of their down payments so that the borrowed amount and their loan payments will be less, thereby reducing risk.

Investors using leverage are interested in their cash on cash return. If an investor buys a building for \$1 million with \$100,000 down and realizes an annual cash flow of \$50,000 (cash flow is spendable cash after all cash expenses) then the investors have cash on cash return of 50 percent since the investor receives \$50,000 cash each year on a \$100,000 investment.

☞ *If the real estate market is heading into an inflationary period, then risk capital should be highly leveraged in real property, keeping in mind that it is risk capital.*

BASIC ECONOMIC PRINCIPLES

ECONOMIES OF SCALE

Economies of Scale is obtained by producing more and spreading costs over a larger number of units, and results in savings to the producer. As production increases the average cost per unit declines.

As an example, the price per unit to build 100 identical homes would be much less than the price for a single unit. Lower material costs, handling costs and even labor and management savings would be possible. In property management, firms realize that it does not take twice the effort and expense to manage 1,000 units as it does to manage 500.

It is more economical to build a larger structure on a larger lot than a small structure on a small lot. Doubling the square footage of a structure does not double the length of its exterior walls; nor does it generally double the cost of plumbing, electrical, heating and air conditioning. Therefore, as structures become larger, the price per square foot is reduced.

- ♦ Similarly, two-story structures are more economical than one-story structures, as they can double the square footage without doubling the foundation and roof costs.

Diseconomies of Scale would be a situation in which increases in production increase the per-unit costs. In other words, large production units are inefficient.

LAW OF DIMINISHING RETURNS

The **Law of Diminishing Returns** states that at some point, as production is increased, additional units will result in increasing costs, so that as units are added, profits may decrease.

This law is applicable not only to factory production, but to real estate development and real estate brokerage as well.

The savings possible on structures of three or more stories are somewhat offset by the added costs of elevators. Eventually, the cost for each additional floor increases due to the expense of cranes and elevators to lift workers and materials. Increasing the number of floors eventually leads to a point of diminishing returns.

2: REAL ESTATE ECONOMICS

In advertising, a point will be reached where additional ads provide smaller and smaller benefits; finally, the cost of advertising will exceed the benefits.

In agricultural production, additional labor applied to a fixed area of land will result in diminishing returns and will finally reach a point where labor costs will not be covered by the increased production.

ECONOMICS OF ASSEMBLAGE

Assemblage is the concept of assembling a group of smaller lots to form one large lot, which can net a larger profit.

Once an area has been fully developed, it becomes difficult to put together a group of properties under common ownership for a larger development or redevelopment. In many older cities developers will buy two single-family lots, raze the two homes, and build 10 new condominiums.

The shortage of larger parcels within a highly developed area allows an owner or assembler to get a higher price for the group of properties than the total value of each of the individual properties.

As an example, four adjacent small commercial parcels of land might be worth \$100,000 each but if they were combined might bring a sale price of \$500,000. This increase in value of \$100,000 from the assemblage process is known as the plottage increment.

ECONOMICS OF SUBDIVIDING

There are more buyers for smaller parcels than there are for larger parcels. The lower prices for smaller parcels make smaller properties affordable for more people. The increased demand and an economy of scale allow a subdivider to make more money on individual, subdivided parcels than on a larger parcel (not subdivided) that was originally sold as one unit.

ECONOMIC OBSOLESCENCE AND ECONOMIC LIFE

External Obsolescence occurs when the value of a property decreases because of negative factors affecting the neighborhood (rather than the property itself). For example, a slaughterhouse opens for business next to your home; your home then loses its value. Economic obsolescence cannot be cured because it is based on external forces.

 ***More buildings are torn down than falling down.***

The **Economic Life** of a structure is the period in which the structure is worth more than the economic benefit of tearing it down. When improvements no longer contribute to property value, they have exceeded their economic life and should be replaced with improvements offering a higher use. (To capitalize income we divide the net income by the capitalization rate.)

As an example, assume there is a hotel with a net income of \$3,000,000 per year. Also assume that an appropriate capitalization rate would be 10 percent. By capitalizing the net income you will find the value of the property to be \$30,000,000.

$$\$3,000,000 / 0.10 = \$30,000,000$$



REAL ESTATE PRACTICE

Assume also that the value of the land alone to be used for alternative purposes is \$50,000,000. In this case the hotel would have exceeded its economic life because as a hotel the land and building together would justify a price of only \$30,000,000. A good economic decision would be to tear the hotel down and put the land to another use.

Often fairly new structures are razed because the value of the site has so increased that the income attributable to its present use is less than the value of the land alone.

These structures do not represent the highest and best use. The **Highest and Best Use** would be that use which provides the greatest net income attributable to the land alone.

MULTIPLIER EFFECTS

A **Multiplier Effect** measures the outcome of an economic event as a multiple of the amount of the initial change. A large change in a variable is obtained as a result of only a small initial change in another variable. An initial one-dollar change will result in more than a dollar's change overall.

Manufacturing and Service

There is approximately one manufacturing position for every service type position. Therefore, in the United States, for each additional manufacturing position created, an additional service position should also be created.

Dollar Multiplier

Dollars spent in a community are generally multiplied in effect by a factor of between two and three. When a dollar is spent, the person receiving it will spend a portion and save a portion. The net effect of a \$1,000,000 per year payroll would therefore be between two and three million dollars spent per year. The exact multiplier value could vary based upon the propensity to save or spend.

Marginal Propensity to Save

☞ ***Marginal propensity to save is relatively higher than the average savings rate because the income is unexpected.***

Based on negative expectations for the future, a person might save a larger proportion of the money he or she receives. If the future is expected to be good, savings could be reduced. Increases in the marginal propensity to save would be deflationary, as it would reduce the demand for goods.

Fear of a depression or recession can become a self-fulfilling prophecy because it can cause spending to fall. A large reduction in spending after applying the multiplier effect will result in fewer goods being produced, which will mean layoffs and fewer dollars spent, which will lead to further layoffs, and so on.

Marginal Propensity to Consume

In the same way, the propensity to consume will be greater when there are positive expectations. It will fall when expectations are lower.

2: REAL ESTATE ECONOMICS

☞ *Increases in the propensity to consume will mean less money saved and a greater demand for goods. This increase in demand could be inflationary.*

THEORY OF FILTERING DOWN

Filtering Down is the principle by which housing tends to be passed on to lower economic groups. With quality new housing available, people tend to “move up,” leaving more marginal housing units available for people on a lower economic scale. For example, if a couple sells a \$500,000 home and then buys a million-dollar home, their economic status has increased and their former house will be passed on to someone on a lower economic scale who is moving up. As you can see, this principle applies to all socioeconomic groups. The least desirable housing should then become vacant and will be demolished. In many areas the less desirable housing units are not demolished because of the demand caused by population growth, both natural growth and immigration growth.

ECONOMIC THEORIES

PRINCIPLE OF FIRST CHOICE

The **Principle of First Choice** states that a business that needs a particular type of location for a specific use will pay the most. What this means is that uses which are limited, will result in a higher price for a suitable location than uses which are not as limited. There is a competition of uses and the use that will pay the most will prevail. This use will be the highest and best use for the location.

PRINCIPLE OF COMPETITION

The **Principle of Competition** states that when extraordinary profits are made in a field, then competition will enter the field and profits will decline. We saw this principle applied recently in mini-warehouses. The first mini-warehouses filled immediately to capacity and showed an exceptional cash return to total cost and investment. As additional units were built, however, the vacancy factor increased.

PRINCIPLE OF CHANGE

The **Principle of Change** states that real estate values do not remain constant but are always in a state of flux. Outside forces work to increase or decrease value. Short-term changes follow the “business cycle” but the “real estate cycle” is subject to longer-term changes.

☞ *Property is not static, it is always changing. (Sometimes change is imperceptible, while in other cases it is dramatic and swift.)*

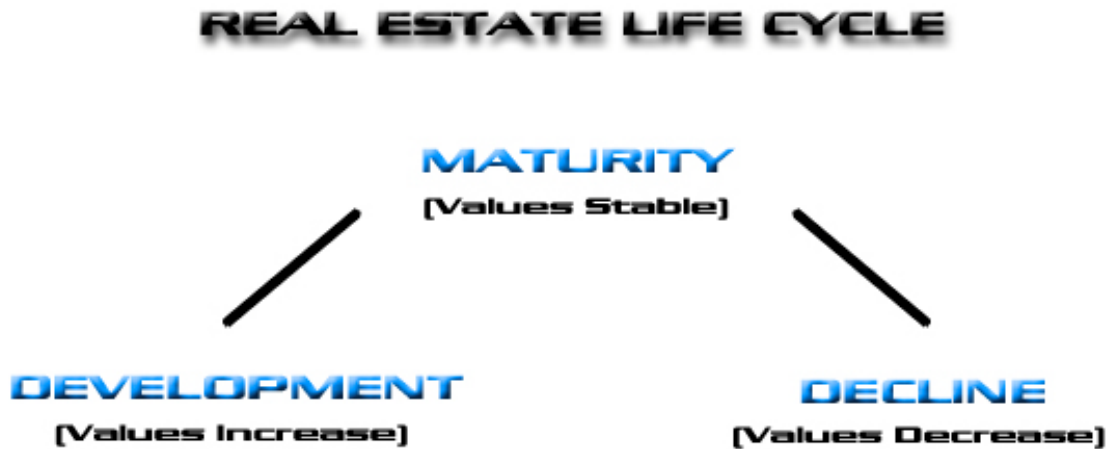
PRINCIPLE OF REAL ESTATE CYCLES

During the **development stage (integration)**, property is going up in value. The property and its surrounding area then generally reach a plateau, or **maturity (equilibrium stage)**. Occasionally an area is revived or discovered so that the real estate development cycle begins again. Decline (disintegration) then happens when the deterioration of the structure or neighborhood reduces the useful life of the property. (See Figure below.)



REAL ESTATE PRACTICE

Figure 2-2: Real Estate Life Cycle (Age Cycle)



BUSINESS CYCLES

There are many theories about the cause of business cycles. Although economists are continually debating the merits of each theory, most agree that no single factor is the sole cause of business cycles. Instead, cycles are caused by a combination of the factors listed below, and the combination or 'mix' varies with each swing in business activity.

Business cycles can be caused by the following:

1. War and other international conflicts.
2. The introduction of innovations that create new industries. Examples include radio in the 1920s, television in the 1950s, computers in the 1960s, electronics in the 1980s, and internet in the 1990s.
3. Effective spending patterns of consumers, businesses, and government. There is a tendency for consumers, businesses, and government each to have periods of spending followed by periods of saving. This causes irregular supply and demand patterns.
4. Changes the amount of money and credit in circulation. When money is plentiful and interest rates are low, spending tends to increase. When money is scarce and interest rates are high, spending tends to decline. In short, some economists believe that incorrect monetary policy causes business cycles.
5. The psychological frame of mind of businesspeople and consumers. If people are optimistic about the future, investment and spending will usually occur. If people are pessimistic, caution will prevail and business activity declines.

We know that there are recurring patterns or business cycles in the economy. (See Figure 2.3.) Economists don't all agree about the length of these cycles or the means to measure them. Cycles are not precise, but vary in length and intensity, influenced by war, government policy, and often by unknown factors.

2: REAL ESTATE ECONOMICS

Cycles are waves that have a high point or peak. After the peak a recessionary period is entered into as activity decreases. The cycle bottoms out with a trough, and the recovery period then starts. Cycles are not geometrically precise, as there may be undulations within the general wave of the cycle.

FORECASTING CHANGES IN ECONOMIC ACTIVITY

What a person does today is greatly influenced by what he or she thinks will occur tomorrow. One purchases real estate today on the basis of what one feels will happen to rents and property values in the future.

Economic forecasting is one way of reducing this inherent uncertainty. If investors can anticipate the direction of economic change, they will have a better idea of what lies ahead. Then they can decide whether they should take steps to protect their real estate investments from a shortage in income or an increase in expenses. In addition, economic forecasting can help investors decide whether now is the time to capitalize on a new investment opportunity.

Economic forecasting is an art, not a science. It is impossible to predict the future with absolute accuracy. Nevertheless, educated guesses are possible and are almost always better than blind plunges. Real estate students are encouraged to follow forecasts that are published by government agencies, financial institutions, economic research companies, and major universities. One can contact any of these institutions for monthly economic newsletters, many of which are available to interested parties at nominal or no charge.

REAL ESTATE CYCLES

If we have national business cycles, do we also have national real estate cycles? Does real estate activity move through phases of prosperity, recession, depression, and recovery? Real estate markets clearly do have their ups and downs; however, the patterns are irregular.

A review of U.S. economic history shows that until the 1940s, real estate construction activity fluctuated severely, experiencing great booms and deep depressions. On the average, these cycles took approximately 18 years to move through the four phases of prosperity, recession, depression, and recovery. This 18-year cycle is known as the *long real estate cycle*.

Since the 1940s, economists have not been able to find clear signs of this long real estate cycle. Instead, they have located another, much shorter real estate cycle that takes perhaps three to six years to move through all four phases. This new cycle and its ups and downs are called the ***short real estate cycle***.

Long-run trends in real estate activity appear to be influenced by gradual changes in population, age distribution, marriage rates, income levels, construction costs, taxes, and transportation patterns. Short-run trends in real estate markets are heavily influenced by the availability and cost of mortgage money and the current state of the national and local economy.

Most real estate purchases require the use of borrowed funds. If these funds are available at reasonable interest rates, real estate activity increases. If these mortgage funds are available at very high interest rates, real estate activity declines. Most drops in housing construction since World War II can be somewhat attributed to the availability and cost of mortgage money. In addition, in order to qualify for a real estate loan, people must have jobs



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and businesses must have profits. If the national or local economy is in a recession with high unemployment, the demand for real estate loans will decline.

Does this mean that the old long real estate cycle is dead? There is no definite answer, and economists are still debating the question. It is obvious that national real estate activity since 1945 has been closely tied to changes in the mortgage market and employment trends.

☞ ***Lenders can accelerate a downward construction cycle by restricting credit and can stimulate an upswing in the cycle by loosening credit requirements.***

Because real estate activity is dependent upon the availability and cost of money (interest), changes in these factors can cause wild swings in activity. In a boom period, the demand for money will drive up interest rates. The Federal Reserve is also likely to raise interest rates further to ward off what they perceive as inflationary trends.

FOUR PHASES OF BUSINESS CYCLE

There are recurring cycles in our economy, which are similar to waves.

The business cycle described here is a generalization of the business cycles we actually experience. No two cycles are quite the same, yet they all have much in common. In real life, actual business cycles will vary, but the characteristic patterns described here (peaks, recession, bottom and recovery) can always be observed. We hope you can learn to identify the distinctive aspects of each phase of peaks, recession, bottom and recovery. Each phase is characterized by different economic conditions.

The crest or peak would correspond to a prosperous period; the downward slope is a recessionary period; and the low point, which is also the turnaround point, is the trough, the lowest point of the recession. An upswing would be a recovery period. These are discussed in detail in following paragraphs.

Figure 2-3: Business Cycles

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Phase 1: Prosperity

The **Prosperity (or peak)** is the highest point in a new business cycle, and is usually



higher than the peak of the previous cycle. It is the upper or top part of the business cycle. Goods sell briskly and inventory selection is good. Good jobs are available and unemployment is low.

Phase 2: Recession

A **Recession (or contraction)** is the period in the business cycle from the peak down to a trough during which output and employment fall.

Recession follows the peak with a slow downturn in business activity. Interest rates may have increased. People are experiencing job losses as inventories are reduced and production is cut back to reduce operating costs.

As unemployment increases, the demand for goods and services also decreases which can result in even further cutbacks in business.

Phase 3: Depression

A **Depression (bottom)** is evidenced by a fall in output and employment followed by an increase in business activity. At the end of the bottom, interest rates usually have been lowered by the Fed and remain low in order to stimulate a recovery.

Phase 4: Recovery

A **Recovery (or expansion)** is the period in the business cycle from the bottom up to a peak during which output and employment rise.

The recovery is a happy period during which the economy is expanding. People are purchasing more from an expanding inventory of consumer goods.

A real estate recession tends to precede a general business recession although a real estate recovery tends to lag behind a general business recovery.



REAL ESTATE PRACTICE

Even political elections follow the business cycle; in a recession, politicians in power often get voted out while they are more likely to remain in office when the economy is strong.

Seasonal Variations and Trends

One must realize that seasonal patterns and long-term trends will disturb the business cycle. Retail sales go up every Christmas and beach area hotels are crowded every summer. Long-term trends, such as the automobile industry trends, are on the rise and must be taken into consideration when evaluating the business cycle. Business conditions never remain static. Prosperity is eventually followed by an economic recession although, in good times, people tend to expect prosperity to continue unabated.

While a commercial building cycle tends to follow the general business cycle, the residential building cycle declines as commercial building is peaking. Because housing requires longer-term debt, residential buyers appear to be more sensitive to interest rate changes than commercial users. Added interest costs for commercial enterprises might be passed on to consumers.

☞ ***The downward swing of the real estate cycle tends to precede a general business recession.***

During a period of economic contractions, demand of both business and industry for capital decline. The lowered demand for borrowed funds causes interest rates to decline. A recovery is likely to occur when inventories have fallen to the point where manufacturing must increase. Increased business activity coupled with low interest rates will tend to stimulate the real estate market.

With a business recovery speculators will enter the real estate marketplace with the expectation of profit. Speculator activity will accelerate the real estate recovery.

☞ ***A real estate recovery tends to lag behind a general business recovery.***

There is a shorter real estate cycle that seems to run approximately three and a half years. It is related to interest rates and the low point of real estate activity tends to match the high point in interest rates.

There is a commercial construction cycle of about seven years. According to the Massachusetts Institute of Technology's (MIT) Professor Jay Forrester, "It takes three and a half years to get overbuilt and three and a half years to start building again."

During any cycle there are industries that run counter to the cycle. For example, in a business recession new machinery sales could be slow, but parts and repairs of existing machinery could conceivably be booming.

In snow areas where construction is seasonal, there are annual construction cycles based on climate. The market in lots becomes active in the early spring prior to the building season and declines in the late summer.

☞ ***Sales of family housing are generally strongest in the spring until September, when the market slows down.***

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The reason for this slowdown is that family buyers generally want to be settled before school starts in the fall.

There are local cycles as well as national cycles. A strong local economy based on a strong industry can cause that local economy to expand while the national economy is in a recession. In the same way, a local economy can be in the depths of a depression while the national economy is expanding, as evidenced by the economic situation in California from 1991 to 1993.

While economists tend to agree on the validity of cycles, they do not always agree on where the economy will go next. As an example, during recessionary periods, some economists will predict an imminent turn-around while others might predict that conditions will get much worse before they get better. With the large number of economic indicators that abound, it is understandable that there will be differences among economists as to the immediate future of the economy.

RECESSIONS AND DEPRESSIONS

Many economists define a **recession** as a minimum of two quarters in which the growth of real Gross Domestic Product is negative.

Researchers have agreed to accept the decisions of the National Bureau of Economic Research as to when a recession starts.

This nonprofit bureau usually has a lag time of about six months in determining and analyzing the various economic indicators. Therefore, by the time they have determined that a recession exists, the economy would be well into the recessionary period.

During a business recession inventories are depleted and labor is laid off. Profits decline, as does demand for credit, which results in lowered interest rates.

☞ ***A depression really is nothing more than a severe recession, during which the economy shrinks considerably.***

The recovery period usually takes place after inventories are depleted and production must be increased. Just as the economy can go into a downward spiral, it can also build up with new hiring. More demand for goods means more production and hiring.

1990-1993 - California's Long, Deep Recession

California's economic downturn (1990-1993) was the longest in the state in over 50 years, whereas the national recession lasted only a year.

California's long, deep recession from 1990 to 1993 was the most severe since the 1979-1982 recession. The national recession was relatively short, from 1990 to 1991. All of California's major economic indicators - jobs, income, spending, construction, and home prices - were worse than the nation's.

Approximately 600,000 jobs were lost between July 1990 and December 1993.

The national economy recovered, while job losses and recession continued in California.

Reasons for California's long recession



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Courtesy of: Center for Continuing Study of the California Economy
Palo Alto, by Stephen Levy.

1. Defense Spending Cutbacks

Since California had more defense contracts than the rest of the nation (over 20 percent of U.S. defense spending and related jobs), defense spending cutbacks were more severely felt, especially as military bases continued to close.

California's defense industry underwent a structural change.

A **structural change** is a permanent change in the economic equation. In California's case, the nation has downsized military bases and continues to trim all types of defense spending. This affects civilian jobs on or near defense contracting sites or military bases, from barbers to bartenders.

2. The Decline of Commercial Aerospace Jobs and Exports

A drop in commercial and export aircraft sales caused aerospace jobs in California and the nation to decline sharply. As a result of the global recession, the airline industry placed fewer orders for commercial airplanes. Exports fell from \$45 billion to \$37 billion in 1993.

3. The Decline of Residential Construction

California experienced a substantial drop in residential construction after 1989 in response to the increases in home prices and, later, the economic downturn. This contributed to huge losses in construction jobs, and in construction-related jobs in manufacturing which amounted to an industry unemployment rate of 50 percent.

Residential building fell 64 percent from 237,700 units in 1989 to 84,400 in 1993.

This sharp decline was largely caused by the equally sharp increase in home prices between 1987 and 1989 - increases that pushed home prices out of the reach of most Californians and out of balance with prices in other regions.

4. Falling Consumer Confidence Curtails Spending

Spending declined much faster than income in California. The decline in spending relative to income, which was rooted in falling consumer confidence, had a large impact on retail trade and service sector jobs. Retail sales, adjusted for inflation, fell by 10 percent in three years. If spending had kept pace with the state's poor income growth, retail sales would have been \$28 billion higher, with a gain of \$2 billion in sales tax revenues and parallel gains in retail jobs.

The geographical concentration of California's job and spending declines is the final factor in clarifying what happened during the California Recession of 1990-1993. Depending on what job measure is used, between 80 percent and 90 percent of California's job losses were in the Los Angeles Basin and over 70 percent were in Los Angeles County alone. The Basin experienced the highest exposure to civilian and defense aerospace cuts and some of the largest home price increases prior to 1989.

California's economic base, such as high-tech industries, foreign trade, tourism and entertainment and professional services, will play a key role in determining the growth of jobs and income in the state.

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WAYS TO FIGHT ECONOMIC PROBLEMS

One of the prime responsibilities of the federal government is to maintain economic stability by limiting the adverse effects of unemployment, inflation, and recession. This section discusses the major tools the federal government uses to fight declines in GDP and economic activity. The same tools can be used to fight inflation caused by excessive spending.

FISCAL POLICY

Fiscal policy is the government's use of taxing and spending power to help counteract recession, unemployment, and inflation. When the economy is in a recession, an increase in government spending may create a demand for more land, labor, and capital. This generates more income for individuals in the form of rents, wages, and interest. Some of this added income will be saved, but much will be spent in the marketplace. This increase in spending should stimulate economic activity.

In addition to direct government spending, the economy can be stimulated if the government cuts taxes. A general tax cut will give consumers more disposable income and give businesses more after-tax profits. Some of this additional income and profit will be spent, thereby stimulating economic activity.

Government spending to fight recession should not be financed by an increase in taxes, because a tax increase would reduce private income at the very time an increase in spending is needed. Instead, the government frequently finances additional spending by going into debt. When government spending exceeds government income, it is called *deficit spending*.

When the U.S. economy is producing at full capacity and employment is high, it is in the prosperity phase of the business cycle. If consumers, business, and government continue to spend, pushing demand beyond the economy's ability to supply, then prices will rise, causing inflation.

Inflation is harmful because it drives up prices without increasing output. The uncertainty about price changes causes business and consumers to act hastily and to become dismayed, discouraged, and confused. This eventually causes major disruptions in all segments of the economy. The government can fight inflation by cutting back on government spending or increasing taxes. This will reduce disposable income and demand, thereby reducing the pressure on prices. The combination of reduced government spending and increased taxes can create a situation in which government income exceeds government spending, resulting in a *budget surplus*.

MONETARY POLICY

In addition to fiscal policy, the government can use monetary policy to counteract recession, unemployment, and inflation.

The government uses monetary policy when it increases or decreases the supply of money in an effort to stabilize the economy.

During periods of recession, the government may increase the supply of money, which in the short run may lower interest rates and increase the availability of credit. With easier credit, the government hopes that consumers and businesses will borrow for expenditures and business expansion. This could generate employment and help fight the recession.



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However, excessive long-run expansion of the money supply will eventually increase interest rates, as inflation causes lenders to “index” or increase their interest as a hedge against inflation.

During periods of inflation, the government can use monetary policy to curb spending by reducing the supply of money and credit. A reduction in the supply of money will usually drive up interest rates. High interest rates discourage borrowing, which in turn will reduce spending. As spending declines, the pressure is taken off prices, and inflation may recede.

GOVERNMENT AND CYCLES

Government fiscal policy affects the business cycle. Fiscal policy is the responsibility of our federal government (President and the Congress) to tax its citizens and wisely spend our money to benefit the nation. Increased government spending and lower taxes would stimulate an economy and could lead the country out of a recession. Likewise, increasing taxes and reducing government spending would act to slow a booming economy. The government, by its fiscal policies, ideally seeks a slow and steady growth, which will not result in excessive inflation.

This was the policy of Alan Greenspan (Fed Chairperson) in 2002, the idea being to use the power of the Federal Reserve to keep inflation in check but avoid a hard landing with a recession.

 ***The Federal Reserve controls the money supply and interest rates (Monetary Policy).***

SOME POTENTIAL PROBLEMS

In theory, fiscal and monetary policy can fine-tune the economy to prevent recession and inflation. However, in the real world, fiscal and monetary tools run into some problems. Most of these problems fall into two broad categories: political and structural.

Fiscal and monetary policies are enacted by the government. The governmental process is essentially political because governmental representatives must be elected. Critics point out that either Congress, the President, or both will often delay appropriate fiscal measures that conflict with current political realities. In times of high prosperity, for example, fiscal theory suggests that taxes be increased and government spending be cut to create a budget surplus to help pay off previous budget deficits. But if an election is coming up, these actions may be delayed for fear that higher taxes or cutting someone's favorite government program might prove unpopular at the polls. Thus, budget deficits tend not to be reduced, but rather increased, even during a booming economy.

Moreover, the monetary policy of the Federal Reserve Board is not immune to political pressure, despite its theoretical independence. The Federal Reserve Board is a creature of Congress and, realistically, can be abolished or altered by an act of Congress. Thus, for better or worse, economics frequently must give way to politics.

The second major problem is structural. Neither fiscal nor monetary policies can be changed very rapidly. Fiscal policy must be enacted by Congress and approved by the President. The legislative process is long and drawn out. By the time the policy is enacted, it sometimes is too late to be effective.

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Although monetary policy can be changed more quickly because the Federal Reserve Board does not have to contend with congressional red tape, monetary change, once enacted, takes a great deal of time to work its way into the economy. Indeed, it may be six months or more before changes in the money supply begin to influence economic decisions.

LAND AND THE REAL ESTATE MARKET

Land was for all to use. The concept of individual ownership came with an agrarian society. The Indians on Manhattan thought they were getting the better deal because they didn't think they were giving up anything. They did not understand the concept of ownership. Our modern concepts of ownership evolved out of the European feudal system, in which a monarch owned the majority of a society's land but gave certain rights to farm the land to his or her lords, who in turn allowed serfs to till the land in return for rents.

☞ ***Land by itself has no intrinsic value. When mankind was nomadic, land use had no real value.***

The value of land resides in its use; from the benefits that can be derived from it. To obtain and increase these benefits, land is often improved.

The real estate market is in a constant state of flux with different buyers and sellers emerging and the inventory of available property changing.

In a perfect economic model, we would have willing, informed buyers and sellers. We do not have a perfect market in real estate because of a number of imperfections. Market imperfections are discussed in detail later.

THE BROKER IN THE MARKETPLACE

Real estate brokers and salespeople do not set the market price but they do influence the real property market in a positive manner. Each broker, in effect, controls a miniature marketplace. By offering numerous properties for sale, brokers representing both buyers and sellers exert a stabilizing influence on the real estate market.

☞ ***Informed buyers and sellers make for a narrower range of sales prices.***

Through multiple listing services (MLSs), Boards of Realtors® provide greater structure to the marketplace by providing listing and sales price information on a great many available properties over a wide area. A **Multiple Listing Service (MLS)** is an association of real estate agents providing for the pooling of listings, recent sales, and sharing of commissions on a specific basis. This allows agents to provide price information to both buyers and sellers.

Real estate transactions require technical knowledge on how to reach binding agreements that meet the needs of both buyers and sellers, as well as knowledge of how to finance purchases. By providing expertise, real estate agents increase the ease of making a real property purchase and thus help to improve our entire economy.

Real Estate agents stabilize local markets by providing information about current selling prices as part of their service.

Buyer's brokers have helped stabilize the real estate marketplace.



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The dramatic increase in brokers acting as buyer's agents has resulted in more informed buyers. Buyers represented by an agent are less likely to purchase property at prices that cannot be justified by market data.

INTERNET MARKETING TOOL

The Internet is serving as a significant factor as a real estate marketing tool as well as serving to provide for a marketplace with informed buyers and sellers. Where buyers and sellers are cognizant of prices asked for property in specific areas, sellers are less likely to sell below current market value and buyers are less likely to pay more than market value.

Seeing property in other areas encourages relocation decisions for jobs as well as retirement.

Homebytes.com and *econobrokerinc.com* charge a flat fee. *Homebytes.com* charges \$499 for posting a home on the web plus \$150 for a virtual house tour.

According to the National Association of Realtors®, approximately 40 percent of buyers surveyed used the Internet to shop for a home.

There are Internet sites that help homeowners in choosing a broker. *Homegain.com* allows homeowners to post their property and the form of agency representation they want. Brokers then submit proposals to the owner.

As a greater percentage of Americans begin to rely on the Internet, it is likely that online brokerage firms will handle more transactions. However, the authors express doubt that online brokerage will ever supplant conventional brokerage firms.

Some experts predict that the pressure of lower priced online brokerage will result in traditional brokerage firms lowering rates in a manner similar to that seen in stock market brokerage firms.

According to the National Association of Realtors®, 8.5 million homes were sold in 2001 with gross commissions of \$46.3 billion. Internet based brokers have been dramatically increasing.

Major sites for homebuyers are:

homestore.com
homes.com
homeadvisor.com
homeseekers.com
realtor.com

TYPES OF COMPETITION

There are two basic types of competition:

1. **Perfect Competition** - many sellers, selling identical items, together with many buyers.
2. **Imperfect Competition** - fewer sellers, possibly different products, possibly fewer buyers.
 - A. Oligopoly - few sellers

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- B. Monopoly - one single seller
- C. Monopsony - one buyer
- D. Oligopsony - few buyers

PERFECT COMPETITION

Perfect competition is an economic situation in which no single seller or buyer can influence prices. Perfect competition requires the product needed to be nearly homogeneous (identical) for example oil, wheat and corn.

Real estate does not fit into this category because the product is not homogeneous and the sale of one property can affect the sale prices of other properties.

IMPERFECT COMPETITION

Imperfect competition is an economic situation where many sellers and buyers have some degree of control over prices. Real estate fits into this category because the sale of only one property can change the sale price of another property. Real property is unique in that each location is different from any other location. Different types of buildings and individual designs create a wide variance in sale prices. Good marketing and persuasive advertising can create sales as well.

☞ **Imperfect competition is the arena in which most sales of real estate take place.**

With imperfect competition, when the number of sellers becomes smaller, an oligopoly or monopoly situation may occur.

Oligopoly

An **oligopoly** is an economic situation in which a market is controlled by a small number of firms such that the production and pricing of one will affect all. In an oligopoly, smaller firms cannot sell for a price higher than that charged by the dominant firms. A **duopoly** occurs in a market controlled by two firms.

While price fixing is a violation of antitrust laws, in an oligopoly each firm realizes that lowering prices will not increase its market share for long since any action by one will be followed by a similar action by others. In an oligopoly, sellers tend to follow a price leader. When the price leader raises prices, the other suppliers follow. An oligopoly-like situation might occur in a real estate market where lots are available only from a small group of subdividers.

Monopoly

In a monopoly there is **no** competition to act as a curb against higher prices and excess profits.

A **monopoly** occurs where there is only one producer in a market, as compared with an oligopoly, where there are a few producers. Unchecked, capitalism could lead to monopolies or oligopolies. In a monopolistic market, one individual or firm controls the marketplace, whereas in a free market of many buyers and sellers, prices are determined by the forces of supply and demand. On a limited scale we do find monopolistic situations in real estate, where one individual or firm controls all available land within a certain market area. As an example, one firm might control the only industrial sites in an entire area.



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☞ ***The federal government has a monopoly on leasing rights to our natural forestlands.***

Our government regulates businesses to prevent monopolies because in a monopolistic market the consumer and the economy will suffer. We can expect any business to raise its prices to maximize profits in the absence of competition.

The National Association of Realtors® (NAR) realized that monopoly and oligopoly situations would work to the detriment of the public. The preamble of the Realtors® Code of Ethics states:

☞ ***“Under all is the land. Upon its wise utilization and widely allocated ownership depend the survival and growth of free institutions of our civilizations.”***

Monopsony

A **monopsony** is a market situation in which there is only one buyer. It is similar to a monopoly in that only one person or firm really controls the market. It is unusual to find a true monopsony situation in the real estate marketplace.

The right of governmental agents to acquire property through eminent domain is an example of monopsony.

Oligopsony

Oligopsony is a market situation in which there are only a few buyers.

These few buyers tend to have a power similar to that of the sellers in an oligopoly. They realize that offering a higher price for available goods will not work to their benefit. A buyers' market in real estate with many sellers and only a very few buyers is really an oligopsony situation.

IMPERFECTIONS IN REAL ESTATE MARKETS

- ♦ **Knowledge** - Uninformed sellers result in a fairly wide range of asking prices and uninformed buyers result in a greater range of actual selling prices.
Real estate agents help eliminate the problem of limited knowledge.
- ♦ **“Must Sell” and “Will Sell” Sellers** - Sellers who, for various reasons, must sell quickly will often accept a price less than what would be acceptable for a sale not made under pressure. Similarly, a seller who does not need to sell immediately, but who will wait to sell at the right price, is likely to sell only for a premium price.
- ♦ **“Must Buy” and “Will Buy” Buyers** - Alternatives are often not available. Therefore, a buyer under pressure to buy quickly or to buy a particular property for a particular need might be willing to pay a premium price. However, a buyer who is not particularly motivated to buy would be unlikely to buy unless the price is particularly attractive.
- ♦ **Product Differentiation** - Product differentiation occurs *where* an item for *sale* can be *distinguished* from other *similar items for sale*. Real estate is not a homogeneous

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product. Every piece of real property is unique. Factors such as age, condition, shape, size, location, and even design and color could affect value. Because of Product Differentiation it is not possible to set an exact market value for each parcel.

- ♦ **Immobility** - Real estate is immobile, and most people work at fixed job sites. This tends to result in real estate marketplaces being localized by commuting capability. The mobility of prospective buyers is also limited by leases or the need to sell other property prior to purchase.
- ♦ **Production Time** - Because it takes a long period of time to produce additional new inventory of improved property, present prices could exceed the cost of producing new similar property.
- ♦ **Financing** - Because most real estate sales are financed, the real estate marketplace is directly influenced by the availability of financing and the cost of financing (the interest rate).
- ♦ **Discrimination** - While great strides have been made, in recent years to eliminate discrimination, some de facto discrimination still remains, which limits the access of buyers and renters to the marketplace.

Discrimination is far greater in the rental market than in the sales market.. All ethnic and racial discrimination is against the law.

- ♦ **Bargaining Skills** - A buyer's ability to bargain adroitly will in many cases result in a lower sale price. In the same manner, a lack of bargaining skill can result in a buyer paying a higher price.

The market price is ultimately determined more by buyers than sellers. What buyers will pay ultimately determines prices.

Buyers and sellers generally *have* some flexibility as to what they will pay or take for property. Even when limits are *expressed*, *they are* often not absolute.

- ♦ **Price Setting** - Prices of properly tend to be set at what others are asking for similar properties, not *at* the prices other properties are actually selling for. Sellers who do list their properties *at prices close to* actual selling prices tend to close sales in a shorter time than sellers of property listed at higher prices.

Prices set above market prices create a surplus. If the quantity supplied exceeds the quantity demanded, properties are harder to sell. Prices set below market prices create a shortage, since the quantity demanded then exceeds the quantity supplied and property sells quickly.

When actual selling prices are analyzed for similar properties, the sales prices do not generally appear to be significantly different among properties listed at or above prices paid for comparable properties.

In some areas the real estate marketplace resembles used car sales where sellers often hope to get asking prices, but do not really expect to get them. By asking more, they hope that the final sales price will be greater.

Asking prices for similar properties generally range from the reasonable to the excessive.

In a sellers market, where there are more buyers than sellers, sale prices tend to be closer to offering prices than in a buyer's market where sellers outnumber buyers.

- ♦ **Decision Time** - Real estate usually involves a substantial investment. For the average person, a home purchase is the largest purchase and credit obligation he or she will



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ever make. Buyers, therefore, tend to take more time than purchasers of other goods. They tend to compare and often visit property several times before making a purchase decision.

DEFINITION OF VALUE

Economists speak of a model person known as the economic person. The **economic person** is guided in all decision making solely by economic considerations. As with any model₁ it is a model only; no one uses economic reasoning alone.

People are often slow to react to economic changes. We often hesitate to make a change even when that change would be in our best interest. Our individual needs and wants affect both our decision-making as well as our failures to make decisions. Our passions, prejudices₁ preconceived ideas and even the choices of others affect our decision making. In addition, we often have incomplete or erroneous knowledge, so that the proper economic analysis necessary before making a decision is not possible.

HIGHEST AND BEST USE

The **highest and best use** of land is that use which will provide the greatest net value attributable to the land itself. As an example, assume a lot has two possible uses; one as a parking lot and the other as space for an office building. Assume the parking lot would require \$75,000 in improvements, but when completed the land and improvements would have a market value of \$500,000:

Value of land and improvements	\$500,000
Cost of improvements	-75,000
Value attributable to the land alone	\$425,000

Assume the improvements for an office building would cost \$900,000 but when completed, the land and improvements would have a market value of \$1,250,000:

Value of land and improvements	\$1,250,000
Cost of improvements	-900,000
Value attributable to the land alone	\$350,000

When comparing the above two uses, the highest and best use would be the parking lot, which provides the greatest net value attributable to the land itself.

VALUE

Values are not static. They are in a constant state of flux moving both up and down due to changes in the use of other properties as well as in the supply and demand forces of the marketplace.

☞ **The value of property is its worth measured in benefits.**

We normally relate value to exchange benefits, to what goods and services could be obtained in exchange. If the dollars received in a sale will buy more benefits than the dollars paid for the property, then the property has increased in value at a rate greater than the rate of inflation.

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Value can also be related to use benefits. Real estate value is often defined as “the present worth of future benefits.” The benefits referred to are the economic use benefits of ownership. Cost (what a buyer paid) has no real relationship to value defined in this way, as it reflects neither the benefits of use nor the exchange benefits. Buyers ultimately determine value. What buyers perceive as the future benefits determines value.

For raw land, potential agricultural benefits tend to set the minimum value. The possibility of other higher uses will result in a higher value.

There are four forces influencing value:

- Physical - Size, shape, accessibility, location as to other uses and conveniences, utilities, climate, topography, environmental considerations, transportation, etc.
- Social - Change in population size and attitudes towards education, recreation, etc.
- Economic - Economic trends, employment wage levels, credit availability, etc.
- Political - Building codes, zoning, health and fire ordinances, rent control, environmental legislation, etc.

As a corollary to land having value, you should realize that space has value as well.

There can be a three-dimensional aspect to value. The Merchandise Mart in Chicago was constructed partially over a rail line; skyscrapers use land in a way unimaginable 200 years ago.

PRICE

⇒ *Price is NOT necessarily the same as value.*

A **price** is the amount obtained when an item or service is actually sold. Because of deficiencies in the marketplace, properties will often be sold for more or less than their beneficial use should indicate as a fair value.

In the real estate market, a price is generally directly related to the time available to sell, with a higher price possible when more time is provided and a lower price necessary when a sale must be completed in a short period of time.

⇒ *The price paid will be based upon the relative advantages for the purchaser that one property has over alternative properties.*

Price can be a function of terms. A low down payment and low interest rate can result in a premium price while cash could result in a much lower price.

There is a direct correlation between rents and price. This is understandable since buyers of income property will formulate offers based upon estimates of value obtained by capitalizing the income.

Unlike value, the most important determination of price is not imputed benefits, but the marketplace itself. The market forces of supply and demand will determine what price will have to be paid to effect a purchase. In a depressed market, a purchaser may be able to buy property at a price considerably lower than that the purchaser believes the value to be.

Market forces will clear the market. This means that the price level will adjust to a point where there is no surplus or shortage. *The price that will clear the market is known as the **equilibrium price**.*



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RENT

Rent is the economic return from use of land or improvements. While a higher use can result in a higher rent, tenants will pay what they must based upon supply and demand in the marketplace. The fewer the alternatives available to a user, the more that user will be willing to pay. Rents are not necessarily related to owners costs, although owners will customarily request rents sufficient to cover their costs and provide a return on their investment. Rents are more directly related to the effects of market competition.

⇒ *Vacant units do NOT compete against units that are already rented since these units are NOT available to prospective tenants. They compete only with other vacant units.*

If there are few alternatives, then demand is relatively inelastic. More alternatives demand more sensitivity to price (elastic). An increase in rent, where there are few alternatives will lead to a relatively slight decrease in the quantity of rental units demanded.

The rental market is not perfect, as some owners lack perfect knowledge as to what other owners are charging for similar space. Tenants, however, are much more likely to have a feel for the current rental market and are unlikely to pay significantly more in rent than the marketplace requires.

For a tenant already in possession, an economic landlord (who is an economic person) will strive for an equilibrium rent, one that will maximize his or her income given the market situation. The rent could be higher than competitive rentals, but not so high that the tenant would relocate. The cost and time of relocating will affect a tenant's decision to relocate and induce him or her to remain if the rent is not too high.

Often rents are not what they seem. Owners are generally reluctant to cut their scheduled rentals but instead will offer tenants concessions. **Tenant concessions** are reductions in the effective amount of rent paid. Tenant concessions can be two months of free rent or paying for the moving, etc. The owner's reasoning is that prospective buyers or lenders will concentrate on appraisal income (capitalize the income to determine value). While lower rents would reduce the appraisal, rent concessions would be less likely to do so.

Also, owners are reluctant to raise rents since tenants are more likely to remain on a new lease at an existing rent than at a higher level of rent.

Because of leases and the reluctance of some owners to raise rents, rent often will lag behind the value determined by the marketplace.

PROFIT

Profit is a return beyond the value of the land, labor, material, and management that goes into a project. It is a return "on" an investment rather than only the return "of" the investment itself.

Without profit as a motivation, decisions would be based on noneconomic considerations.

Profit is directly related to risk. As risk increases, investors demand greater profit. **Unearned Increment** or **Unearned Profit** is profit, which did not result from an owner's efforts. As an

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example, a property tax reduction would result in greater profit, as expenses would be reduced.

TOOLS ON ECONOMIC MEASUREMENTS

There are a great many indicators used to measure the health of our economy in general and of our real estate economy in particular. By studying changes in these indicators, economists attempt to predict future economic changes. The most popular measurement tools are discussed below

NATIONAL ECONOMIC MEASURES

A number of government agencies provide information on measures of our national economy.

Federal Reserve

The Federal Reserve keeps a number of statistics that are of interest to economists including:

- Statistics on money and debt
- Reserve data on depository institutions
- Assets and liabilities of U.S. commercial banks
- Selected interest rates

☞ The Federal Reserve's website is: www.federalreserve.gov

Bureau of Economic Analysis

The Bureau of Economic Analysis is responsible for statistics as to:

- Gross Domestic Product
- Nonresidential fixed investment
- Residential investment
- Personal savings rate
- Corporate profits
- Personal consumption expenditure
- Gross Domestic Purchaser Prices
- Disposable personal income
- Per-capita income

☞ The Bureau of Economic Analysis's website is: www.bea.doc.gov

Energy Information Administration

The energy information administration keeps statistics as to crude oil prices.

☞ The Energy Information Administration website is: www.eia.doe.gov

Bureau of Labor Statistics

The Bureau of Labor Statistics keeps a number of statistics as well as indexes including:

- Consumer Price Index
- Employment Cost Index



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Employment situations
Producer Price Index
Productivity and costs
Real earnings
U.S. import and export
Price Indexes
Civilian labor force
Unemployment
Unemployment rate
Employees on nonfarm payrolls
Average weekly hours
Average hourly earnings

☞ The Bureau of Labor Statistics website is: www.bls.gov/bls/home.htm

U.S. Census Bureau

The U.S. Census Bureau keeps statistics on:

Housing starts
Advance reports on durable goods, manufacturers shipments and orders
Industrial productivity
Capacity utilization
Household income
Poverty rate
Household wealth

☞ The U.S. Census Bureau website is: www.census.gov

Gross Domestic Product (GDP)

The **gross domestic product** is the total value of all goods and services produced in the country within a stated period of time. It is normally expressed as an annual figure. In a growing economy the gross domestic product should be growing at a rate in excess of the rate of inflation. *The Gross Domestic Product, when adjusted for inflation, is known as the real gross domestic product.* The rate of growth and any change in the rate of growth are closely watched as indicators of economic change.

M₁

This is the nation's money supply, which includes coins, currency, and demand deposits held by the public. Increases in the money supply can be inflationary. A decrease in the money supply would mean fewer available consumer dollars, which could be deflationary.

M₂

Another measure of our money supply is M₂. It adds to M₁ all savings deposits and mutual type funds, which can readily be converted into cash.

Prime Rate

The **prime rate** is customarily described as the rate of interest a commercial bank offers to its most favored customers.

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Adjustable loans are sometimes tied to the prime rate. As an example, interest might be set for each period at 2 percent above the prime rate for the lender at a certain date.

Increases in the prime rate indicate a tightening of credit nationally while a lowered prime rate indicates cheaper credit and can be expected to lower all interest rates including those on mortgage type instruments. Lower interest rates have a directly positive effect on business activity, while higher rates tend to discourage purchases that must be financed, as well as building up inventory. Real estate interest rates being on long-term debt are not as responsive to changes in the prime rate as are loans for consumer credit.

Wholesale Price Index

The wholesale price index of various selected items is an excellent indicator of future inflation, as any increase in wholesale prices would be passed on by retailers to consumers if demand were inelastic. With an elastic demand, both retailer and consumer might share the burden of increased wholesale prices.

Consumer Price Index (CPI)

The CPI shows changes in the cost of living. Leases are often tied to the Consumer Price Index so that rents will adjust to give the lessor the same relative purchasing power from rents during a period of inflation.

 ***The CPI is our best inflation indicator.***

SUMMARY

Economics is a social science that examines how people use and allocate scarce resources. There are several ways of solving the problems of what will be produced, how it will be produced, and for whom it will be produced. A capitalistic economy leaves the decisions to private individuals operating in competitive markets. Command or socialistic systems look toward government for the decision-making. The United States operates under a mixed capitalistic system, using both government and private enterprise to make economic decisions.

All economies need four elements, known collectively as the factors of production, in order to produce goods and services: land, labor, capital, and entrepreneurship. In a capitalistic economy, these factors are privately owned and must be paid for before being used. The payment for land is called rent, for labor it is called wages, for capital it is called interest, and for entrepreneurship it is called profit. When rent, wages, interest, and profits are received, they are called income. Income is earned by individuals when they sell the factors of production. The earned income is then spent to purchase goods and services produced by these same factors of production. Thus, the U.S. economy has a circular flow, of which imports and exports from international trade are a part.

Today, the government is deeply involved in private economic affairs. Imperfect competition, international conflicts, nonprofit social goals, and a desire to maintain economic stability are some of the reasons why the government has become a full partner in the operations of the U.S. economy.

Economists have tools to measure the state of the economy. The most common measurement is gross domestic product (GDP), which measures the total value of goods and services produced domestically in a year. Other measurements include personal



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income, disposable personal income, and discretionary income. These measurements may be on a total or per capita basis.

The GDP does not stay level or change at a constant rate, but rather changes in irregular up and down movements. These fluctuations in economic activity are either seasonal, cyclical, or long-term secular trends. Most attention centers on business cycles, but to date no single theory is universally accepted as explaining the causes of business cycles.

In addition to business cycles, there are real estate cycles, which can be classified as either long or short. Since the 1940s, the short real estate cycle caused by changes in the availability and cost of mortgage credit and in current business conditions, has been the most obvious. It is important for real estate investors to understand business and real estate cycles and to forecast their swings, because these cycles give a better idea of what lies in the future. Investors can then decide whether they should take steps to protect their investments.

Leverage is the use of borrowed capital. During an inflationary period, high leverage investments allow the investor to achieve maximum appreciation as well as have the advantage of paying back borrowed capital with cheaper dollars.

The real estate market differs from other commodity markets in a number of ways, including the following:

1. Buyers and sellers are constantly changing.
2. Buyers and sellers have incomplete knowledge.
3. The motivation of buyers and sellers affects prices offered and accepted.
4. Product differentiation.
5. Immobility of real estate.
6. Necessity of financing and effects of financing.
7. Market discrimination.
8. Effects of bargaining skills on price.

INTERNET WEB LINKS

www.bea.doc.gov	Bureau of Economic
www.bls.gov	Bureau of Labor Statistics
www.census.gov	US Census Bureau
www.eia.doe.gov	Energy Information Administration
www.federalreserve.gov	Federal Reserve
www.homes.com	Homebuyers website
www.homesearchers.com	Homebuyers website
www.homestore.com	Homebuyers website
www.realtors.com	Homebuyers website
www.irs.gov	Internal Revenue Services

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CHAPTER QUIZ

1. The real estate marketplace is more closely related to as :
 - A. National market.
 - B. Market having inelastic demand.
 - C. Local market.
 - D. Market regarded as a perfect economic model.
2. The difference between the national economy with a local economy is:
 - A. A local economy could be different than the national economy.
 - B. The local economy tends to lag behind the national economy.
 - C. The local economy will closely mimic the national economy.
 - D. While the national economy can change the local economy remains constant.
3. It is true, when demand increases and supply decreases:
 - A. Prices will fall.
 - B. Prices and supply or (supplies) will remain in equilibrium.
 - C. The demand will increase further.
 - D. Prices will rise.
4. A recession is said to occur when:
 - A. Supply exceeds demand.
 - B. The Gross Domestic Product has a growth rate of less than 5 percent.
 - C. There are two quarters of declining growth in the Gross Domestic Product.
 - D. There is no equilibrium point reached by supply and demand curves.
5. Which of the following is a true statement regarding **demand**?
 - A. Demand for real estate is inelastic.
 - B. Demand is meaningless without purchasing power.
 - C. Demand increases with supply increases.
 - D. Demand decreases with increases in supply.
6. Buying a property with a minimum down payment would be:
 - A. An economy of scale.
 - B. Leverage.
 - C. Assemblage.
 - D. Inflationary.
7. One study real estate economics in order to:
 - A. Meet state education requirements.
 - B. Predict what will be happening in the future.
 - C. Impress clients with our knowledge.
 - D. Balance our needs with the needs of others.
8. A sophisticated investor would consider paying with maximum leverage when:
 - A. Prices were falling.



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- B. Prices were expected to continue to rise rapidly
 - C. Seeking to reduce risk.
 - D. Interest rates were expected to fall.
9. A market controlled by a single producer is called a:
- A. oligopsony.
 - B. monopsony.
 - C. oligopoly.
 - D. monopoly.
10. Which of the following is the best inflation indicator?
- A. Balance of trade
 - B. CPI
 - C. Federal deficit
 - D. Unused plant capacity
11. Which of the following would be a lagging economic indicator?
- A. Vendor performance
 - B. Change in Consumer Price Index
 - C. Building permits
 - D. Index of consumer expectations
12. A developer considering building new office space would be most interested in:
- A. Changes in the office vacancy rate.
 - B. Changes in vendor performance.
 - C. Changes in the Consumer Price Index.
 - D. Changes in the housing affordability index.
13. The return beyond the value of land, labor material and management would be:
- A. Rent.
 - B. M_2 .
 - C. Gross domestic product.
 - D. Profit.
14. Imperfections in the real estate market are caused by all **except**:
- A. Bargaining skills.
 - B. Must sell and will sell sellers.
 - C. Production time.
 - D. Informed buyers and sellers.
15. The term net value attributable to the land would be related to:
- A. Price.
 - B. Highest and best use.
 - C. Elasticity of demand.
 - D. Rent.

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Answers: 1-C, 2-A, 3-D, 4-C, 5-B, 6-B, 7-B, 8-B, 9-D, 10-B, 11-B, 12-A, 13-D, 14-D, 15-B.

CHAPTER 3: REAL ESTATE LAW



Preview

The bulk of real estate licensing law is based upon English Common Law and is found in the Business and Profession Code. Real estate licensing law is upheld under police power, the power of the State to enact laws in order to promote the order, safety, health, morals and general welfare of the public.

Most laws are created by legislative act. In California, the *Treaty of Guadalupe Hidalgo* between the United States and Mexico generated “Community Property Laws”. Violation of the real estate Law can result either disciplinary action by the Department plus a fine and/or in some case, a sentence in jail.

In this chapter you will learn:

- ♦ The role of the Department of Real Estate,
- ♦ Prohibited acts of licensees,
- ♦ Real Estate Funds,
- ♦ Real Estate Professional Associations.

DEPARTMENT OF REAL ESTATE

The **Department of Real Estate** determines administrative policy and enforces the real estate law. The main purpose of the department is to protect the public by enactment and enforcement of laws relating to real estate and by establishing requirements for real estate salespersons or brokers licenses. These laws help to protect both the individual citizen and the real estate profession. There are obvious benefits derived by shielding citizens from dishonest or incompetent real estate licensees. The reputation of the real estate profession is upheld by making sure that all practicing salespeople and brokers are both honest and capable of performing their jobs properly.

REAL ESTATE COMMISSIONER

The **commissioner**, appointed by the governor, is chief executive of the Department of Real Estate and presides at the meetings of the Real Estate Advisory Commission. The commissioner who sets all the rules and regulations for the Department of Real Estate receives



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his or her police power from the state legislature. The police power granted is the right to enact and enforce laws beneficial to the health, safety, morals and general welfare of the public.

Duties of the Real Estate Commissioner

- ♦ Screens and qualifies applicants for licenses. *He has the sole authority to issue, suspend and revoke all licenses.*
- ♦ Issues rules and regulations, which have the force and effect of law and become a part of the California Code of Regulations.
- ♦ Decides the business policy of the State Department of Real Estate.
- ♦ Use state attorney general as the legal advisor.
- ♦ Regulate the sale of subdivision and nonexempt franchises.
- ♦ Investigate complaints against licensees and non-licensees who engage in acts requiring a real estate license. The District Attorney prosecutes law violations in his own county.
- ♦ Hold formal hearings within terms of the Administrative Procedure Act (use established legal procedures to discipline licensees).
- ♦ The Commissioner cannot make the licensee pay damages, only the courts can do this.
- ♦ If a buyer wins a civil judgment against a broker for fraud, the commissioner can suspend or revoke the broker's license only after a hearing.

Real Estate Advisory Commission Board

A board that consists of the Commissioner and **ten (10)** other members who are appointed by the Commissioner. The purpose is to advise the Commissioner on real estate matters important to the industry and the public. Six members must be licensed real estate brokers. Four must be public members. Everyone, except the Commissioner, serves without any compensation other than actual expenses.

The Commissioner is required to call Advisory Committee meetings at least four times a year; the proceedings of all meetings must be made public. At such meetings, the views and suggestions of the public and of the licensees of the Department are heard.

REAL ESTATE LAW AND REGULATIONS

California laws affecting real estate are included in several different acts and codes. The California Real Estate Law is the portion of the Business and Professions Code that refers to licensing and subdivisions. On the other hand, the Commissioners Regulations are rules that form part of the California Administrative Code established and enforced by the Commissioner of Real Estate. All licensees should be familiar with the Real Estate Law, the Commissioners Regulations and the Subdivided Lands Act administered by the Commissioner.

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ENFORCEMENT OF THE REAL ESTATE LAW

Licensing and regulatory law is effective only to the extent that it is enforced. The Commissioner, as the chief officer of the Department of Real Estate, is duty bound to enforce the provisions of the Real Estate Law. The Commissioner may, by his or her own choice, and must upon a verified complaint in writing, investigate the actions of any person engaged in the real estate business or acting in the capacity of a licensee within this state. He or she has the power to suspend any real estate license or revoke it permanently. The Commissioner also has the authority to deny a license to an applicant if the applicant does not meet the full requirements of the law.

REAL ESTATE LICENSING

Any person doing any real estate act for another for compensation or in expectation of compensation must have a license. Some of the real estate activities are as follows:

- ♦ Selling, buying, soliciting or obtaining listings of, or negotiating the purchase, sale or exchange of real property or a business opportunity.
- ♦ Leasing, renting, collecting rents, managing property, or negotiating the sale, or exchange of leases on real property or a business opportunity.
- ♦ Soliciting borrowers or lenders, or negotiating loans on real property or a business opportunity.
- ♦ Buying, selling a promissory note secured by real property or a business opportunity.

 ***A California licensee can negotiate in California for the purchase of property in another state.***

EXCEPTIONS

The following exceptions do not need a real estate license:

- ♦ Principal handling his or her own properties.
- ♦ Attorney in fact acting under a power of attorney. An attorney-in-fact is the person who is authorized to perform certain acts for another under power of attorney. Power of attorney may be limited to a specific act or acts or be general.
- ♦ Attorney at law (lawyer) while performing duties as an attorney. If the attorney charges a fee as a broker, then a real estate license is required.
- ♦ Trustee selling under a deed of trust.
- ♦ Resident Property Managers or their employees, hotel, motel and trailer park managers. A full-service, off-site property manager must have a real estate license.
- ♦ Anyone working under the direction of court.
- ♦ A licensed securities broker or dealer involved in the sale, lease or exchange of a business opportunity in that capacity.



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- ♦ A corporation that performs any of the specified activities through one of its regular officers, who must receive no special compensation for doing so;
- ♦ Employees of lending institutions, pension trusts, credit unions or insurance companies, in connection with loans secured by liens on real property or business opportunity;
- ♦ Escrow agents collecting funds in connection with loans secured by liens on real property when the funds are deposited in the escrow agents trust account.

☞ ***The fine for an unlicensed person who receives an illegal commission is \$10,000 for an individual and \$50,000 for a corporation.***

PROHIBITED ACTS

A real estate licensee can be disciplined for the following violations of the real estate law:

Torts

A **tort** is any civil injury or wrong committed upon a person or that person's property. Fraud, misrepresentation, negligence and secret profit all stems from a breach of an agent's duty. In some cases, they can even be considered criminal acts. They are responsible for their own acts and representations even when following their principals (sellers) directives.

Fraud

A **fraud** is an intentional deceive of material facts used to induce another party to enter into a contract to his detriment. Actual fraud includes the suppression of the truth or the concealment of material facts.

Misrepresentation

Misrepresentation is making false statement of facts without knowing whether they are true. A misrepresentation is a civil wrong that differs from criminal fraud in that it is not intentional. Misrepresentation nevertheless is fraud.

Puffing

Puffing is a statement that exaggerates a property's benefits. It is not advised. An agent should never misrepresent a material fact.

False Promise

Making a **false promise** which is likely to influence or persuade. Guaranteeing a profit which doesn't occur could subject a broker to civil penalties and disciplinary action.

Divided Agency

Divided agency is acting for more than one party in a transaction without the knowledge and consent of all parties.

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- ♦ If agent informs and obtains consent from all principals, he may collect a commission from each principal.
- ♦ If agent does not disclose his dual agency to both parties, he may be disciplined, may provide grounds for either party to rescind, and may not receive any commission.

Commingling

Commingling has taken place when a broker has mixed his own money with the funds of his principals.

- ♦ Failure to deposit or place trust funds received into escrow, into the hands of the principal, or in a trust fund account by the next business day is commingling.
- ♦ Keeping the buyers cash deposit in brokers safe is commingling.
- ♦ Broker may hold an uncashed check with written instructions from the seller.
- ♦ The opposite of commingling is to segregate.

Conversion

Conversion is misappropriation of client's funds. It is using client's money as his own, for example, for a vacation in Hawaii.

No Contract Copies

Failing to give a copy of listing or deposit receipt to the person signing, when he signs it.

Secret Profit

If an agent is offered a secret profit, he or she has a duty to let the principal know of the bribe. In addition, a broker may not allow others (friends and relatives) to make a secret profit with his or her knowledge.

An agent making a secret profit violates the fiduciary relationship between the principal and the agent. All financial offers, whether legitimate or not, must be presented to the seller.

Licensee Status

- ♦ Licensee must reveal to other party that he has a license whenever he is involved in a real estate transaction as a principal. Licensee cannot buy through a "dummy buyer."
- ♦ If buyer is a close relative, broker must reveal fact to seller.

⇒ *To check the status of a real estate salesperson or broker, one may use Department of Real Estates Internet web address: www.dre.ca.gov. You may search the salespersons information by name or license number.*

Supervision of Salesperson

Broker must exercise reasonable supervision over activities of salespeople.



Inducement to Panic Selling

Seeking listing on the basis of the entry into neighborhood of a person or persons of another race or religion, ancestry or nation origin.

Employing or paying an Unlicensed Person

- ◆ Broker may have his license revoked or suspended if he employs or compensates any unlicensed person for performing acts requiring a license.
- ◆ Broker can share his commission with an unlicensed buyer or seller if (s)he informs all parties.

Advertising

- ◆ Licensee must disclose, when advertising, that he is acting as an agent. A blind ad is an ad where an agent does not identifying the broker.
- ◆ When advertising their own property, agents and brokers must inform the public that the owner is a licensee.

Kickbacks (Prohibited)

A licensee cannot receive referral fees or commissions from others like Escrow Company, Termite Company, Title Company or lender.

HEARINGS FOR LICENSE VIOLATIONS

One function of Real Estate Law is to hold hearing when there is a question as to the rights of persons to obtain or keep their real estate licenses. All hearings must be conducted in accordance with certain legal regulations. These regulations are set forth in the Administrative Procedure Act. The Department of Real Estate and other licensing agencies must conduct hearings with strict regard for the rules, since the rights of the individual are protected by the act. Before denying, suspending or revoking any license, the licensee is served a statement, and the commissioner acts as the complaint. The licensee, or respondent as he or she is known in the hearing procedures, may appear with or without counsel. The hearing is conducted according to rules of evidence in the civil matters.

☞ ***A decision is made by the hearing officer based upon his or her findings.***

The commissioner may reject or accept the proposed decision or reduce the proposed penalty, and then make his or her official decision. The respondent has the right of appeal to the courts.

If the charges are not sustained at the hearing, they are dismissed. On the other hand, if the testimony substantiates the charges and they appear to be sufficiently serious, the license of the respondent is suspended or revoked. After a license is revoked, the person affected may not apply for reinstatement until one year has passed. Deputies in the department also investigate persons or firms who appear to be operating improperly or without benefit of a license, or who subdivide land without complying with the subdivision laws enforced by the commissioner.

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☞ *A license can be revoked for pursuing a flagrant course of misrepresentation.*

REAL ESTATE FUNDS

There are two accounts: (a) Education and Research account, and (b) the Recovery Account. All the money collected from license and exam fees goes into the Real Estate General fund. Eight percent of this money is used for the operating expenses of the Department of Real Estate. Twenty percent (20%) of all license fees are directed to Real Estate funds, 40% of this account are for educational research; 60% is placed in the recovery account.

EDUCATION AND RESEARCH FUND

It gives money to the University of California, State Colleges and Community Colleges to foster real estate education.

RECOVERY ACCOUNT FUND

Established for the payment of damages and arbitration awards to people who have suffered financial loss due to the wrongful act of a licensee in a real estate transaction. To qualify for these funds, plaintiffs must first obtain a judgment in civil court or through arbitration against a licensee on the grounds of fraud, misrepresentation, deceit or conversion of trust funds. If, after reasonable effort, the judgment remains uncollectable, a claim may be filed with the Commissioners office.

Limits

It is limited to the following amounts on losses incurred after January 1980.

\$20,000 for each claimant is possible in any one transaction for losses occurred after January 1, 1980. \$100,000 for multiple transactions of any one licensee. If a claim against a licensee is paid, the licensees license is suspended until he has repaid the recovery account, plus interest at the prevailing legal rate. If there is not enough money to pay all claims, they will share proportionately.

☞ *A license is **SUSPENDED** until the fund is reimbursed plus interest.*

A license can be revoked for failure to account for funds belonging to others.

PROFESSIONAL ASSOCIATIONS

A trade or professional association is a voluntary, non-profit organization made up of independent firms in the same industry. It is formed to promote progress, aid in solving the industries problems and enhance its service to the community.

NATIONAL ASSOCIATION OF REALTORS(NAR)

The largest real estate trade association is the **National Association of Realtors® (NAR)**. It unites and unifies the organized real estate interest of the nation. It is the national trade association for all the state associations and local boards of Realtors in the United States. It encourages legislation favorable to the real estate industry and enforces professional conduct standards in behalf of its members across the nations.

☞ *NAR is a powerful force in lobbying on behalf of its members.*



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CALIFORNIA ASSOCIATION OF REALTORS® (CAR)

A state organization of the National Association of Realtors. It is comprised of local boards through out the state. The CAR has nearly 200 boards of Realtors, with over 100,000 members in California, and is the largest Realtor organization in the United States.

The objectives of the California Association of Realtors are:

- ♦ To promote high standards and unite its members.
- ♦ To safeguard the property buying public.
- ♦ To foster legislation for the benefit and protection of the real estate field.
- ♦ To cooperate in the economic growth and development of the state.

CAR also has many standing committees that specialize in specific areas such as education, ethics, legislation, political affairs, taxation, and other areas.

A **Realtor** is a member of NAR. The trade right limited to its member. No licensees may advertise or present himself or herself to be a Realtor if not associated with NAR or CAR.

☞ The California Association of Realtor's web site is: www.car.org

AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS (AIREA)

An organization of real estate appraisers that merged with the Society of Real Estate Appraisers to form the Appraisal Institute in 1991. **MAI**: Member of the Appraisal Institute: The professional designation of a member.

COMMERCIAL INVESTMENT REAL ESTATE INSTITUTE (CIREI)

Enhances the professional development of those engaged in commercial-investment real estate.

CCIM : CERTIFIED COMMERCIAL INVESTMENT MEMBER

A Certified Commercial Investment Member (CCIM) is a recognized professional in commercial real estate brokerage, leasing, asset management, valuation, and investment analysis. As an experienced expert, a CCIM is an invaluable resource to the commercial real estate owner, investor, and user.

INSTITUTE OF REAL ESTATE MANAGEMENT (IREM)

The Institute of Real Estate Management® (IREM) was created by the National Association of Realtors® as a professional society for real property managers. To bolster professionalism within the industry, they offer the designation Certified Property Manager® (CPM) to qualified candidates who can demonstrate a high standard of competence, ethics and experience. Property management companies may apply for the Accredited Management Organization® (AMO) designation, while residential on-site managers, who live up to the education and experience guidelines, are bestowed with the Accredited Resident Managers® (ARM) designation.

3: REAL ESTATE LAW

The California Apartment Association® has many local associations to assist property owners with forms and credit checks. Their professional designation for resident managers is Certified Apartment Manager® (CAM) for on-site managers.

INTERNET WEB LINKS

www.courtinfo.ca.gov

www.leginfo.ca.gov/calaw.html

www.dre.ca.gov

www.leginfo.ca.gov/statute.html

California Courts information

California Law

Department of Real Estate - California

State Statutes

CHAPTER QUIZ

1. If a seller's agent in a real property sale transaction pays part of his commission to the buyer of property, the agent:
 - A. Must inform the seller that he is doing so;
 - B. Is subject to criminal penalties;
 - C. Is always subject to disciplinary action by the real estate commissioner;
 - D. May be subject to all of the above.
2. According to the regulations of the real estate commissioner, the broker must have a signed employment agreement with each of his salespersons. According to those regulations, a copy of the agreement must be kept by both parties for:
 - A. One year from date of termination;
 - B. Two years from date of termination;
 - C. Three years from date of termination;
 - D. Five years from date of termination
3. A licensee who is guilty of conversion is one who is:
 - A. Misrepresenting;
 - B. Misappropriating the funds of client;
 - C. Commingling;
 - D. Failing to make a full disclosure of material facts;
4. A private party offers a single-family residence for sale without the services of a real estate broker and advertises that the property is to be sold in an "as is" condition. Under these circumstances, the seller:
 - A. Need not disclose any known defects in the property;
 - B. Must provide a Real Estate Transfer Disclosure Statement to a prospective buyer;
 - C. Need not provide a Real Estate Transfer Disclosure Statement to a prospective buyer;
 - D. Has invoked the "Caveat Emptor (Buyer Beware) representation and has no further obligation to a prospective buyer
5. The major part of the California Laws relating to real property are created by:
 - A. The State Constitution;
 - B. Legislative acts;
 - C. The Real Estate Commissioner;
 - D. The Business and Professions Code



REAL ESTATE PRACTICE

6. A REALTOR® is
- A. A specially licensed real estate professional who acts as a point of contact between two or more people in negotiating the sale, purchase or rental of property.
 - B. Any real estate broker or salesperson who assists buyers, sellers, landlords or tenants in any real estate transaction.
 - C. A member of the National Association of Real Estate Brokers who specializes in residential properties.
 - D. A real estate licensee who is a member of the National Association of REALTORS®.
7. A broker must retain a copy of a mortgage loan broker disclosure statement which he prepared and had the borrower sign for at least:
- A. Two years;
 - B. Four years;
 - C. Three years;
 - D. Five years
8. *Commingle* has a meaning most completely opposite to:
- A. Trust fund;
 - B. Conversion;
 - C. Segregate;
 - D. Mingle;
9. Which of the following would best describe a “blind ad”:
- A. The licensee gave an unlisted telephone number;
 - B. The property address was not shown;
 - C. The price of the property was not listed;
 - D. The licensee placing the ad was not identified as a licensee.
10. A real estate salesman went into a neighborhood to obtain listings of residential property. He made representations that because of the entry into the neighborhood of minority groups, property values would be reduced by a decline in the quality of schools and an increase in the crime rate. These practices by the salesman are:
- A. Permissible of the representations are true;
 - B. Unethical, but beyond the jurisdiction of the Real Estate Commissioner;
 - C. Grounds for disciplinary action;
 - D. Justified of his activities do not decrease property values for neighboring properties.

Answers: 1-A, 2-C, 3-B, 4-B, 5-B, 6-D, 7-C, 8-C, 9-D, 10-C

CHAPTER 4: LICENSING & CODE OF ETHICS



Preview

Anyone wishing to handle a real estate transaction in California for a commission or other compensation must be licensed by the Department of Real Estate as a real estate broker or real estate salesperson. Too many times real estate licensees have misconducts and are not aware of them.

In this chapter you will learn:

- ♦ Types of real estate licenses.
- ♦ Develop awareness and also compliance's with real estate ethics and professional conducts.

This ethics section is an excerpt from “Ethics and Professional conducts” published by California DRE. We also illustrate by analyzing California case and statutory law. It is important to realize that the law is in a state of constant change and that is of utmost importance to licensees to stay current with the law and to adapt to changing conditions.

TYPES OF REAL ESTATE LICENSE

BROKER LICENSE

A broker license is issued to a person (natural or legal) who for compensation or in expectation of compensation performs any “*real estate act*.”

- ♦ Office must be maintained by the broker (residence is okay).
- ♦ Brokers license and Salespersons licenses must be available for inspection.
- ♦ City Business License - Most cities require a broker to hold a city business license and pay a business license tax.



SALESPERSON LICENSE

A salesperson license is issued to an individual that is employed by a broker. He/she must be under the control and supervision of a broker.

- ♦ Salesperson cannot act as an independent agent.
- ♦ All legal actions must be filed through the broker.
- ♦ There must be a written agreement with the broker.
- ♦ The license must be on file at the broker's main office.

CORPORATION LICENSE

A brokerage can be set up as a corporation, provided that at least one officer of the corporation is a licensed broker and is designated the responsible broker-officer. A qualified broker must be designated as the responsible broker-officer to supervise the real estate activities of the corporation. Salespersons working for a corporate real estate office may not, individually or jointly, own or control a majority of the outstanding shares of stock of the corporation, directly or indirectly.

- ♦ The broker-officer must submit a completed Corporation License application (RE Form 201).
- ♦ A Certificate of Status, obtained from the Office of the California Secretary of State must be submitted.

Form 4-1: RE 201 Corporation License Application (3 pages)

4: LICENSING & CODE OF ETHICS

STATE OF CALIFORNIA — DEPARTMENT OF REAL ESTATE

CORPORATION LICENSE APPLICATION

RE 201 (Rev. 7/01)

GENERAL INFORMATION

- This application may be used to license: 1) a corporation with a designated broker-officer, 2) an additional broker-officer with a new or currently licensed corporation, or 3) a new officer as a substitute (replacement) for the existing designated broker-officer.
- Read Sections III and IV before completing this application.
- A Certificate of Status or Articles of Incorporation and the appropriate fee **must** accompany this form. Refer to Section IV.
- Any changes (addresses, DBA, etc.) to a currently licensed corporation must be submitted on a Corporation Change Application (RE 204A).

SECTION I — CORPORATION INFORMATION

1A. DOES THIS CORPORATION CURRENTLY HOLD OR HAS IT PREVIOUSLY HELD A REAL ESTATE LICENSE IN CALIFORNIA?		1B. IDENTIFICATION NUMBER	DRE USE ONLY
<input type="checkbox"/> NO <input type="checkbox"/> YES IF YES, COMPLETE ITEMS 1B AND 1C.		1C. EXPIRATION DATE	
2A. CORPORATION NAME (PRINT NAME AS IT APPEARS ON CERTIFICATE OF STATUS, DO NOT LIST FICTITIOUS BUSINESS NAMES.)			
2B. CALIFORNIA SECRETARY OF STATE IDENTIFICATION NUMBER (REFER TO PAGE 4)		2C. CALIFORNIA FRANCHISE TAX BOARD IDENTIFICATION NUMBER (REFER TO PAGE 4)	
3A. MAILING ADDRESS (STREET ADDRESS OR POST OFFICE BOX)			
3B. CITY		3C. STATE	3D. ZIP CODE
4A. MAIN OFFICE ADDRESS (STREET ADDRESS - MUST BE A PHYSICAL ADDRESS)			
4B. CITY		4C. STATE CA	4D. ZIP CODE
5. FICTITIOUS BUSINESS NAME (IF ANY) - ATTACH A COPY OF THE FICTITIOUS BUSINESS NAME STATEMENT AS FILED WITH THE COUNTY CLERK.			
6. CHECK "NO MAILINGS" BOX IF YOU DO NOT WANT THE CORPORATION NAME AND ADDRESS TO BE INCLUDED ON MAILING LISTS. <input type="checkbox"/> NO MAILINGS			

SECTION II — BROKER-OFFICER INFORMATION

1A. DO YOU CURRENTLY HOLD OR HAVE YOU PREVIOUSLY HELD A REAL ESTATE LICENSE IN CALIFORNIA? <input type="checkbox"/> NO <input type="checkbox"/> YES IF YES, COMPLETE 1B-1D.		
1B. LICENSE IDENTIFICATION NUMBER	1C. TYPE OF LICENSE	1D. EXPIRATION DATE OF LICENSE
2. NAME OF BROKER-OFFICER (LAST, FIRST & MIDDLE)		
3. SOCIAL SECURITY NUMBER (SEE PRIVACY NOTICE)	4. BIRTH DATE	5. CORPORATE OFFICER TITLE
6. TYPE OF BROKER-OFFICER LICENSE REQUESTED: (CHECK ONE) REFER TO FEE SECTION ON PAGE 4. <input type="checkbox"/> DESIGNATED BROKER-OFFICER <input type="checkbox"/> ADDITIONAL BROKER-OFFICER (Refer to Fees.) <input type="checkbox"/> SUBSTITUTION OF CURRENT DESIGNATED BROKER-OFFICER (Refer to page 4, Section II Instructions, #6.)		
7. DO YOU RESIDE IN THE STATE OF CALIFORNIA? <input type="checkbox"/> NO <input type="checkbox"/> YES IF NO, THEN A CONSENT TO SERVICE OF PROCESS (RE 234) MUST ALSO BE COMPLETED. (Refer to #7 instruction on page 5.)		
8. BUSINESS TELEPHONE NUMBER (DO NOT LIST FAX NUMBERS.) (INCLUDE AREA CODE)		9. RESIDENCE TELEPHONE NUMBER (INCLUDE AREA CODE)

FOR OFFICE USE ONLY

RESTRICTED LICENSE <input type="checkbox"/> CORPORATION <input type="checkbox"/> OFFICER	FINGERPRINTS <input type="checkbox"/> RECEIVED <input type="checkbox"/> NOT NEEDED	FLAG CLEARANCE	VIOLATIONS
------------------------------------------------------------------------------------------------	------------------------------------------------------------------------------------------	----------------	------------

NOTES:

EXAM ID NUMBER	PROCESSOR # & DATE PROCESSED	LICENSE EFFECTIVE DATE	LICENSE EXPIRATION DATE
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REAL ESTATE PRACTICE

RE 201

Page 2 of 5

SECTION II — BROKER-OFFICER INFORMATION (Continued)

10. HAVE YOU EVER USED ANY OTHER NAMES (I.E., MAIDEN NAME, AKA, ETC.)?

☐ NO☐ YES

IF YES, LIST NAMES USED.

11. HEIGHT

12. WEIGHT

13. COLOR OF EYES

14. COLOR OF HAIR

15. GENDER

☐ MALE☐ FEMALE

- **Carefully read and provide detailed answers to questions #16-18.** You must provide a yes or no response to all questions.
- "Convicted" as used in Question 17 includes a verdict of guilty by judge or jury, a plea of guilty or of nolo contendere, or a forfeiture of bail in municipal, superior or federal court. All convictions must be disclosed

whether or not the plea or verdict was set aside, the conviction against you was dismissed, or expunged or if you have been pardoned. Convictions occurring while you were a minor must be disclosed unless the record of conviction has been sealed under Section 1203.45 of the California Penal Code or Section 781 of the California Welfare and Institutions Code.

16A. HAVE YOU EVER HAD A **DENIED, SUSPENDED, RESTRICTED OR REVOKED** BUSINESS OR PROFESSIONAL LICENSE (INCLUDING REAL ESTATE), IN CALIFORNIA OR ANY OTHER STATE? (DO NOT INCLUDE DRIVER'S LICENSE SUSPENSIONS, ETC.)☐ NO☐ YES

IF YES, COMPLETE #16B-16F AND #19A-19D. INCLUDE THE DATE ACTION WAS TAKEN, REASON IT OCCURRED, AND (IF APPLICABLE) WHEN ACTION AGAINST YOU WAS TERMINATED.

16B. TYPE OF LICENSE

16C. ACTION (REVOKED, ETC.)

16D. LICENSE EXPIRATION DATE

16E. LICENSE ID NO.

16F. STATE

17. HAVE YOU EVER BEEN CONVICTED OF ANY VIOLATION OF LAW? CONVICTIONS EXPUNGED UNDER PENAL CODE SECTION 1203.4 MUST BE DISCLOSED. HOWEVER, YOU MAY OMIT MINOR TRAFFIC CITATIONS WHICH DO NOT CONSTITUTE A MISDEMEANOR OR FELONY OFFENSE.

☐ NO☐ YES

IF YES, COMPLETE #19 BELOW.

18. ARE THERE ANY CRIMINAL CHARGES PENDING AGAINST YOU AT THIS TIME?

☐ NO☐ YES

IF YES, COMPLETE #19 BELOW.

19. DETAILED EXPLANATION OF ITEMS 16-18. COMPLETE ONE LINE FOR EACH VIOLATION AND PROVIDE EXPLANATION BELOW. IF YOU ARE UNABLE TO PROVIDE THIS INFORMATION, A DETAILED EXPLANATION MAY SUFFICE. INDICATE WHETHER EACH CONVICTION WAS A MISDEMEANOR OR FELONY AT THE TIME THE CONVICTION OCCURRED. IF THE CONVICTION STATUS HAS BEEN SUBSEQUENTLY CHANGED OR REDUCED, NOTE THAT FACT IN THE AREA PROVIDED FOR ADDITIONAL INFORMATION.

* CODE SECTION VIOLATED (I.E., 484)

** CODE VIOLATED (I.E., PENAL CODE)

*** DISPOSITION (I.E., PROBATION, PAROLE, TIME, LENGTH OF TERM, ETC.)

COURT OF CONVICTION (Name and Address)	ARRESTING AGENCY (Name and Address)	DATE OF CONVICTION	TYPE OF CONVICTION	* CODE SECTION VIOLATED	** CODE VIOLATED	***DISPOSITION	CASE NUMBER
Example: Sacramento Cnty. 456 Main St., Sac	Sacramento City Police 123 Main St., Sac	2/20/87	<input type="checkbox"/> Felony <input checked="" type="checkbox"/> Misdemeanor	484	Penal Code	6 months probation and \$200 fine	1234
A.			<input type="checkbox"/> Felony <input type="checkbox"/> Misdemeanor				
B.			<input type="checkbox"/> Felony <input type="checkbox"/> Misdemeanor				
C.			<input type="checkbox"/> Felony <input type="checkbox"/> Misdemeanor				
D.			<input type="checkbox"/> Felony <input type="checkbox"/> Misdemeanor				

Additional Information: Specify which items are being explained. (Attach extra sheets if more room is needed. **Each additional sheet must be signed by applicant when applicable.**)

OFFICER CERTIFICATION

I certify under penalty of perjury that I am an official corporate officer, and that the answers and statements given in this application are true and correct. I also certify that when the license is issued I will be 18 years of age or older, and that if licensed I will not violate any provisions of the Real Estate Law nor abuse the privileges of a real estate licensee. I understand that the license issued upon this application entitles the applicant to act only for this corporation and not in an individual capacity. I understand that if I fail to qualify for a license for any reason or withdraw this applica-

tion, the Department of Real Estate **cannot refund the fees** remitted with this application.

I hereby grant to the Real Estate Commissioner of the State of California and his/her authorized Department of Real Estate representatives, pursuant to Business and Professions Code 10145 and 10146, the authority to examine the financial records of any trust fund account maintained by this corporation in a financial institution, wherever located, for any period of time in which I hold a real estate license or have the right to renewal of such real estate license or which relates to a

transaction which occurred when I held such a real estate license. I understand that the information to be obtained from the financial records of the corporation trust fund account(s) is for the purpose of aiding the Commissioner in his/her statutory duty to enforce the provisions of the Real Estate Law.

I am aware of the provisions of Section 3700 of the Labor Code which requires every employer to be insured against liability for workers' compensation.

20. SIGNATURE OF OFFICER APPLICANT

21. DATE

»

22. TYPED NAME OF SIGNER

4: LICENSING & CODE OF ETHICS

RE 201

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SECTION III — REGULATION 2746

Corporate Real Estate Brokers, Officers, Directors and Shareholders

- (a) At the time of application for, or in the reinstatement of, an original real estate broker license, the designated officer shall file a background statement of information for each director, the chief executive officer, the president, first level vice presidents, secretary, chief financial officer, subordinate officers with responsibility for forming policy of the corporation and all natural persons owning or controlling more than ten percent of its shares, if such person has been the subject of any of the following:
- (1) Received an order or judgment issued by a court or governmental agency during the preceding 10 years temporarily or permanently restraining or enjoining any business conduct, practice or employment;
 - (2) Has had a license to engage in or practice real estate or other regulated profession, occupation or vocation denied, suspended or revoked during the preceding 10 years;
 - (3) Engaged in acts requiring a real estate license of any state without the benefit of a valid license or permit authorizing that conduct during the preceding 10 years which have been enjoined by a court of law or administrative tribunal;
 - (4) Been convicted of a crime which is substantially related to the qualifications, functions or duties of a licensee of the Department as specified in Section 2910 of these Regulations (excluding drunk driving, reckless driving and speeding violations).
- (b) The background statement shall be set forth in DRE Form 212 and shall inquire only about the information to be disclosed pursuant to subdivision (a). The background statement must be verified and completed by each corporate officer, director or stockholder as named in subdivision (a) to the fullest extent of the signatory's actual knowledge.
- (c) Whenever there is a change in the person whose background statements are required to be on file with the Department for a corporate licensee pursuant to subdivision (a) or an addition to the persons required to file statements pursuant to subdivision (a), the designated officer of the corporation shall, within 30 days thereafter file with the Department a background statement of information for each new or changed person.

Note: Authority cited: Section 10080, Business and Professions Code. Reference: Section 10152, Business and Professions Code.

CERTIFICATION

I certify that I have read and understand the provisions described above.

- ☐ I also certify that a Corporation Background Statement (RE 212) is not needed for any officers or persons owning or controlling more than ten percent of the corporation shares including myself.
- ☐ A completed Corporation Background Statement(s) is attached for each officer, director or shareholder with a reportable item under Regulation 2746.

CORPORATE NAME

SIGNATURE OF OFFICER APPLICANT

DATE

»



REAL ESTATE PRACTICE

PARTNERSHIP LICENSE

A brokerage can be established as a partnership. All partners performing activities that require a real estate license must be individually licensed. At least one other partner must be licensed at each branch location. The partnership itself needs no separate license.

Fictitious Business

A brokerage whether an individual, corporation or partnership, can do business under a fictitious name, provided a fictitious business name statement is filed with the county recorder in the county of the brokers principal business address and a copy is sent to the Real Estate Commission.

Filing a Fictitious Business Name Statement is good for 5 years from December 31st in the year filed. RE Form 204 or 204A must be submitted with the fictitious business statement.

BRANCH OFFICE LICENSE

This is the license required for each additional location if a broker maintains more than one place of business in the state. RE Form 203 must be submitted.

MINERAL, OIL, AND GAS (MOG) BROKERS LICENSE (HAS BEEN ELIMINATED)

The DRE no longer issues MOG licenses.

Form 4-2: RE 204 Broker Change Application (1 page)

4: LICENSING & CODE OF ETHICS

STATE OF CALIFORNIA — DEPARTMENT OF REAL ESTATE

BROKER CHANGE APPLICATION (For Broker Licensees)

RE 204 (Rev. 10/98)

- This form is to be used by brokers (including those working as broker-salespersons).
- Licensed salespersons should use RE 214. Corporations and corporation officers should use RE 204A.
- **Read instructions on reverse side before completing.**
- Do not write in shaded areas.

TYPE OF CHANGE (Mark one or more boxes)

- ☐ Mailing Address
- ☐ Main Office Address
- ☐ Personal Name
- ☐ Add/Cancel Fictitious Business Name
- ☐ ISSUE DUPLICATE LICENSE — \$10 (See reverse.)

BROKER INFORMATION

1. BROKER'S IDENTIFICATION NUMBER		
2. BROKER'S NAME (LAST)	(FIRST)	(MIDDLE)
3. BROKER'S NEW PERSONAL NAME (LAST)	(FIRST)	(MIDDLE)

4. CHECK HERE IF YOU DO NOT WANT YOUR NAME AND ADDRESS TO BE ON MAILING LISTS. ☐ NO MAILINGS
5. DO YOU RESIDE IN CALIFORNIA? ☐ YES ☐ NO
IF NO, AN "RE 234" MAY BE REQUIRED. SEE REVERSE SIDE.
6. BROKER'S MAILING ADDRESS (STREET ADDRESS OR POST OFFICE BOX)

CITY	STATE	ZIP CODE
------	-------	----------

7. BROKER'S MAIN OFFICE ADDRESS (STREET ADDRESS) — ENTER MAIN ADDRESS OR "NO BUSINESS ADDRESS"; DO NOT LEAVE BLANK.

CITY	STATE	ZIP CODE
------	-------	----------

8. SOCIAL SECURITY NO. (REQUIRED)	9. RESIDENCE PHONE NUMBER	10. BUSINESS PHONE NUMBER
-----------------------------------	---------------------------	---------------------------

11. FICTITIOUS BUSINESS NAME (DBA) — PRINT AS IT APPEARS ON FILING FROM COUNTY CLERK.

- ☐ ADD OR
- ☐ CANCEL

- 11A. ADDITIONAL FICTITIOUS BUSINESS NAME, IF ANY

- ☐ ADD OR
- ☐ CANCEL

12. ORIGINAL SIGNATURE OF BROKER (IF NAME CHANGE HAS OCCURRED, USE NEW LEGAL NAME.)

DATE

»»»

FOR DRE USE ONLY

PROC. #	COMMENTS
DATE PROCESSED	

- Refer to page 2.
- Enter one name per line.
- Check "add" or "cancel" box.
- Attach FBNS.
- **Broker-Salesperson's** — Do not list your employer or your employer's DBA.



REAL ESTATE PRACTICE

Selling Mobile Homes

A broker may list or sell a mobile home. The mobile home must be greater than 8 feet wide and 40 feet long. (It is no longer required that it be registered for more than one year).

Real estate brokers can sell, lease, or finance mobile homes once they are considered real property (wheels removed, placed on a foundation and having a building permit). A real estate broker must report all sales of mobile homes, within ten calendar days, to the Department of Housing and Community Development (HCD). New mobile homes can only be sold by licensed mobile home dealers.

🔗 **Information on HCD can be found at the HCD web site:** ➡ www.housing.hcd.ca.gov

RESTRICTED LICENSE (PROBATIONARY LICENSE)

Certain restricted licenses by terms of conditions of employment may be issued by the commissioner when a license has been suspended or revoked after a hearing; they are probationary licenses.

It can be restricted by:

- ♦ By term.
- ♦ To employment by a particular broker.
- ♦ To certain area of license activity.
- ♦ By requiring detailed reports on each transaction.
- ♦ By filing a surety bond.
- ♦ By other conditions or combination of conditions.

SUSPENDED LICENSE

License temporarily lost. If brokers license is suspended, the salespeople may share commissions earned before suspension date.

Form 4-3: RE 203 Branch Office Application (1 page)

4: LICENSING & CODE OF ETHICS

STATE OF CALIFORNIA — DEPARTMENT OF REAL ESTATE

BRANCH OFFICE APPLICATION

RE 203 (Rev. 7/99)

Instructions on reverse

EFF. DATE (FOR DRE USE ONLY)

1. BROKER ID NO.	INDIVIDUAL BROKER NAME — DO NOT LIST DBAs OR TRACT NAMES		
2. CORPORATION ID NO.	CORPORATION NAME — DO NOT LIST DBAs OR TRACT NAMES		
NAME OF LICENSED BROKER-OFFICER			
3. MAILING ADDRESS — STREET ADDRESS			
CITY		STATE	ZIP CODE
4. MAIN OFFICE ADDRESS — STREET ADDRESS			
CITY		STATE	ZIP CODE
BRANCH OFFICE(S)			
(CHECK ONE) A <input type="checkbox"/> ADD D <input type="checkbox"/> CANCEL L <input type="checkbox"/> DUPLICATE LICENSE (\$10 fee)	A. BRANCH OFFICE ADDRESS — STREET ADDRESS (DO NOT LIST DBAs OR TRACT NAMES)		
	2ND LINE OF ADDRESS, IF ANY		
	CITY	CA	ZIP CODE
(CHECK ONE) A <input type="checkbox"/> ADD D <input type="checkbox"/> CANCEL L <input type="checkbox"/> DUPLICATE LICENSE (\$10 fee)	B. BRANCH OFFICE ADDRESS — STREET ADDRESS (DO NOT LIST DBAs OR TRACT NAMES)		
	2ND LINE OF ADDRESS, IF ANY		
	CITY	CA	ZIP CODE
(CHECK ONE) A <input type="checkbox"/> ADD D <input type="checkbox"/> CANCEL L <input type="checkbox"/> DUPLICATE LICENSE (\$10 fee)	C. BRANCH OFFICE ADDRESS — STREET ADDRESS (DO NOT LIST DBAs OR TRACT NAMES)		
	2ND LINE OF ADDRESS, IF ANY		
	CITY	CA	ZIP CODE
(CHECK ONE) A <input type="checkbox"/> ADD D <input type="checkbox"/> CANCEL L <input type="checkbox"/> DUPLICATE LICENSE (\$10 fee)	D. BRANCH OFFICE ADDRESS — STREET ADDRESS (DO NOT LIST DBAs OR TRACT NAMES)		
	2ND LINE OF ADDRESS, IF ANY		
	CITY	CA	ZIP CODE
(CHECK ONE) A <input type="checkbox"/> ADD D <input type="checkbox"/> CANCEL L <input type="checkbox"/> DUPLICATE LICENSE (\$10 fee)	E. BRANCH OFFICE ADDRESS — STREET ADDRESS (DO NOT LIST DBAs OR TRACT NAMES)		
	2ND LINE OF ADDRESS, IF ANY		
	CITY	CA	ZIP CODE
(CHECK ONE) A <input type="checkbox"/> ADD D <input type="checkbox"/> CANCEL L <input type="checkbox"/> DUPLICATE LICENSE (\$10 fee)	F. BRANCH OFFICE ADDRESS — STREET ADDRESS (DO NOT LIST DBAs OR TRACT NAMES)		
	2ND LINE OF ADDRESS, IF ANY		
	CITY	CA	ZIP CODE
5. ORIGINAL SIGNATURE OF INDIVIDUAL BROKER OR LICENSED BROKER-OFFICER		DATE	BUSINESS PHONE #
»»»			
DRE ONLY	PROCESSOR #	DATE PROCESSED	SENDER'S # DATE SENT



REAL ESTATE PRACTICE

REVOKED LICENSE

License lost for an unlimited time.

LICENSE INSPECTION

The broker's license and that of any salesperson(s) must be available for inspection by the commissioner or a designated representative at the broker's principal place of business. If a broker maintains more than one place of business in the state, each branch office must be separately licensed and the license must be available for inspection there.

TRANSFER OF SALESPERSON LICENSE

When a salesperson changes employment from one broker to another, the former employing broker must immediately notify the Department of Real Estate in writing (within 10 days). The former employer returns the salesperson's license certificate. The new employer and salesperson must sign the Salesperson Change Application, RE Form 214 within 5 days and send it to the Department of Real Estate, P. O. Box 187003, Sacramento, CA. 95818-7003.

If a salesperson is fired for cause, broker must immediately send the Commissioner a certified written statement of facts.

LICENSE TERM AND RENEWAL

Initial Renewal

The initial term for a broker's or salesperson's license is **four** years. All real estate brokers and salespersons (except for salespersons renewing an original license for the first time*) **initially** renewing a license on or after January 1, 1996 must complete 45 clock hours of DRE-approved continuing education consisting of:

Four separate three-hour courses in the following subjects: Ethics, Agency, Trust Fund Handling, and Fair Housing;

A minimum of 18 clock hours of consumer protection courses; and
The remaining 15 clock hours related to either consumer service or consumer protection.

*Salespersons renewing an original license for the first time need only complete the four separate three-hour courses in Ethics, Agency, Trust Fund Handling, and Fair Housing.

Subsequent Renewals


For subsequent renewals, all real estate brokers and salespersons must complete 45 clock hours of DRE-approved continuing education consisting of:

One six-hour course that covers the four mandatory subjects (Ethics, Agency, Trust Fund Handling, and Fair Housing);
At least 18 clock hours of consumer protection courses; and
The remaining 21 clock hours in either consumer service or consumer protection courses.

4: LICENSING & CODE OF ETHICS

If a license is not renewed before it expires, the licensee's real estate activities must cease immediately. A license that is not renewed before the expiration of its term may be renewed at any time up to two years from its expiration date upon application and payment of a late renewal fee. After the two-year period, an original application must be made again.

COMMISSIONERS CODE OF ETHICS

 ***Unlawful conducts are specific acts and omissions which do violate existing law and are grounds for disciplinary action***

I. UNLAWFUL CONDUCTS 2785 PROFESSIONAL CONDUCT

In order to enhance the professionalism of the California real estate industry, and maximize protection for members of the public dealing with real estate licensees, whatever their areas of practice, the following standards of professional conduct and business practices are adopted:

(a) Unlawful Conduct in Sale, Lease and Exchange Transactions.

Licensees when performing acts within the meaning of Section 10131 (a) of the Business and Professions Code shall not engage in conduct which would subject the licensee to adverse action, penalty or discipline under Section 10176 and 10177, of the Business and Professions Code including, but not limited to, the following acts and omissions:

1. Knowingly making a substantial misrepresentation of the likely market value of real property to:
 - (A) Its owner, either for the purpose of securing a listing or for the purpose of acquiring an interest in the property for the licensee's own account.
 - (B) A prospective buyer for the purpose of inducing the buyer to make an offer to purchase the real property.
2. Representation to an owner of the real property that the soliciting licensee has obtained a bona fide written offer to purchase the property, unless at the time of the representation the licensee has possession of a bona fide written offer to purchase.
3. Stating or implying to an owner of real property during listing negotiations that the licensee is precluded by law, regulation or by the rules of any organization, other than the broker firm seeking the listing, from charging less than the commission or fee quoted to the owner by the licensee.
4. Knowingly making substantial misrepresentations regarding the licensee's relationship with an individual broker, corporate broker, or franchised brokerage company or that entity's/persons responsibility for the licensee's activities.
5. Knowingly underestimating the probable closing costs in a transaction in a communication to the prospective buyer or seller of real property in order to induce that person to make or to accept an offer to purchase the property.
6. Knowingly making a false or misleading representation to the seller of real property as to the form, amount and/or treatment of a deposit toward purchase of the property made by an offeror.



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7. Knowingly making a false or misleading representation to the seller of real property as to the form, amount and/or treatment of a deposit toward the purchase of the property made by an offeror.
8. Making an addition to or modification of the terms of an instrument previously signed or initialed by a party to a transaction without the knowledge and consent of the party.
9. A representation made as principal or agent to a prospective purchaser of a promissory note secured by real property about the market value of the securing property without a reasonable basis for believing the truth and accuracy of the representation.
10. Knowingly making a false or misleading representation or representing, without a reasonable basis for believing its truth, the nature and/or condition of the interior or exterior features of a property when soliciting an offer.
11. Knowingly making a false or misleading representation or representing, without a reasonable basis for believing its truth, the size of a parcel, square footage of improvements or the location of the boundary lines of real property being offered for sale, lease or exchange.
12. Knowingly making a false or misleading representation or representing, without a reasonable basis for believing its truth, that the property can be used for certain purposes with the intent of inducing the prospective buyer or lessee to acquire an interest in the real property.
13. When acting in the capacity of an agent in a transaction for the sale, lease or exchange of real property, failing to disclose to a prospective purchaser or lessee facts known to the licensee materially affecting the value or desirability of the property, when the licensee has reason to believe that such facts are not known to, nor readily observable by a prospective purchaser or lessee.
14. Willfully failing when acting as a listing agent, to present or cause to be presented to the owner of the property any offer to purchase received prior to the closing of a sale, unless expressly instructed by the owner not to present such an offer, or unless the offer is patently frivolous.
15. When acting as the listing agent, presenting competing offers to purchase real property to the owner by the listing broker in such a manner as to induce the owner to accept the offer which will provide the greatest compensation to the listing broker, without regard to the benefits, advantages, and/or disadvantages of the owner.
16. Failing to explain to parties or prospective parties to a real estate transaction the meaning and probable significance of a contingency in an offer or contract that the licensee knows or reasonably believes may affect the closing date of the transaction, or the timing of the vacating of the property by the seller or its occupancy by the buyer.
17. Failing to disclose to the seller of real property in a transaction in which the licensee is acting in the capacity of an agent, the nature and extent of any direct or indirect interest that the licensee expects to acquire as a result of the sale. The prospective purchase of the property by a person related to the licensee by blood or marriage, purchase by an entity in which the licensee has an ownership interest, or purchase by any other person with whom the licensee occupies a special relationship where there is a reasonable probability that the

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licensee could be indirectly acquiring an interest in the property, shall be disclosed to the seller.

18. Failing to disclose to the buyer of real property in a transaction in which the licensee is an agent for the buyer the nature and extent of a licensee's direct or indirect ownership interest in such real property. The direct or indirect ownership interest in the property by a person related to the licensee by blood or marriage, by an entity in which licensee has an ownership interest, or by any other person with whom the licensee occupies a special relationship shall be disclosed to the buyer.
19. Failing to disclose to a principal for whom the licensee is acting as an agent any significant interest the licensee has in a particular entity when the licensee recommends the use of the services or products of such entity.
20. The refunding by a licensee, when acting as an agent or subagent for seller, of all or part of an offeror's purchase money deposit in a real estate sales transaction after the seller has accepted the offer to purchase, unless the licensee has the express permission of the seller to make the refund.

(b) Unlawful Conduct When Soliciting, Negotiating or Arranging a Loan Secured by Real Property or the Sale of a Promissory Note Secured by Real Property.

Licensees when performing acts within the meaning of subdivision (d) or (e) of Section 10131 of the Business and Professions Code shall not violate any of the applicable provisions of subdivision (a), or act in a manner which would subject the licensee to adverse action, penalty or discipline under Section 10176 and 10177 of the Business and Profession Code including, but not limited to, the following acts and omissions:

- (1) Knowingly misrepresenting to a prospective borrower of a loan to be secured by real property or to an assignor/endorser of a promissory note secured by real property that there is an existing lender willing to make the loan or that there is a purchaser for the note, for the purpose of inducing the borrower or assignor/endorser to utilize the services of the licensee.
- (2) (a) Knowingly making a false or misleading representation to a prospective lender or purchaser of a loan secured directly or collaterally by real property about a borrower's ability to repay the loan in accordance with its terms and conditions;

(b) Failing to disclose to a prospective lender or note purchaser information about the prospective borrower's identity, occupation, employment, income and credit data as represented to the broker by the prospective borrower;

(c) Failing to disclose information known to the broker relative to the ability of the borrower to meet his or her potential or existing contractual obligations under the note or contract including information known about the borrower's payment history on an existing note, whether the note is in default or the borrower in bankruptcy.
- (3) Knowingly underestimating the probable closing costs in a communication to a prospective borrower or lender of a loan to be secured by a lien on real property for the purpose of inducing the borrower or lender to enter into the loan transaction.



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- (4) When soliciting a prospective lender to make a loan to be secured by real property, falsely representing or representing without a reasonable basis to believe its truth, the priority of the security, as a lien against the real property securing the loan, i.e., a first, second or third deed of trust.
- (5) Knowingly misrepresenting in any transaction that a specific service is free when the licensee knows or has a reasonable basis to know that it is covered by a fee to be charged as part of the transaction.
- (6) Knowingly making a false or misleading representation to a lender or assignee/endorsee of a lender of a loan secured directly or collaterally by a lien on real property about the amount and treatment of loan payments, including loan payoffs, and the failure to account to the lender or assignee/endorsee of a lender as to the disposition of such payments.
- (7) When acting as a licensee in a transaction for the purpose of obtaining a loan, and in receipt of an “advance fee” from the borrower for this purpose, the failure to the borrower for the disposition of the “advance fee.”
- (8) Knowingly making false or misleading representation about the terms and conditions of a loan to be secured by a lien on real property when soliciting a borrower or negotiating the loan.
- (9) Knowingly making a false or misleading representation or representing, without a reasonable basis for believing its truth, when soliciting a lender or negotiating a loan to be secured by a lien on real property about the market value of the securing real property, the nature and/or condition of the interior or exterior features of the securing real property, its size or square footage of any improvements on the securing real property.

Authority: Business and Professions Code Section 10080. Reference: Sections 10176 and 10177.

Note: The Real Estate Commissioner has issued Suggestions for Professional Conduct on Sale, Lease and Exchange Transactions and Suggestions for Professional Conduct When Negotiating or Arranging Loans Secured by Real Property or Sale of a Promissory Note secured by Real Property.

The purpose of the Suggestions is to encourage real estate licensees to maintain a high level of ethics and professionalism in their business practices when performing acts for which a real estate license is required.

The Suggestions are not intended as statements of duties imposed by law nor grounds for disciplinary action by the department of real estate, but as suggestions for elevating the professionalism of real estate licensees.

II. BENEFICIAL CONDUCT

Suggestions for Professional Conduct

As part of the effort to promote ethical business practices of real estate licensees, the Real Estate Commissioner has issued the following Suggestions for Professional Conduct as a companion to the Code of Professional Conduct (Section 2785, Title 10, California Code of Regulations):

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A. Suggestions for Professional Conduct in Sale, Lease, and Exchange Transactions

In order to maintain a high level of ethics and professionalism in their business practices, real estate licensees are encouraged to adhere to the following suggestions in conducting their business activities:

- (1) Aspire to give high level of competent, ethical and quality service to buyers and sellers in real estate transactions.
- (2) Stay in close communication with clients or customers to ensure that questions are promptly answered and all significant events or problems in a transaction are conveyed in a timely manner.
- (3) Cooperate with the California Department of Real Estates enforcement of, and report to that department any evident violations of, the Real Estate Law.
- (4) Use care in the preparation of any advertisement to present an accurate picture or message to the reader, viewer, or listener.
- (5) Submitting all written offers in a prompt and timely manner.
- (6) Keeping oneself informed and current on factors affecting the real estate market in which the licensee operates as an agent.
- (7). Make a full, open, and sincere effort to cooperate with other licensees, unless the principal has instructed the licensee to the contrary.
- (8). Attempting to settle disputes with other licensees through mediation or arbitration.
- (9). Advertise or claim to be an expert in an area of specialization in real estate brokerage activity, e.g., appraisal, property management, industrial sitting, mortgage loan, etc., only if the licensee has had special training, preparation or experience in such area.
- (10). Strive to provide every opportunity for quality housing and a high level of service to all persons regardless of race, color, sex, religion, ancestry, physical handicap, material status or national origin.
- (11). Base opinions of value, whether for the purpose of advertising or promoting real estate brokerage business, upon documented objective data.
- (12). Make every attempt to comply with these Guidelines for Professional Conduct, and the Code of Ethics of any organized real estate industry group of which the licensee is a member.

B . Suggestions for Professional Conduct when Negotiating or Arranging Loans Secured by Real Property or Sale of a Promissory Note Secured by Real Property.

In order to maintain a high level of ethics and professionalism in their business practices, when performing acts within the meaning of subdivisions (d) and (e) of Section 10131 and Sections



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10131.1 and 10131.2 of the Business and Professionals Code, real estate licensees are encouraged to adhere to the following suggestions, in addition to any applicable provisions of subdivision (a) in conducting their business activities:

- (1) Aspire to give high level of competent, ethical and quality service to buyers and sellers in real estate transactions.
- (2) Stay in close communication with clients or customers to ensure that questions are promptly answered and all significant events or problems in a transaction are conveyed in a timely manner.
- (3) Keep oneself informed and current on factors affecting the real estate market in which the licensee operates as an agent.
- (4) Advertise or claim to be an expert in an area of specialization in real estate brokerage activity, e.g., appraisal, property management, industrial sitting, mortgage loan, etc., only if the licensee has had special training, preparation or experience in such area.
- (5) Strive to provide every opportunity for quality housing and a high level of service to all persons regardless of race, color, sex, religion, ancestry, physical handicap, material status or national origin.
- (6) Base opinions of value in a loan transaction, whether for the purpose of advertising or promoting real estate mortgage loan brokerage business, on documented objective data.
- (7) Respond to reasonable inquiries of a principle as to the status or extent of efforts to negotiate the sale of an existing loan.
- (8) Respond to reasonable inquiries of a borrower regarding the net proceeds available from a loan arranged by the licensee.
- (9) Make every attempt to comply with these Guidelines for Professional Conduct, and the Code of Ethics of any organized real estate industry group of which the licensee is a member.

The conduct suggestions set forth in subsections (a) and (b) are not intended as statements of duties imposed by law nor as grounds for disciplinary action by the Department of Real Estate, but as guidelines for elevating the professionalism of real estate licensees.

III. UNETHICAL CONDUCT

In order to maintain a high level of ethics in business practice, real estate licensees should avoid engaging in any of the following activities:

1. Representing, without a reasonable basis, the nature and/or condition of the interior or exterior features of a property when soliciting an offer.

E.g.: Salesperson states that the plumbing is all copper tubing, without having inspected or having been informed by the seller that this is the case.

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2. Failing to respond to reasonable inquiries of a principal as to the status or extent or efforts to market property listed exclusively with the licensee.

E.g.: An owner lists a house with a broker, and the broker fails to return the owners phone calls or does not respond to the owners requests of what has transpired with the sales efforts in advertising, showings, etc.

3. Representing as an agent that any specific service is free when, in fact, it is covered by a fee to be charged as part of the transaction.

E.g.: A salesperson represents that the house inspection is free when their office lists a property. Naturally, a salesperson is obligated to know all the facts and inspect a property when taking a listing, and this service is included in the commission of sales.

4. Failing to disclose to a person when first discussing the purchase of real property, the existence of any direct or indirect ownership interest of the licensee in the property.

E.g.: An owner/broker submits a listing to a multiple listing service, and another broker sells his property, however the owner/broker does not disclose that he is a broker.

5. Recommending by a salesperson to a party to a real estate transaction that a particular lender or escrow service be used when the salesperson believes his broker has a significant beneficial interest in such entity without disclosing this information at the time the recommendation is made.

E.g.: A salesperson suggests using an escrow company that is owned by the salespersons broker, without informing the buyer or seller of the relationship.

6. Claiming to be an expert in an area of specialization in real estate brokerage, e.g., appraisal, property management, industrial siting, etc., if, in fact, the licensee has had no special training, preparation or experience in such areas.

E.g.: An experienced salesperson states to his client that he is an industrial appraiser when in fact the salesperson has never dealt in industrial properties.

7. Using the term “appraisal” in any advertising or offering for promoting real estate brokerage business to describe a real property evaluation service to be provided by the licensee unless the evaluation process will involve a written estimate of value based upon the assembling, analyzing and reconciling of facts and value indicators for the real property in question.

E.g.: Broker advertises: “appraisal service included in listing service.” Broker only uses the comparison of sales lists which he/she receives from .

8. Failing to disclose to the appropriate regulator agency any conduct on the part of a financial institution which reasonably could be construed as a violation of the Housing Financial Discrimination Act of 1977 (anti redlining).

E.g.: A broker contacts a lender who informs the broker that they have “red-lined” the area (no lending in the area because of minorities), and a broker fails to notify the statue authorities of this discriminatory practice.

9. Representing to a customer or prospective customer that because the licensee or his or her broker is a member f, or affiliated with, a franchised real estate brokerage entity, that such



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entity shares substantial responsibility, with the licensee, or his or her broker, for the proper handling of transactions if such is not the case.

E.g.: A salesperson advertises a seller that she/he is backed by a national company with thousands of real estate specialists. Salesperson does not state that his/her broker is only a franchise of a large firm. Salesperson should not intimate that seller will receive services other than what the broker can provide.

10. Demanding commission or discount by a licensee purchasing real property for ones own account after an agreement in principle has been reached with the owner as to the terms and conditions of purchase without any reference to price reduction because of the agents license status.

E.g.: A broker fails to sell a listing, then advises the owner to sell to him/her at a lower price than the listed price, and also demanding a commission for the sale.

IV. BUSINESS & PROFESSIONS CODE

Section 10176 and 10177 of the Real Estate Law constitute the foundation for most license suspensions or revocations. The various grounds for disciplinary action against a licensee are:

Section 10176 (a): Misrepresentation

The majority of complaints allege misrepresentation by the agent. A cause for discipline is the failure of the agent to disclose material facts which the principal should know. If the misrepresentation was not important and the principal would have proceeded with the transaction anyway, the misrepresentation probably would not be material.

Section 10176 (b): False Promise

A false promise and a misrepresentation differ. A misrepresentation is a false statement of fact. A false promise is a false statement about what the promisor is going to do in the future. A false promise may be proved by showing that the promise was impossible of performance and that the person making the promise knew it was impossible.

Section 10176 (c): Continued Misrepresentation

The right to discipline a licensee for “a continued and flagrant course of misrepresentation or making of false promises through real estate agents.”

Section 10176 (d): Divided Agency

A licensee is required to inform all principals if licensee is acting as agent for more than one party in a transaction.

Section 10176 (e): Commingling

Commingling is when a broker has mixed the funds of principals with brokers own money. Commingling differs from conversion. Conversion is misappropriating and use. Conversion can be a more serious offense.

Section 10176 (f): Definite Termination Date

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A specified termination date is required for all exclusive listings in transactions which require a real estate license including loan authorizations, bonds, exclusives for sale, purchase or exchange of real estate and business opportunities. If a definite date is specified, or if a definite period of time is indicated, the requirement is satisfied. If it cannot be determined from the listing itself when it expires, then the listing does not meet the requirement..

Section 10176 (g): Secret Profit

A secret profit usually arises when an agent, who already has a higher offer from another buyer, makes a low offer through a “dummy” purchaser. The difference is the secret profit.

Section 10176 (h): Listing Option

If a licensee uses a form, which is both an option and a listing, he is required to inform the principal of the profit he will make and to obtain the principals written consent before he may exercise the option. This is not applicable to an option only.

Section 10176 (i): Dishonest Dealing

Dishonest Dealing is a catch all similar to Section 10177(f). This section differs in that the acts must have been those of a licensee.

Section 10177 (a): Obtaining License by Fraud

A licensee may be disciplined for misstatements of fact in a license application and for having procured a license by fraud, misrepresentation, or deceit.

Section 10177 (b): Convictions

A licensee may be disciplined after a criminal conviction for either a felony or a misdemeanor which involves moral turpitude. Moral turpitude is “everything done contrary to justice, honest, modesty, or good moral.”

Section 10177 (c): False Advertising

Licensees who are parties to a false advertising are subject to disciplinary action in subdivision sales as well as general property sales.

Section 10177 (d): Violations of Other Sections

The Department of Real Estate has the authority to proceed against the licensee for violation of any of the other sections of the Real Estate Law, the regulations of the commissioners, and the subdivision laws.

Section 10177 (e): Misuse of Trade Name

Only active members of the national association or local associations of real estate boards are permitted to use any term or insignia of any real estate organization. No licensees may advertise or hold themselves out as “Realtors” without proper entitlement.

Section 10177 (f): Conduct Warranting Denial



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Almost any act which involves crime or dishonest will fall within this section since a key requirement to issuance of a license is the honest and truthfulness of an applicant any acts which establish the contrary are a cause for disciplinary action.

Section 10177 (g): Secret Profit

Demonstrated negligence or incompetence is cause for disciplinary action. A license is careless or unqualified if allowing him to handle a transaction would endanger the interests of either clients or customers.

Section 10177 (h): Supervision of Salespersons

A broker is subject to disciplinary action if he fails to exercise reasonable supervision over his salespersons activities

Section 10177 (j): Other Dishonest Conduct

Any other conduct which constitutes fraud or dishonest dealing may result in license suspension or revocation.

Section 10177 (k): Restricted License Violation

The violation of any terms, conditions, restrictions contained in a restricted license is grounds for disciplinary action.

Section 10177 (l): Inducement of Panic Selling

The solicitation or inducement of the sale, lease, or listing for sale or lease, or residential property on the ground of loss of value, increase in crime, or decline of the quality of the schools due to the entry of persons of another race, color, religion, ancestry, or national origin into a neighborhood is a cause for disciplinary action.

CODE OF ETHICS: NATIONAL ASSOCIATION OF REALTORS

Preamble

Under all is the land. Upon its wise utilization and widely allocated ownership depend the survival and growth of free institutions and of our civilization. The REALTOR should recognize that the interests of the nation and its citizens require the highest and best use of the land and the widest distribution of land ownership. They require the creation of adequate housing, the building of functioning cities, the development of productive industries and farms, and the preservation of a healthful environment.

Such interests impose obligation beyond those of ordinary commerce. They impose grave social responsibility and patriotic duty to which the REALTOR should dedicate him, and for which he should be diligent in preparing himself. The REALTOR, therefore, is zealous to maintain and improve the standards of his calling and shares with his fellow REALTORS, a common responsibility for its integrity and honor. The term REALTOR has come to connote competency, fairness, and high integrity resulting from adherence to a lofty ideal of moral conduct in business relations. No inducement of profit and no instruction from clients ever can justify departure from this ideal.

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In the interpretation of his obligation, a REALTOR can take no safer guide than that which has been handed down through the centuries, embodied in the Golden Rule, "Whatsoever you would that men should do to you, do you even so to them."

Accepting this standard as his own, every REALTOR pledges himself to observe its spirit in all of his activities and to conduct his business in accordance with the tenets set forth below:

Article 1

The REALTOR should keep himself informed on matters affecting real estate in his community, the state, and the nation so that he may be able to contribute responsibly to public thinking on such matter.

Article 2

In justice to those who place their interests in his care, the REALTOR should endeavor always to be informed regarding laws, proposed legislation, governmental regulations, public policies, and current market conditions in order to be in a position to advise his clients properly.

Article 3

It is the duty of the REALTOR to protect the public from fraud, misrepresentation, and unethical practices in real estate transactions. He should endeavor to eliminate in his community any practices which could be damaging to the public or bring discredit to the real estate profession. The REALTOR is charged with regulating the practices of brokers and salesmen in his state.

Article 4

The REALTOR should seek no unfair advantage over other REALTOR and should willingly conduct his business so as to avoid controversies with other REALTORS.

Article 5

In the best interests of society, of his associates, and his own business, the REALTOR should willingly share with other REALTOR the lessons of his experience and study for the benefit of the public, and should be loyal to the Board of REALTORS of his community and active in its work.

Article 6

To prevent dissension and misunderstanding and to ensure better service to the owner, the REALTOR should urge the exclusive listing of property unless contrary to the best interest of the owner.

Article 7

In accepting employment as an agent, the REALTOR pledges himself to protect and promote the interests of the client. This obligation of absolute fidelity to the clients interests is primary, but it does not relieve the REALTOR of the obligation to treat fairly all parties to the transaction.

Article 8

The REALTOR shall not accept compensation from more than one party, even if permitted by law, without the full knowledge of all parties to the transaction.



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Article 9

The REALTOR shall avoid exaggeration, misrepresentation, or concealment of pertinent facts. He has an affirmative obligation to discover adverse factors that a reasonably competent and diligent investigation would disclose.

Article 10

The REALTOR shall not deny equal professional services to any person for the reasons of race, creed, sex, or contrary of national origin. The REALTOR shall not be a party to any plan or agreement to discriminate against a person or persons on the basis of race, creed, sex, or country of national origin.

Article 11

A REALTOR is expected to provide a level of competent service in keeping with the Standards of Practice in those fields in which the REALTOR customarily engages.

The REALTOR shall not undertake to provide specialized professional services concerning a type of property or service that is outside his field of competence unless he engages the assistance of one who is competent on such types of property or service, or unless the facts are fully disclosed to the client. Any person engaged to provide such assistance shall be so identified to the client and his contribution to the assignment should be set forth.

The REALTOR shall refer to the Standards of Practice of the National Association as to the degree of competence that a client has a right to expect the REALTOR to process, taking into consideration the complexity of the problem, the availability of expert assistance, and the opportunities for experience available to the REALTOR.

Article 12

The REALTOR shall not undertake to provide professional services concerning a property or its value where he has a present or contemplated interest unless such interest is specifically disclosed to all affected parties.

Article 13

The REALTOR shall not acquire an interest in or buy for himself, any member of his immediate family, his firm or any member thereof, or any entity in which he has a substantial ownership interest, property listed with him, without making the true position known to the listing owner. In selling property owned by himself, or in which he has any interest, the REALTOR shall reveal the facts of his ownership or interest to the purchaser.

Article 14

In the event of a controversy between REALTOR associated with different firms, arising out of their relationship as REALTOR, the REALTORS shall submit the dispute to arbitration in accordance with the regulations of their board or boards rather than litigate the matter.

Article 15

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If a REALTOR is charged with unethical practice or is asked to present evidence in any disciplinary proceeding or investigation, he shall place all pertinent facts before the proper tribunal of the member board or affiliated institute, society, or council of which he is a member.

Article 16

When acting as agent, the REALTOR shall not accept any commission, rebate, or profit on expenditures made for his principal-owner, without the principals knowledge and consent.

Article 17

The REALTOR shall not engage in activities that constitute the unauthorized practice of law and shall recommend that legal counsel be obtained when the interest of any party to the transaction requires it.

Article 18

The REALTOR shall keep in a special account in an appropriate financial institution, separated from his own funds, moneys coming into his possession in trust for other persons, such as Escrows, trust funds, clients moneys, and other like items.

Article 19

The REALTOR shall be careful at all times to present a true picture in his advertising and representations to the public. He shall neither advertise without disclosing his name nor permit any person associated with him to use individual names or telephone numbers, unless such persons connection with the REALTOR is obvious in the advertisement.

Article 20

The REALTOR for the protection of all parties, shall see that the financial obligations and commitments regarding real estate transactions are in writing, expressing the exact agreement of the parties. A copy of each agreement shall be furnished to each party upon his signing of such agreement.

Article 21

The REALTOR shall not engage in any practice or take action inconsistent with the agency of another REALTOR.

Article 22

In the sale of property which is exclusively listed with a REALTOR, the REALTOR shall utilize the services of other brokers upon mutually agreed upon terms when it is in the best interests of the client.

Negotiations concerning property which is listed exclusively shall be carried on with the listing broker, not with the owner, except with the consent of the listing broker.

Article 23

The REALTOR shall not publicly disparage the business practice of a competitor nor volunteer an opinion of a competitors transaction. If his opinion is sought and if the REALTOR deems it



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appropriate to respond, such opinion shall be rendered with strict professional liability and courtesy.

CHAPTER QUIZ

1. To become truly successful in the real estate business, one should:
 - A. Attain as high a level of academic education as possible
 - B. Take as many courses in real estate as one can find
 - C. Continually educate oneself throughout one's career
 - D. All of the above
2. The "Code of Ethics and Professional Conduct" is considered to be:
 - A. One of the Real Estate Commissioner's regulations which applies to all real estate licensees;
 - B. Of relevance for brokers only;
 - C. Recommended, but not required for all real estate professionals;
 - D. A model office policy manual.
3. Claiming to be an expert in an area of specialization in real estate brokerage, e.g. Appraisal, property management, industrial sitting, etc., If, in fact, the licensee had no special training, preparation or experiences in such area is considered common practice in the real estate field:
 - A. True;
 - B. False;
4. If an agent tells his principal the race, creed, or color of a prospective buyer or tenant, has he committed a discriminatory act?
 - A. Yes, because an opinion of the California Attorney General states that race, creed, or color is not a material fact and should not be disclosed even though the owner requests the information
 - B. No, because an agent is obligated to tell his principal all material facts that might influence the principal's decision in any real estate transaction;
 - C. No, because a fiduciary relationship exists between the agent and the principal and the agent must use the utmost good faith when working for his principal's interest;
 - D. Yes, because that disclosure would violate a state law;
5. A broker persuades a Caucasian family to list their home for sale by telling them that nonwhite people are moving into the area and that this may reduce property values. Such persuasion is considered all of the following, **except**
 - A. Blockbusting;
 - B. Encouragement of panic selling;
 - C. Legal but unethical
 - D. Illegal conduct;

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6. Unlawful Conduct as set forth in the Commission's Regulations is best described as:
- A. Acts which are not grounds for disciplinary action by DRE;
 - B. Not an actual act but a statement of duties imposed by law;
 - C. Specific acts and omissions which do violate existing law and are grounds for disciplinary action;
 - D. Acts which are set as guidelines.
7. When a licensee has knowledge of facts which could materially affect the value or desirability of the listed property and when the licensee has reason to believe the facts are unknown to the prospective purchaser, the licensee has the duty to:
- A. Disclose nothing, it is the buyer's duty to thoroughly check the property before entering into a contract;
 - B. Disclose all facts to the prospective purchaser
 - C. Disclose only those facts that are readily observable by a prospective purchaser;
 - D. None of the above.
8. Acting for more than one party in a transaction without knowledge or consent of all parties thereto is best described as:
- A. Divided agency;
 - B. Collusion;
 - C. Commingling;
 - D. Conspiracy;
9. Which of the following is not considered unethical conduct:
- A. Failing to disclose to a purchaser a direct or indirect ownership interest of the licensee in the property;
 - B. Failing to respond to reasonable inquiries of a principal as to the extent of efforts to market property listed with the licensee;
 - C. Making a modification to the terms of a contract previously signed by a party without the knowledge and consent of the party;
 - D. Representing that a service is free, when in fact, it is covered by a fee to be charged as part of the transaction.
10. Commingling of funds is:
- A. Misappropriating and using of funds;
 - B. Mixing the broker's funds with funds of the principal;
 - C. More serious of an offense than conversion;
 - D. All of the above.



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Answers: 1-D, 2-A, 3-B, 4-A, 5-C, 6-C, 7-B, 8-A, 9-B, 10-B

CHAPTER 5: CONTRACT LAW



Preview

Probably no other phase of the law is as important to real estate agents as the Law of Contracts because nearly every transaction of any consequence invariably includes one or more contracts. In this chapter, you will be acquainted with some of the rules governing their creation, operation and enforcement.

CONTRACT

A **contract** is a promise made by one person to another to do or not to do a certain thing; or an agreement between two or more persons consisting of promise or mutual promises, which the law in some way will recognize as a duty.

 *It is a meeting of the minds.*

TYPES OF CONTRACT

Before we start, we should get familiar with the meaning of the following terms.

Express Contract (By Words)

Parties declare the terms and manifest their intentions in *words* either oral or written.

Implied Contract (By Conduct)

Parties show their agreement by *acts and conduct* rather than words. It is one, the existence and terms of which are manifested by conduct. It is an agreement, that while not specifically stated, is understood by the parties.

Bilateral Contract (A Promise for a Promise)

A **bilateral contract** is one in which the promise of one party is given in exchange for the promise of the other party. Both parties are bound to perform. *A promise for a promise.* For example, a listing agreement, exclusive right to sell, or an employment contract.



Unilateral Contract (One Promise)

A **unilateral contract** is a promise is given by one party to induce some actual performance by the other party who is not bound to act. But, if he does, the first party must keep his promise. A *one sided contract*, e.g. *options* or *open listing*).

Executory Contract (Still Open)

An **executory contract** is a contract in which something remains to be done by one or both parties. A contract to be performed.

Executed Contract (Performed, Discharged)

An **executed contract** is contract in which either both parties have completely performed or have been discharged. Since a signature may be all that is required to perform, the term “**executed**” also means to sign a document, while **execution** of a contract is the act of performing or carrying out the contract.

Void Contract (Invalid Contract)

A **void contract** is actually no contract at all because it lacks a legal essential element of a contract. Never had and never will have any legal effect. An example would be a contract by a minor to purchase a home.

Voidable Contract (Victim can Rescind)

A **voidable contract** is one that is valid and enforceable on its face, but because of some deficiency (defect), the injured party (victim) may legally rescind, reject or refuse to perform the contract.

☞ **Example: Someone signs a contract while intoxicated.**

Valid Contract (Binding)

A **valid contract** is one where all legal essential elements are present. One that is binding and enforceable in a court of law. Performance is expected or legal action can be filed.

Unenforceable Contract (Cannot be sued)

An **unenforceable contract** is a legal contract but, one in which one or both parties to the contract cannot be compelled or sued to perform. Laws make the performance illegal. An example would be an oral contract in a matter that the law requires to be in writing, or the Statute of Limitations may apply and time has run out.

Types of unenforceable contracts are:

- ♦ Promissory notes charging Usurious interest.

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- ♦ Contracts of unlicensed “*brokers*.”
- ♦ Gambling debts.

Parol Contract (Oral Contract)

A **parol contract** is one that is entirely or partially oral. Some contracts are enforceable even though they are oral.

ELEMENTS OF VALID CONTRACT

A valid contract contains four essential elements, namely: “capable parties,” “mutual consent,” “lawful object,” and “sufficient consideration.”

Capable Parties (Capacity)

Everyone (including aliens) has the capacity to contract with the exceptions of (1) minors, (2) incompetents (persons of unsound mind) and (3) convicts (persons deprived of their civil rights).

1. **Minor:** A single person under 18 years of age who has never been married, is not in the US armed forces, or is not emancipated. A broker cannot be employed by a minor.

Emancipated Minor: A minor can contract as an adult, if he or she has been emancipated. A minor becomes emancipated by marrying, joining the armed forces or by petitioning the court, which makes that decision. Once emancipated, always emancipated.

2. **Incompetent:** A person who is entirely without understanding or one who has been judicially declared of unsound mind.
3. **Convicts:** Persons imprisoned in a state or federal prison. They lost their rights to contract during that time. However, an inmate may enter into a contract provided it is ratified by the California Adult Authority.

☞ ***A minor can acquire property by gift or inheritance. A minor may buy and sell real estate through a guardian if the action is given court approval.***

☞ ***Aliens (Non Residents) have the right to own property in California. A person, whether he or she is a U. S. Citizen or not, may buy, hold or transfer real property.***

Mutual Consent (Agreement)

Normally evidenced by an “**offer and acceptance**.” (Offer of one party and acceptance by the other party. It is a “**meeting of the minds**.”)

Since courts cannot read minds, any secret or unexpressed intentions are immaterial. The consent must be genuine and free from fraud or mistake, and there must be a true intention to be obliged or it may be voidable by one or more parties.



☞ ***Death does not cancel most contracts; they are binding on the estate, except as a listing agreement, which is a personal employment contract.***

Offer and Acceptance

An **offer** expresses a person's willingness to enter into a contract. The *offeror* (buyer) is the person who has made the offer, and the *offeree* (seller) is the person to whom the offer has been presented.

- ♦ An offer must be **communicated** to the offeree.
- ♦ An offer must be **definite and certain** in terms and manifest a **contractual intention**.
- ♦ **Contractual intent** exists when a party communicates an offer to another with the intention of forming a binding contract.
- ♦ An advertisement or a social invitation is merely an invitation and not meant to be a contract.
- ♦ **Definite and certain** means that the precise acts to be performed must be clearly stated and ascertainable.
- ♦ The offer must be **"nonillusory"** in character. It must bind the offeror if accepted. An **"illusory contract"** appears to be contract but is one in which the terms are uncertain, therefore the contract is unenforceable.
- ♦ All financing terms should be spelled out.
- ♦ Property must be accurately described.

An **acceptance** is the consent to the terms by the offeree. The person to whom the offer is made must know he or she has been made an offer before that person can accept the offer.

☞ ***Silence cannot be interpreted as an acceptance of an offer because a party cannot be forced to express rejection of an offer.***

One cannot say: "If I do not hear from you in 15 days the offer is considered accepted." There must be a communicated acceptance of an offer, in writing, personally or by delivery.

- ♦ The broker most likely to have earned a commission is the one who has communicated acceptance of the offer.
- ♦ The principle obstacles to genuine acceptance are *fraud, mistake, menace, duress and undue influence*. The presence of any one of these makes the contract voidable. They will be discussed later.

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- ♦ The acceptance must be absolute and unqualified, because if it modifies the terms of the offer, it becomes a counter offer.
- ♦ A counter offer is the rejection of an original offer and the proposal of a new offer. The offeree rejects the offer then becomes the offeror of the counter offer. Any offer after the original offer is a counter offer.

Legality (Lawful Object)

A contract must be legal in its formation and operation. Its consideration and its objective must also be lawful.

☞ ***A contract that forces one to break the law is void.***

Both the consideration and its objective must also be lawful. The objective refers to what the contract requires the parties to do or not to do. If the contract consists of single objective, which is unlawful in whole or in part, then the contract is void. If there are several objectives, the contract is normally valid as to those parts that are lawful.

The law will not enforce an illegal contract. If an illegal contract is not completed, the courts will not force its completion.

Sufficient Consideration (Compensation)

Every contract requires sufficient consideration, which may be anything of value.

Consideration may be a promise, money, property, benefit conferred like the performance of an act, or the forbearance (nonperformance) of an act. It cannot be an illegal act or services.

- ♦ The broker most likely to have earned a commission is the one who has communicated acceptance of the offer.
- ♦ Some rare contracts require that consideration be adequate. In such contracts the condition of adequate consideration must be met for those contracts to be enforceable. Other contracts, without such a condition, are enforceable no matter what the consideration is, as long as it is agreed by all parties.

Writing (Statute of Frauds)

A fifth essential element dictated by Statute of Frauds requires that In Real Estate Contract must be in **writing** to be enforceable.

ELEMENTS OF VOIDABLE CONTRACT

The presence of “*fraud, mistake, menace, duress and undue influence*” makes the contract voidable by victim.

Actual Fraud (Intentional Deceive)

Actual fraud is the *intentional deceive* of a material fact used to induce the other party to enter a contract to his detriment. When complete deception exists, the contract is voidable.



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For example, a broker tells buyer the living square footage is 2500 but actually it is much less.

- ♦ Actual fraud includes the suppression of the truth, a promise made without any intention of performing it, and the intentional cheating of another person.
- ♦ A misrepresentation is a fraud if it is false, made with knowledge of its falsehood, and caused the innocent party to enter into the contract.

Constructive Fraud (Unintentional Deceive)

Constructive fraud is a breach of duty which, *without fraudulent intent*, gains an advantage for the person at fault. The injured party relied on the misrepresentation. For example, Broker tells buyer the add-on has permits, when he actually does not know. Broker being an professional in the field should know.

To sue for actual/constructive fraud, the plaintiff generally must be able to prove five elements. When all of these elements are present, the fraud is said to be **actionable**.

1. A person makes a false statement of a material fact or fails to disclose a material fact that he or she has a legal duty to disclose.
2. In regard to a misrepresentation, the person making the statement knows or should know that it is false.
3. The statement or concealment is made with the intent of inducing another to enter into a transaction.
4. The other person relies on the statement or lack of knowledge of the concealed information and is induced to enter the transaction.
5. The other person is harmed as a result of entering the transaction.

⇒ *Note: Element #2 expresses the distinction between intentional misrepresentation (knows that the statement is false). In a suit alleging constructive fraud, it is not necessary to prove element #2 and #3.*

Most fraud cases are based on spoken or written statements that are false or misleading. But conduct can also be fraudulent.

Mistake exists when parties are mistake as to the identity of the subject matter or where the subject matter has, unknown to the parties, ceased to exist.

☞ **The contract is usually voidable when mistake exists.**

- ♦ **Carelessness or negligence does not void a contract.** If through carelessness or negligence one sign a contract without reading it or without familiarization oneself with the contract, no relief is granted.
- ♦ **Subornation** means doing something by lie, trickery or deceit.

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Penalties for fraud can be severe:

- ♦ A contract induced by fraud is voidable by the injured party.
- ♦ The injured party may also seek money damages, including punitive damages.
- ♦ A criminal prosecution may be brought against the person who committed the fraud resulting in a fine or imprisonment.

Duress (Pressure)

Duress is unlawful pressure exercised upon a person whereby he/she is forced to act against his will. Duress generally is regarded as force.

Menace (Threat)

Menace is a *threat* to commit duress or violent injury to a person.

Undue Influence (Not Acting under Free Will)

Undue influence exists when a confidence or authority over another is used to gain unfair advantage. It is improper persuasion based on the relationship of parties whereby a person really is not acting under his or her own free will.

Misrepresentation (False Statement)

Misrepresentation is a civil wrong that differs from criminal fraud in that it is *not intentional*. While there are no criminal penalties for misrepresentations, it, like criminal fraud, makes a contract voidable and may induce civil damages.

A person who honestly believed that his or her false assertions of fact were true but had no reasonable grounds for this belief will have committed the tort of ***negligent misrepresentation***.

STATUTE OF FRAUDS (REQUIRES WRITTEN CONTRACT)

A California Law found in California Civil Code which provides that certain contracts are “*invalid / unenforceable*” unless the same or some note or memorandum is in writing and signed by the party to be charged. The purpose is to prevent perjury and dishonest.

The following contracts fall within the statute.

- ♦ That by its terms will not be performed within a year from the making of the contract.
- ♦ A special promise to answer for the debt, default or non performance of another.
- ♦ For the leasing of real property for more than one year or for the sale of real property or an interest therein.
- ♦ Employing an agent, broker or any other person, to purchase or sell real estate or handle the lease of a property for more than one year.
- ♦ Which by its terms is not to be performed during the lifetime of the promisor, or any will.



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- ♦ By a purchaser of real property to assume an existing loan unless assumption of that debt by the purchaser is specifically provided for in the conveyance of the property.

The Statute of Frauds also applies to personal property. If the sales price of an item is more than **\$500**, the contract must be in writing. Furthermore, if several items are purchased with the intent that the agreement be a single contract, the contract should be in writing if the total sales price is \$500 or more.

Limited Partnership Agreement

Although not covered in the Statute of Frauds, this must be in writing.

Despite the statute of frauds, the following contracts need not be in writing to be valid:

- ♦ General Partnership agreement.
- ♦ Lease of real property for one year or less.

STATUTE OF LIMITATION (TIME LIMITS TO TAKE ACTION)

The state law sets certain time limits in which bars any court action seeking relief, if not taken within specified time limits. If the legal action has not been started within that given time, no legal recourse will be possible. This policy of law states that a person who *“sleeps upon his rights”* may find himself barred from any legal action. The following real estate activities must be brought up within the time limits specified in order to be enforceable:

Personal Property - Within 90 days

Recovery of personal property; for example, properties left at hotel, motel, or boarding house.

Injury - Within One Year

An action for libel, slander, injury or death caused by the neglect of another, or against a bank for the payment of a forged check, must be started within one year of the alleged wrong. Example: Automobile accidents.

Oral Contract - Within Two Years

An action based on an oral agreement;

Fraud - Within Three Years

An action based on fraud must be brought within three years of the discovery of the fraud; or, an action for trespassing upon real property, encroachment, and attachment.

Written Instrument

Within Four Years - An action based on a written contract (such as a real estate sales contract).

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Title - Within Five Years

An action to recover title to real property (adverse possession, easement by prescription, tax sale, escheat).

Judgment - Within Ten Years

An action based on a judgment of a court must be brought within ten years of the awarding of the judgment.

Judgment Lien (General, Involuntary Lien)

Recording an abstract of a judgment creates a lien on all of the debtors' property in the county where it is recorded. A judgment is a general, involuntary, equitable lien on both real and personal property owned by the debtor. Judgment lien normally continues for ten years from the date of entry of the judgment or decree, judgment lien can be renewed for another 10 years.

Injunction (Restrict)

Injunction is the court order to stop (restrict) a party from doing an act such as violating private restrictions. Injunction is a permanent order, while **restraining** order is temporary.

Writ of Execution (Court Order to Sell)

It is a court order forcing the sale of a debtor's property to satisfy a judgment. In California, the Sheriff's Sale is the usual method of forcing someone to sell property to pay off a judgment. The county sheriff, or other local officials, are then ordered to secure and sell the real or personal property to satisfy the lien.

☞ ***The state controls lien and attachment laws, cities and counties do not.***

Lis Pendens (Litigation Pending)

The word ***lis-pendens*** means "***notice of pendency***," it is a recorded notice by a party to indicate pending litigation (lawsuit) which will affect title to the property. Attorneys often file a lis pendens before a court date is set in order to stop the transfer (sell) of the property. A lis pendens places a *cloud on the title, and makes the property unmarketable* until the lis pendens is removed.

A lis pendens remains on the public record until the lawsuit is dismissed, or final judgment is rendered.

Attachment (Court Ordered Property Seizure)

Attachment is the pre-judgment process by which property (real or personal) is seized by court order and is held as security for possible future judgment in a pending court suit. It is valid for a 3-year period and does not terminate upon death. The purpose of the attachment is to have the property of the defendant available to satisfy a judgment in favor of the plaintiff. Because so much property is exempt from attachment, such as personal home, wages, and so on, the use of attachment has declined in recent years. Instead of seeking an attachment, many creditors go directly for a judgment.

Equitable Estoppel



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A person may convey or appear to convey a property interest he or she does not yet own but may acquire at some future time. Such **after-acquired-title** must be transferred to the new owner. The **doctrine of equitable estoppel** prohibits a refusal to make the transfer. Equitable estoppel also prevents fraud or misrepresentation by the present owner of property. If a property owner misrepresents his or her ownership (whether by act or by omission) to a person who then buys the property from another person who is the apparent owner, the true owner must convey the property to the innocent party.

☞ **Example: Jessica owns Blackacre but does not want Jeff to know. One day, when Jessica, Jeff and Steven are together, Jeff asked Jessica and Steven if one of them owns Blackacre. Steven says he owns Blackacre, and Jessica doesn't object. Jeff then pays Steven for Blackacre. Who owns Blackacre?**

Answer: Jeff owns Blackacre. Jessica is equitable estopped from denying Jeff's ownership. By his conduct Jessica allowed Jeff to believe Jeff was buying Blackacre from Steven. Jessica will be left with an action for damages against Steven, who has pocketed the money Jeff paid for Blackacre.

INTERPRETATIONS OF CONTRACTS

The language of the contract governs its interpretation and should be clear and concise.

- ♦ The written part (longhand or typed) supersedes the printed parts.
- ♦ **Rider:** An amendment to a contract.
- ♦ **Waiver:** A unilateral act, which relinquishes a right in a contract.
- ♦ **Privity** - A relationship of privateness exists in contractual relationships.

☞ ***If a contract contains any ambiguity, the courts generally interpret the agreement against the party who prepared it.***

Parol Evidence Rule (Written supersedes Oral)

Parol evidence means that prior oral or written agreements of the parties cannot be introduced as evidence to modify a written document that is complete on its face. The rule establishes that any previous oral agreements must be included in the written agreement when parties agree to a written contract.

Under the "**parol evidence rule**," a contract expressed in writing is intended to be complete and final as an expression of the rights and duties of the contracting parties. The courts will permit such outside evidence to be introduced only when the written contract is incomplete, ambiguous, or when it is necessary to show that the contract is not enforceable because of mistake or fraud.

☞ ***Rarely will a court allow prior "oral parts or an entire oral contract" to be substituted for a later written contract.***

Printed Form

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The general rule regarding preprinted forms is that:

- ♦ Typed insertions take precedence over printed material,
- ♦ Handwritten insertions take precedence over both typed and printed material, and
- ♦ Specific information takes precedence over general information.

Aleatory Contract (Not Equal)

An **aleatory contract** means that equal value is not given by both parties to the contract. Examples are insurance contracts. The insured (or the insureds beneficiary) may receive a great deal more from the insurance company than the total premiums paid.

Contract of Adhesion (one-sided)

When we say real estate contracts are **contracts of adhesion** we mean that they are somewhat “one-sided.” The provisions of the contract are prepared by one party. The other party, the buyer, does not take part in the preparation of the contract.

This concept is important because when a contract of adhesion is ambiguous in its terms, the courts will interpret the contract against the party who prepared it.

Insurance contracts like real estate contracts are contracts of adhesion. In insurance contracts, the court will usually grant any reasonable expectation on the part of the policyowner or the beneficiaries from a contract that was drawn up by the insurance company.

Novation (Substitution)

A **novation** is the substitute or replacement (by mutual agreement of the parties) of a new obligation or contract for an existing one with intent to cancel the old one.

Tender (Offer)

A **tender** is an offer to perform.

Laches (Excessive Delay)

Laches is preventing a person from asserting a right or claim when his or her delay in asserting that right causes or results in disadvantage, injury, injustice, detriment or prejudice to the defendant in a lawsuit

☞ *A person could be estopped (prevented) by laches from having an encroachment removed if he or she were aware of the construction and waited until it was completed to demand its removal. To grant the landowner his or her rights would not be equitable based on the delay in bringing action.*

Revocation

A **revocation** is the cancelling of an offer to contract by the original offeror.



DISCHARGE OF CONTRACTS

A contract may be discharged by either full performance or mutual rescission or assignment or breach (operation of law).

Full Performance

It is the normal ideal situation, where the contract is completed according to the terms specified in the contract and will discharge a contract.

Mutual Rescission

If both parties agree, they may rescind/cancel the contract by mutual agreement (agree to disagree). Most knowledgeable contractors include ways for the contract to be discharged if one of the parties defaults on the original contract.

Assignment

Most contracts are assignable unless it calls for a personal service of the promisor or it specifically prohibits an assignment. An assignment is the transfer of all of the persons interest and right in a contract of the assignor to the assignee.

- ◆ Listings are not assignable because they are personal service contracts.
- ◆ If the assignee does not perform, the assignor remains liable (secondary liability) for the contract.

Breach

Breach occurs when one of the parties fails to perform all or part of the obligations required by the contract. A non-breaching party who is injured by the breach is entitled to legal relief.

REMEDIES FOR BREACH OF CONTRACT

There are four remedies when a contract is breached:

1. Acceptance of breach
2. Sue for Monetary Remedies (Dollar Damages)
3. Sue for Equitable Remedies (Specific Performance)
4. Nonjudicial Remedies

Acceptance of Breach

In an acceptance of breach the wronged party does not pursue legal action. Sometimes he or she may feel that the damages recoverable are too limited to justify litigation. Perhaps the person considers the other party **judgment-proof**, which means that the other party does not have enough assets available to satisfy a judgment. Moreover, the legal cost of a

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lawsuit, the time, the effort and the psychological effect may not be worth the possible outcome.

Dollar Damages

If a victim of a breach is not willing to accept the breach, he may seek an action for **monetary (dollar) damages**.

Dollar damages have one of the following three forms:

1. Liquidated dollar damage
2. Actual dollar damage
3. Punitive dollar damage.


Liquidated Damages (Pre-determined Amount)

A definite specified amount of damages, agreed to at the time of contracting, to be paid by the party breaching the contract.

- ♦ Normally used when it would be impractical or extremely difficult to fix the actual damage.
- ♦ Typically purchase agreements call for the forfeiture of the earnest money deposit as liquidated damages in the event the buyer defaults.
- ♦ On purchase of a real estate resident, the liquidated damages are limited by law to be at most 3% of the sales price.
- ♦ The damages are usually split between the seller and the listing agent (50%-50%).
- ♦ The seller who keeps the deposit as liquidated damages may not sue for any further damages if the contract provides that the deposit is the sellers sole remedy.
- ♦ Construction projects often have a per-day charge as liquidated damages in the event of a delay in completion.

Actual Dollar Damages (Actual Loss)

Money recoverable by one suffering a loss or injury. A clause in the contract providing the amount of actual loss of the damages in case of one party breaks the contract.

 ***If a real estate licensee or seller willfully or negligently fails to comply with the disclosure requirement he or she will be liable for any actual damages suffered by a buyer.***

Punitive or Exemplary Dollar Damages (Additional Awards)

These damages are awarded in addition to compensatory damages to punish the wrongdoer. They are awarded by courts for *intentional* and *outrageous acts*. Excessive



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punitive damages will not be upheld by the courts. Normally damages serve to punish are not allowed for a breach of real estate contract.

Equitable Remedies (Non Dollar Damages)

Equitable remedies are developed by the courts. The equity courts do not generally award monetary damages; their remedies were based on conscience or what was right.

Equitable remedies are **rescission**, **specific performance**, **injunction**, **reformation**, and **declaratory relief**. Only rescission and specific performance are discussed here.

Unilateral Rescission

Unilateral rescission is available to a party when they enter a contract based on fraud, mistake, undue influence, duress, or menace. The rescission must:

1. Be made promptly
2. Restore to the other offending party everything of value received. (*Return to the Status Quo*).

Specific Performance

When dollar damages cannot equitably provide an adequate remedy, the court may order the defendant to perform as agreed in the contract or restrain the party from doing an act (injunction).

The court most likely will not order specific performance if the subject matter of the contract is readily available from another source. An example, in a contract to purchase consumer goods, goods of the same type usually are available elsewhere. Real property is non-substitutable. Every parcel of real estate is considered unique and irreplaceable.

- ♦ A broker cannot bring a suit for specific performance against a seller or buyer.
- ♦ When selling community real property, it is extremely important for a salesperson to acquire the signatures of both husband and wife. Community real property must be transferred by both husband and wife. A buyer who does not realize the existence of a marriage relationship, where the husband alone holds all titles, may have his or her rights enforced through specific performance without the wife's signature. This, however, requires court action. An agreement to obtain a spouses consent cannot be specifically enforced until one years spousal silence on the matter has passed.

☞ **Nonhomogeneity of land means, "No two properties are alike!"**

Injunction

An **injunction** is a remedy in equity that orders a party to cease an activity such as trespass. Prohibiting an action prevents future harm. Courts may order a permanent injunction or a temporary restrain order.

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Reformation

In asking for the equitable remedy of **reformation**, a party is requesting that the contract be modified to reflect what was intended by the parties. Reformation will be granted only when there was a complete understanding between the parties that was not properly reflected because of fraud or a mutual mistake in drafting the contract.

Declaratory Relief

The remedy of **declaratory relief** results in a court order pertaining to the rights and duties of the parties. This remedy can be sought before actual damages occur.

Nonjudicial Remedies (Arbitration / Mediation)

In addition to judicial remedies, nonjudicial remedies of *arbitration* and *mediation* are available for disputing parties.

Arbitration

Arbitration is a process for resolution of disputes. Many agreements call for mandatory arbitration, and the courts generally will enforce these agreements. The contracts usually provide for the choosing of the arbitrator and may state that the rules of the American Arbitration Association apply.

- ♦ The major benefits of arbitration are that it is faster and less expensive than court action.
- ♦ Parties can agree to voluntary arbitration (as in real estate).
- ♦ With voluntary arbitration, you are giving up your judicial rights to discovery and appeal.

☞ ***Arbitration may be binding or nonbinding.***

Mediation

Mediation is a process in which a neutral third party (mediator) works with the parties in a dispute to help them reach a satisfactory solution. The mediator suggests resolutions and alternatives and might confer with parties separately as well as together.

☞ ***The mediation process is not binding on the parties.***

PURCHASE CONTRACT AND RECEIPT FOR DEPOSIT

Since most offers to purchase include a money deposit known as “**earnest money**” the *contract of sale* (or *purchase agreement*) is also a receipt of the deposit and is known as a *Deposit Receipt*. Since the prospective buyer is making the offer to the owner to purchase the property, for definition purposes, the prospective buyer is the offeror; the owner is the offeree.

- ♦ The deposit receipt is an offer and deposit to purchase a specific property on certain terms and conditions.



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- ♦ When acceptance is communicated, this becomes a binding contract on the buyer and seller.
- ♦ An agent should always give a copy of a contract to the parties involved when it is signed.

THE DEPOSIT (LIQUIDATED DAMAGE AMOUNT IF INITIALED)

The deposit is collected as consideration, from a prospective buyer on behalf of the seller, for the deposit receipt contract.

If the liquidated damage clause is initialed by both parties, and the buyer later defaults on the transaction, the seller may retain the deposit (up to three (3) percent of the purchase price).

☞ ***The deposit would then split 50%-50% between the seller and the listing broker, unless otherwise stated in the deposit receipt.***

☞ ***Deposits are always the property of the seller (after the removal of contingencies); Never the broker.***

Initial Offer

Must express the offerors (prospective buyer) willingness to enter into a contract as well as:

- ♦ Be communicated to the offeree (owner).
- ♦ Manifest contractual intention.
- ♦ Be definite and certain in its terms.
- ♦ Have all the characteristics of a contract.

Acceptance

Requires proper assent by the offeree (seller) to the terms of the offeror (buyer).

- ♦ The offeree / seller must have knowledge of the offer.
- ♦ Acceptance must be absolute and unqualified. Any modification becomes a counter offer.
- ♦ It must be within the time limits specified or within a reasonable period if no time limit is specified.
- ♦ It must be expressed or communicated. Silence ordinarily cannot be considered acceptance.

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- ♦ It must be in the manner specified in the offer. If not specified, then by any reasonable an usual mode.
- ♦ Once accepted, the death or insanity of either party will not terminate the contract. The contract is valid, heirs can be bound to perform.
- ♦ Even conflicting offers must be submitted to the seller.

TERMINATION OF AN OFFER

An offer may be terminated in the following ways before acceptance:

- ♦ **Lapse of time:** The offeree fails to accept within the prescribed period or reasonable time if not prescribed.
- ♦ **Revocation:** The offeror may withdraw his offer anytime before the offeree has communicated his acceptance. An offeror is not required to wait for the period specified in the offer.
- ♦ **Rejection by the offeree:** An unequivocal rejection ends the offer. Oral bargaining in the form of suggested changes is not usually considered rejection.
- ♦ **Death or insanity:** Whether it is of the offeror or the offeree.
- ♦ **Supervening illegality:** If proposed contract becomes illegal before acceptance.

COVENANTS (A PROMISE IN THE CONTRACT)

Covenants are promises between the parties to a contract. Covenants represent promises, obligations and considerations exchanged to fulfill a contract.

☞ *If you break a contractual promise, you are liable for damages.*

CONTINGENCIES (SUBJECT TO)

Contingencies, conditions or **subject to** are provisions by which all parties are released from any obligations of a contract if some stated condition fails to materialize. If the contingency falls through, the contract is voidable by the buyer.

If the offeror wants to make any condition or act subject to a specified contingency, the clause should be preceded with any of the following: “offer subject to”, “offer contingent upon” or “offer conditioned upon”

☞ *Offer contingent upon the buyer obtaining financing, or offer subject to the successful sale of another property.*

THE PURCHASE AGREEMENT ADDENDUM

The **Purchase Agreement Addendum** form is used as an addendum to either the Purchase Agreement, another offer form or the counter offer form.



REAL ESTATE PRACTICE

Only the paragraphs that are checked are included as part of the contract. The new two - page addendum (revised 2000) (Form 5-1) covers six separate topics that are occasionally relevant to a transaction.

- ♦ The cancellation of prior sale / back up offers.
- ♦ “Short-pay” lenders (secured lenders and lienholders)
- ♦ Court confirmation (for probate, guardianship, receivership, bankruptcy, etc.)
- ♦ Tenant-occupied properties.
- ♦ Junior or assumed financing.

Form 5-1: Purchase Agreement Addendum

5: CONTRACT LAW



CALIFORNIA
ASSOCIATION
OF REALTORS®

PURCHASE AGREEMENT ADDENDUM

May Also Be Used With Counter Offer

This is an addendum to the ☒ Residential Purchase Agreement, ☐ Counter Offer, or ☐ Other _____, dated _____, ("Agreement"), dated _____, on property known as _____, 123 Main St., Main City, ca 90001 ("Property"), in which _____, Jeffrey Pops, Steven Crape, is referred to as ("Buyer"), and _____, John Smith, Diana Smith, is referred to as ("Seller").

(The definitions in the Residential Purchase Agreement are applicable to the Purchase Agreement Addendum.)

1. ☐ **CANCELLATION OF PRIOR SALE; BACK-UP OFFER:** (If checked) This Agreement is in back-up position number _____, and is contingent upon written cancellation of any prior contracts and related escrows ("Prior Contracts") between Seller and other buyers. Seller and other buyers may mutually agree to modify or amend the terms of Prior Contracts. Buyer may cancel this Agreement in writing at any time before Seller provides Buyer Copies of written cancellations of Prior Contracts Signed by all parties to those contracts. If Seller is unable to provide such written Signed cancellations to Buyer by _____ (date), then either Buyer or Seller may cancel the Agreement in writing.

A. **BUYER'S DEPOSIT CHECK SHALL BE** held uncashed until Copies of the written cancellations Signed by all parties to the Prior Contracts are provided to Buyer, (OR if checked ☐ immediately handled as provided in the Agreement).

B. **TIME PERIODS** in the Agreement for inspections, contingencies, covenants and other obligations, shall begin on the Day After Seller provides Buyer Copies of Signed cancellations of Prior Contracts, (OR, if checked, ☐ all time periods shall begin as provided in this Agreement). However, if the date for Close Of Escrow is a specific calendar date, that date shall NOT be extended, unless agreed to in writing by Buyer and Seller.

2. ☒ **SELLER TO REMAIN IN POSSESSION AFTER CLOSE OF ESCROW:** (If checked) NOTE: This provision is intended for short-term occupancy (i.e. less than 30 Days). If occupancy is intended to be for 30 Days or longer, use Residential Lease After Sale (C.A.R. Form RLAS-14). Note: Local rent control or other Law regarding tenant's rights may impact Buyer's and Seller's rights and obligations.

A. **TERM:** Seller to remain in possession of Property for 21 Days After Close Of Escrow (or ☐ _____).

B. **COMPENSATION:** Seller agrees to pay Buyer \$ 150.00 per Day (or ☐ _____), which shall be deposited into escrow prior to Close Of Escrow or withheld from Seller's proceeds. Seller agrees to pay \$ 200.00 per Day for any holding over.

C. **LATE CHARGE/NSF CHECKS:** If payment for possession is to be made in more than one payment, and any payment is not received by Buyer within 5 (or ☐ _____) Days After date due, or if a check is returned for non-sufficient funds ("NSF"), Seller shall pay to Buyer, respectively, an additional sum of \$ _____ as Late Charge, and \$25.00 as a NSF charge. Seller and Buyer agree that these charges represent a fair and reasonable estimate of the costs Buyer may incur by reason of Seller's late or NSF payment. Buyer's acceptance of any Late Charge or NSF fee shall not constitute a waiver as to any default by Seller.

D. **UTILITIES:** Seller agrees to pay for all utilities and services, and the following charges: _____, which shall be paid for by Buyer.

E. **ENTRY:** Seller shall make Property available to Buyer for the purpose of entering to make necessary or agreed repairs, or to supply necessary or agreed services, or to show Property to prospective or actual purchasers, tenants, mortgagees, lenders, appraisers, or contractors. Buyer and Seller agree that 24 hours notice (oral or written) shall be reasonable and sufficient notice. In an emergency, Buyer may enter Property at any time without prior notice.

F. **MAINTENANCE:** Seller shall maintain the Property, including pools, spas, landscaping and grounds, and all personal property transferred with the Property, in substantially the same condition as on the date of Acceptance of the Agreement. Except as provided in the Agreement, Seller shall not make alterations to the Property without Buyer's written consent.

G. **ASSIGNMENT/SUBLETTING:** Seller shall not assign or sublet all or any part of the Property, or assign or transfer the right to occupy the Property. Any assignment, transfer or subletting of the Property by voluntary act of Seller, by operation of Law or otherwise, without Buyer's prior written consent shall be null and void, and, at Buyer's option, terminate this agreement.

H. **SELLER'S OBLIGATIONS UPON VACATING PREMISES:** Upon delivery of possession to Buyer, Seller shall deliver the Property in the condition and on the terms provided in the Agreement.

I. **INSURANCE:** Seller's personal property and vehicles are not insured by Buyer, and, if applicable, owner's association, against loss or damage due to fire, theft, vandalism, rain, water, criminal or negligent acts of others, or any other cause. Seller is to carry Seller's own insurance to protect Seller from such loss.

J. **WAIVER:** The waiver of any breach shall not be construed as a continuing waiver of the same or any subsequent breach.

K. **OTHER TERMS AND CONDITIONS/SUPPLEMENTS:** _____

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REVISION DATE 4/2000

Buyer and Seller acknowledge receipt of copy of this page.

Buyer's Initials (_____) (_____)

Seller's Initials (_____) (_____)

Reviewed by

Broker or Designee _____ Date _____



PURCHASE AGREEMENT ADDENDUM (PAA-11 PAGE 1 OF 2)

Jerry Fung
JF 2373 S Hacienda Blvd
Hacienda Heights CA 91745

Phone: (626)336.6191

Fax: (626)336.8565

T5243695.ZFX



REAL ESTATE PRACTICE

Property Address: 123 Main St, Main City, ca 90001

Date: _____

3. ☐ **TENANT TO REMAIN IN POSSESSION:** Buyer shall take Property subject to the rights of existing tenants. Seller shall, within 5 (or ☐ _____) Days After Acceptance, deliver to Buyer Copies of all leases, rental agreements, current income and expense statements and estoppel certificates sent to, and received back from tenants ("Rental Documents"). Buyer shall, within 5 (or ☐ _____) Days After receipt of Rental Documents, provide written notice to Seller of any items reasonably disapproved, by the method specified in the Agreement. Seller shall make no changes in leases and tenancies, and shall enter into no new leases or rental agreements during the pendency of this transaction without Buyer's prior written consent. Seller shall transfer to Buyer, through escrow, all unused tenant deposits. No warranty is made concerning compliance with governmental restrictions, if any, limiting the amount of rent that can lawfully be charged, and/or the maximum number of persons who can lawfully occupy the Property, unless otherwise agreed in writing.
4. ☐ **JUNIOR OR ASSUMED FINANCING:** (If checked) Obtaining the following loan or assumption is a contingency of this Agreement. Buyer shall act in good faith to obtain the designated financing. The loan contingency shall remain in effect until the designated loan is funded or assumption of existing financing is approved by Lender and completed, (or ☐ _____) Days After Acceptance, by which time Buyer shall give Seller written notice of Buyer's election to cancel this Agreement because of Buyer's inability to obtain the designated loan or assumption. If Buyer does not give Seller such notice, the contingency of obtaining the loan or assumption shall be removed by the method specified in the Agreement).
- A. ☐ **NEW SECOND DEED OF TRUST** in favor of the LENDER encumbering the Property, securing a note payable at maximum interest of _____ % fixed rate, or _____ % initial adjustable rate, with a maximum lifetime interest rate cap of _____ %, balance due in _____ years. Buyer shall pay loan fees/points not to exceed _____.
- B. ☐ **ASSUMPTION OF EXISTING DEED OF TRUST** encumbering the Property, securing a note payable at maximum interest of _____ % fixed rate, or _____ % initial adjustable rate, with a maximum lifetime interest rate cap of _____ %, balance due in _____ years. Buyer shall pay loan fees/points not to exceed _____. For assumption, Seller shall within 5 (or ☐ _____) Days After Acceptance, request from Lender, and upon receipt provide to Buyer, Copies of all applicable notes and deeds of trust, loan balances and current interest rates. Buyer shall, within 5 (or ☐ _____) Days After receipt, provide written notice to Seller of any items reasonably disapproved by the method specified in the Agreement. Differences between estimated and actual loan balances shall be adjusted at Close Of Escrow by cash down payment. Impound accounts, if any, shall be assigned and charged to Buyer and credited to Seller. If this is an assumption of a VA loan, the sale is contingent upon Seller being provided a release of liability and substitution of eligibility, unless otherwise agreed in writing.
5. ☐ **SHORT PAY:** (If checked) This Agreement is contingent upon Seller's receipt of written consent from all existing secured lenders and lienholders ("Short-Pay Lenders"), no later than 5:00 p.m. on _____ (date) ("Short-Pay Contingency Date"), to reduce their respective loan balances by an amount sufficient to permit the proceeds from the sale of the Property, without additional funds from Seller, to pay the existing balances on loans, real estate taxes, brokerage commissions, closing costs, and other monetary obligations the Agreement requires Seller to pay at Close Of Escrow (including, but not limited to, escrow charges, title charges, documentary transfer taxes, prorations, retrofit costs, and pest control inspection costs and Repairs). If Seller fails to give Buyer written notice of all existing Short-Pay Lenders' consent by the Short-Pay Contingency Date, either Seller or Buyer may cancel the Agreement in writing. Seller shall reasonably cooperate with existing Lenders in the short-pay-off process. Buyer and Seller understand that Lenders are not obligated to accept a short-pay-off and may accept other offers, and that Seller, Buyer and Broker(s) do not have control over whether Short-Pay Lenders will accept a short-pay-off, or any act, omission, or decision by any Short-Pay Lender in the short-pay-off process. Seller is informed that a short-pay may create credit or legal problems, or may result in taxable income to Seller. Seller may present to Short-Pay Lender any additional offers that are received on the Property. Seller is advised to seek advice from an attorney, certified public accountant, or other expert regarding such potential consequences.
6. ☐ **COURT CONFIRMATION:** (If checked) This Agreement is contingent upon court confirmation on or before _____ (date). If court confirmation is not obtained by that date, Buyer may cancel this Agreement in writing. Court confirmation may be required in probate, conservatorship, guardianship, receivership, bankruptcy, or other proceedings. The court may allow open, competitive bidding, resulting in Property being sold to the highest bidder. Buyer is advised to be in court when the offer is considered for confirmation. Buyer understands that (i) Broker and others may continue to market the Property, and (ii) Broker may represent other competitive bidders prior to and at the court confirmation.

Date _____

Date _____

Buyer Jeffrey Pops

Seller John Smith

Buyer Steven Crapes

Seller Diana Smith

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REVISION DATE 4/2000

Reviewed by _____ Date _____
Broker or Designee _____



PURCHASE AGREEMENT ADDENDUM (PAA-11 PAGE 2 OF 2)

T5243695.ZFX

5: CONTRACT LAW

COUNTER OFFER

If the original offer is rejected, a new offer, with only a few different terms (sales price, escrow period, etc), is called a **counter offer**.

- ♦ The counter offer must contain a clause stating that all of the conditions of the original deposit receipt are accepted except for the listed new terms.
- ♦ It is always better to start a new deposit receipt if there are too many counter offers or too many changes in the offer.

Inspection advisory for buyers

Property inspection is important. The physical condition of the land and improvements being purchased are not guaranteed by either Sellers or Brokers, except as specifically set forth in the purchase agreement. For this reason, buyer should conduct a thorough inspection of the property personally and with professionals, who should provide a written report of their inspections.

Form 5-2 shows the CAR Buyers Inspection Form that covers the following:

- ♦ General condition of the property;
- ♦ Square footage, age, and boundaries;
- ♦ Soil stability/geologic conditions;
- ♦ Roof / spa;
- ♦ Waste disposal;
- ♦ Water and utilities;
- ♦ Environmental hazards;
- ♦ Earthquake and flood;
- ♦ Governmental requirements;
- ♦ Rent and occupancy control;
- ♦ Neighborhood, area, conditions; personal factors.

Form 5-2: Buyer Inspection Advisory



REAL ESTATE PRACTICE



CALIFORNIA
ASSOCIATION
OF REALTORS®

BUYER'S INSPECTION ADVISORY

Property Address: 123 Maint Street, Main City, CA 90001

("Property")

(The definitions in C.A.R. Form RPA-11 are applicable to this Form BIA-11.)

A. IMPORTANCE OF PROPERTY INSPECTION: The physical condition of the land and improvements being purchased is not guaranteed by either Seller or Brokers. For this reason, you should conduct thorough inspections of the Property personally and with professionals who should provide written reports of their inspections. A general physical inspection typically does not cover all aspects of the Property nor items affecting the Property that are not physically located on the Property. If the professionals recommend further investigation, tests or inspections, including a recommendation by a pest control operator to inspect inaccessible areas of the Property, you should contact qualified experts to conduct such additional investigations, tests or inspections.

B. BUYER RIGHTS AND DUTIES: You have an affirmative duty to exercise reasonable care to protect yourself, including discovery of the legal, practical and technical implications of disclosed facts, and the investigation and verification of information and facts that you know or are within your diligent attention and observation. The purchase agreement gives you the right to inspect the Property. If you exercise these rights, and you should, you must do so in accordance with the terms of the Agreement. This is the best way for you to protect yourself. It is extremely important for you to read all written reports provided by professionals and to discuss the results of inspections with the professional who conducted the inspection. You have the right to request that Seller make Repairs, corrections or take other action based upon items discovered in your inspections or disclosed by Seller. If Seller is unwilling or unable to satisfy your requests, and you do not want to purchase the Property in its disclosed and discovered condition, you have the right to cancel the Agreement. If you do not timely and properly cancel the Agreement if you do not perform on the contract because of the condition of the Property, you may be in breach of contract.

C. SELLER RIGHTS AND DUTIES: Seller is required to disclose to you all material facts known to him/her that affect the value or desirability of the Property. However, Seller may not be aware of some Property defects or conditions. Seller does not have an obligation to inspect the Property for your benefit nor is Seller obligated to repair, correct or otherwise cure known defects that are disclosed to you or previously unknown defects that are discovered by you or your inspectors during escrow. The purchase agreement obligates Seller to make the Property available to you for inspections.

D. BROKER OBLIGATIONS: Brokers do not have expertise and therefore cannot advise you on many items, such as soil stability, geologic conditions, hazardous substances, structural conditions of the foundation or other improvements, or the condition of the roof, heating, air conditioning, plumbing, electrical, sewer, septic, waste disposal, or other system. The only way to accurately determine the condition of the Property is through an inspection by an appropriate professional selected by you. If Broker gives you referrals to such professionals, Broker does not guarantee their performance. You may select any professional of your choosing. In sales involving residential dwellings with no more than four units, Brokers have a duty to make a diligent visual inspection of the accessible areas of the Property, and to disclose the results of that inspection. However, as some Property defects or conditions may not be discoverable from a visual inspection, it is possible Brokers are not aware of them. If you have entered into a written agreement with a Broker, the specific terms of that agreement will determine the nature and extent of that Broker's duty to you. **YOU ARE STRONGLY ADVISED TO INVESTIGATE THE CONDITION AND SUITABILITY OF ALL ASPECTS OF THE PROPERTY. IF YOU DO NOT DO SO, YOU ARE ACTING AGAINST THE ADVICE OF BROKERS.**

E. YOU ARE ADVISED TO CONDUCT INSPECTIONS OF THE ENTIRE PROPERTY, INCLUDING, BUT NOT LIMITED TO THE FOLLOWING:

- 1. GENERAL CONDITION OF THE PROPERTY, ITS SYSTEMS AND COMPONENTS:** Foundation, roof, plumbing, heating, air conditioning, electrical, mechanical, security, pool/spa, and other structural and non-structural systems and components, fixtures, built-in appliances, any personal property included in the sale, and energy efficiency of the Property. (Structural engineers are best suited to determine possible design or construction defects, and whether improvements are structurally sound.)
- 2. SQUARE FOOTAGE, AGE, BOUNDARIES:** Square footage, room dimensions, lot size, age of improvements, and boundaries. Any numerical statements regarding these items are APPROXIMATIONS ONLY, and have not been and cannot be verified by Brokers. Fences, hedges, walls, retaining walls, and other natural or constructed barriers or markers do not necessarily identify true Property boundaries. (Professionals such as appraisers, architects, surveyors, or civil engineers are best suited to determine square footage, dimensions and boundaries of the Property.)
- 3. PEST CONTROL:** Presence of, or conditions likely to lead to the presence of wood destroying pests and organisms and other infestation or infection. (A registered structural pest control company is best suited to perform these inspections.)

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REVISION DATE 10/2000
BIA-11 (PAGE 1 OF 2)

Buyer acknowledges receipt of a copy of this page.

Buyer's Initials (_____) (_____)

Reviewed by

Broker or Designee _____ Date _____



BUYER'S INSPECTION ADVISORY (BIA-11 PAGE 1 OF 2)

Agent: jerry fung
Broker: JF 2373 S Hacienda Blvd , Hacienda Heights CA 91745

Prepared using WINForms® software

5: CONTRACT LAW

Property Address: 123 Maint Street, Main City, CA 90001

Date: _____

4. **SOIL STABILITY:** Existence of fill or compacted soil, expansive or contracting soil, susceptibility to slippage, settling or movement, and the adequacy of drainage. (Geotechnical engineers are best suited to determine such conditions, causes, and remedies.)
5. **ROOF:** Present condition, age, leaks, and remaining useful life. (Roofing contractors are best suited to determine these conditions.)
6. **POOL/SPA:** Cracks, leaks or operational problems. (Pool contractors are best suited to determine these conditions.)
7. **WASTE DISPOSAL:** Type, size, adequacy, capacity and condition of sewer and septic systems and components, connection to sewer, and applicable fees.
8. **WATER AND UTILITIES; WELL SYSTEMS AND COMPONENTS:** Water and utility availability, use restrictions, and costs. Water quality, adequacy, condition, and performance of well systems and components.
9. **ENVIRONMENTAL HAZARDS:** Potential environmental hazards, including asbestos, lead-based paint and other lead contamination, radon, methane, other gases, fuel, oil or chemical storage tanks, contaminated soil or water, hazardous waste, waste disposal sites, electromagnetic fields, nuclear sources, and other substances including mold (airborne, toxic or otherwise), fungus or similar contaminant, materials, products, or conditions. (Read the booklets "Environmental Hazards: A Guide for Homeowners and Buyers," "Protect Your Family From Lead in Your Home," or consult an appropriate professional.)
10. **EARTHQUAKE AND FLOOD; HAZARD AND OTHER INSURANCE:** Susceptibility of the Property to earthquake/seismic hazards and propensity of the Property to flood. These and other conditions including age of Property may affect the availability and need for certain types of insurance. Since the time it may take to obtain certain types of insurance may vary, Buyer should not wait to explore these options. (An Insurance agent, Geologist, or Geotechnical Engineer is best suited to provide information on these conditions.)
11. **BUILDING PERMITS, ZONING AND GOVERNMENTAL REQUIREMENTS:** Permits, inspections, certificates, zoning, other governmental limitations, restrictions, and requirements affecting the current or future use of the Property, its development or size. (Such information is available through appropriate governmental agencies and private information providers. Brokers are not qualified to review, or interpret any such information.)
12. **RENTAL PROPERTY RESTRICTIONS:** Some cities and counties impose restrictions that may limit the rent, the maximum number of occupants, and the right to terminate a tenancy. Deadbolt or other locks and security systems for doors and windows, including window bars, should be examined to determine whether they satisfy legal requirements. (Local government agencies can provide information about these restrictions and other requirements.)
13. **SECURITY AND SAFETY:** State and local Law may require the installation of barriers, access alarms, self-latching mechanisms and/or other measures to decrease the risk to children and other persons of existing swimming pools and hot tubs, as well as various fire safety and other measures concerning other features of the Property. Compliance requirements differ from city to city and county to county. Unless specifically agreed, the Property will not be in compliance with these requirements. (Local government agencies can provide information about these restrictions and other requirements.)
14. **NEIGHBORHOOD, AREA, SUBDIVISION CONDITIONS; PERSONAL FACTORS:** Neighborhood or area conditions, including schools, proximity and adequacy of law enforcement, crime statistics, the proximity of registered felons or offenders, fire protection, other governmental services, availability, adequacy and the cost of any speed wired, wireless internet connections or other telecommunications or other technology services and installations, proximity to commercial, industrial or agricultural activities, existing and proposed transportation, construction and development that may affect noise, view, or traffic, airport noise, noise or odor from any source, wild and domestic animals, other nuisances, hazards, or circumstances, protected species, wetland properties, historic or other governmentally protected sites or improvements, cemeteries, facilities and condition of common areas of common interest subdivisions, and possible lack of compliance with any governing documents or Homeowners' Association requirements, conditions and influences of significance to certain cultures and/or religions, and personal needs, requirements and preferences of Buyer.

Buyer acknowledges and agrees that Brokers: (a) do not guarantee the condition of the Property; (b) shall not be responsible for defects that are not known to Broker(s) or are not visually observable in reasonably and normally accessible areas of the Property; (c) have not verified square footage, representations made by others, or other information contained in inspection reports, Multiple Listing Service, advertisements, flyers, or other promotional material, unless otherwise agreed in writing; (d) do not guarantee the performance of others who have provided services or products to Buyer or Seller; (e) do not guarantee the adequacy or completeness of Repairs made by Seller or others; (f) cannot identify Property boundary lines; and (g) do not decide what price a buyer should pay or a seller should accept. Buyer agrees to seek desired assistance from appropriate professionals.

By signing below, Buyer acknowledges receipt of a Copy of this document. Buyer is encouraged to read it carefully.

Buyer Signature _____

Date _____

Buyer Signature _____

Date _____

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Reviewed by _____
Broker or Designee _____ Date _____



REVISION DATE 10/2000
BIA-11 (PAGE 2 OF 2)

BUYER'S INSPECTION ADVISORY (BIA-11 PAGE 2 OF 2)



Homeowners guide to Earthquake safety

Earthquakes pose a serious threat to some California homes, and many older homes are not built to modern earthquake codes.

- ♦ CAR has a booklet entitled Environmental Hazards: Guide for Homeowners and Buyers / The Homeowners Guide to Earthquakes.
- ♦ The Homeowners Guide to Earthquake Safety must be given to all buyers of residential dwellings built before 1960.
- ♦ The Earthquake Disclosure Form must be filled out by the seller.
- ♦ California Law requires the seller to certify to the buyer that the water heaters are strapped or braced to the building according to the minimum standards of the Uniform Plumbing Code.

OPTION (UNILATERAL CONTRACT)

An **option** is a **unilateral contract** in which the optionor (owner) gives the optionee (prospective buyer) a right to purchase or lease real property upon specific terms within a specified time in exchange for actual consideration.

☞ ***Option is a contract to make a contract.***

Characteristics of an Option

- ♦ It must be in writing.
- ♦ Actual consideration must pass from optionee to the owner.
 1. This may be by cash, check, promissory note, or other things of value.
 2. This may be as little as 5 cents.
 3. If it is an unsecured promissory note, the option cannot be assigned without consent of the optionor (owner).
- ♦ The owner (optionor) retains consideration whether the option is exercised or not.
- ♦ It can be in the form of an exclusive right to purchase or lease, or in the form of the privilege of first right of refusal to purchase or lease.
- ♦ The owner (optionor) cannot sell or lease to another party during the option period.
- ♦ The optionee may also secure another buyer during its term. Thus, all rights and interests may be transferred without the consent of the optionor, unless stated otherwise.

5: CONTRACT LAW

Options held by Agents

If the listing broker also takes an option on the property, the broker is placed in the dual position of the agent and the principal, and thus has a conflict of interest. If the broker exercises the option, he or she must:

- ♦ Advise any prospective buyer he/she is acting as a principal and not as the owners agent.
- ♦ Reveal all facts to the owner, including anticipated profit, and obtain owners written approval.

Form 5-3: Option Agreement



REAL ESTATE PRACTICE



CALIFORNIA
ASSOCIATION
OF REALTORS®

OPTION AGREEMENT

To be used with a purchase agreement. May
also be used with a lease.

Date April 15, 2002, at Hacienda Heights, California

Seller, ("Optionor"), grants to

Buyer, ("Optionee"),
an option ("Agreement") to purchase the real property and improvements situated in (city) Hacienda Heights
_____, County of Los Angeles
_____, California, described as 123 Main Street, Hacienda Heights, ("Property") as specified in the
attached: ☒ Real Estate Purchase Agreement ☐ Other dated 4/15/02, which is incorporated
by this reference as a part of this Agreement, on the following terms and conditions.

1. OPTION CONSIDERATION:

- A. Three Thousand Dollars and 00/100 Dollars \$ 3,000.00
☐ (if checked) and/or (circle one), the amount specified in paragraph 6B.
B. By ☐ cash, ☐ cashier's check, ☒ personal check, or ☐
made payable to Seller
C. ☐ Payable upon execution of this Agreement,
OR ☐ Payable within _____ days after acceptance of this Agreement, by which time Optionee shall have completed a
due diligence investigation and accepted the condition of the Property. At least 5 (or _____) days before expiration of this time
period, Optionor shall provide to Optionee (i) any mandatory disclosures (such as those required by paragraph 7), (ii) a
preliminary title report, and (iii) _____
OR ☐
D. If payment is not made by the time specified in paragraph 1C above, this Agreement shall become immediately null and void.
E. If this Option is exercised, ☒ all, or ☐ \$ _____, of the Option Consideration shall be applied toward
Optionee's down payment obligations under the terms of the attached purchase agreement, upon close of escrow of that
agreement. Optionee is advised that the full amount of the option consideration applied toward any down payment may not be
counted by a lender for financing purposes.

2. **OPTION PERIOD:** The Option shall begin on (date) July 1, 2002, and shall end at 11:59 p.m.
(or at ☒ _____), on (date) June 30, 2003.

3. **MANNER OF EXERCISE:** Optionee may exercise the Option **only** by delivering a written unconditional notice of exercise, signed
by Optionee, to Optionor, or listing agent, who is authorized to receive it, no earlier than
July 1, 2002 and no later than May 1, 2003.

A copy of the unconditional notice of exercise shall be delivered to the Brokers identified in this Agreement.

4. **EFFECT OF DEFAULT ON OPTION:** Optionee shall have no right to exercise this Option if Optionee has not performed any
obligation imposed by, or is in default of, any obligation of this Agreement, any addenda, or any document incorporated by
reference.

5. **NON-EXERCISE:** If the Option is not exercised in the manner specified, within the option period or any written extension thereof, or
if it is terminated under any provision of this Agreement, then:

- A. The Option and all rights of Optionee to purchase the Property shall immediately terminate without notice; and
B. All Option Consideration paid, rent paid, services rendered to Optionor, and improvements made to the Property, if any, by
Optionee, shall be retained by Optionor in consideration of the granting of the Option; and
C. Optionee shall execute, acknowledge, and deliver to Optionor, within 5 (or _____) calendar days of Optionor's request, a
release, quitclaim deed, or any other document reasonably required by Optionor or a title insurance company to verify the
termination of the Option.

Optionee and Optionor acknowledge receipt of copy of this page, which constitutes Page 1 of 3 Pages.

Optionee's Initials (_____) (_____) Optionor's Initials (_____) (_____)

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or Designee _____
Date _____



OPTION AGREEMENT (OA-11 PAGE 1 OF 3)

Jerry fung
JF 2373 S Hacienda Blvd , Hacienda Heights CA 91745

Phone: (626)336 6191

Fax: (626)336 8565

T4587429 ZFX

Date: April 15, 2002

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Optionee's Initials () () Optionor's Initials () ()



EQUAL HOUSING
OPPORTUNITY

T4587429.ZFX



REAL ESTATE PRACTICE

Property Address: 3573 Holmes Circle, Hacienda Heights Date: April 15, 2002

- 15. TIME OF ESSENCE; ENTIRE CONTRACT; CHANGES:** Time is of the essence. All understandings between the parties are incorporated in this Agreement. Its terms are intended by the parties as a final, complete, and exclusive expression of their agreement with respect to its subject matter, and may not be contradicted by evidence of any prior agreement or contemporaneous oral agreement. **This Agreement may not be extended, amended, modified, altered, or changed, except in writing signed by Optionee and Optionor.**
- 16. OFFER:** This is an offer for an Option to purchase Property on the above terms and conditions. Unless Acceptance of Offer is signed by Optionor, and a signed copy delivered in person, by mail, or facsimile, and personally received by Optionee, or by _____, who is authorized to receive it, by (date) May 1, 2002, at _____
☐ AM ☒ PM, the offer shall be deemed revoked. Optionee has read and acknowledges receipt of a copy of the offer. This Agreement and any supplement, addendum, or modification, including any photocopy or facsimile, may be signed in two or more counterparts, all of which shall constitute one and the same writing.

OPTIONEE _____

OPTIONEE Tenant/Buyer

Address 3573 Holmes Circle
Hacienda Heights, CA. 91745
 Telephone 562-696-0000 Fax _____

- 17. BROKER COMPENSATION:** Optionor agrees to pay compensation for services as follows:
see purchase contract, to Listing Office, Broker, and
see purchase contract, to Selling Office, Broker,
 payable upon execution of this Agreement.
- 18. ACCEPTANCE OF OPTION:** Optionor warrants that Optionor is the owner of the Property or has the authority to execute this Agreement. Optionor accepts and agrees to grant an Option to purchase the Property on the above terms and conditions.

If checked: ☐ **SUBJECT TO ATTACHED COUNTER OFFER, DATED** _____.

OPTIONOR Seller/Landlord

OPTIONOR _____
 Address 2373 S. Hacienda Blvd.,
Hacienda Heights, CA. 91745
 Telephone 626-855-0000 Fax 626-855-0001

Real Estate Brokers are not parties to the Agreement between Optionee and Optionor.

Broker Jerry Fung By _____ Date _____
 Address 2373 S. Hacienda Blvd.,
Hacienda Heights, CA. 91745
 Telephone 626-855-0455 Fax 626-855-0465

Broker _____ By _____ Date _____
 Address _____
 Telephone _____ Fax _____

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Page 3 of 3 Pages.

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OPTION AGREEMENT (OA-11 PAGE 3 OF 3)

T4587429 ZFX

5: CONTRACT LAW

RIGHT OF FIRST REFUSAL

A **right of first refusal** differs from an option in that the prospective buyer is not given the absolute right to purchase but only the right to match an offer from a third party. A right generally is given to buy only if the owner decides to sell. Before the owner can sell, the owner must offer the property to the holder of the right of first refusal at the price and terms that the owner wishes to accept from a buyer. The holder of the right of first refusal loses the right if he or she does not meet the price and terms of the offer within a certain period of time.

A tenant with a right of first refusal might have difficulty exercising the right when consideration offered by another buyer is other than cash.

CHAPTER QUIZ

1. An option to purchase binds which of the following parties?
 - A. Buyer only
 - B. Seller only
 - C. Neither buyer nor seller
 - D. Both buyer and seller
2. The clause in a real estate contract that sets forth a definite amount of damages to be paid by the party breaching the contract which requires both buyer and seller's initials to be placed in the designated places on the contract is known as:
 - A. Caveat emptor clause;
 - B. Risk clause;
 - C. Liquidated damages clause;
 - D. Seller's protection clause.
3. The **purchaser** of real estate under an installment contract:
 - A. Generally pays no interest charge.
 - B. Receives title immediately.
 - C. Is not required to pay property taxes for the duration of the contract.
 - D. Is called a vendee.
4. A **legally enforceable** agreement under which two parties agree to do something for each other is known as a(n):
 - A. Escrow agreement.
 - B. Legal promise.
 - C. Valid contract.
 - D. Option agreement.
5. A contract is said to be **bilateral** if:
 - A. One of the parties is a minor.



REAL ESTATE PRACTICE

- B. The contract has yet to be fully performed.
 - C. Only one party to the agreement is bound to act.
 - D. All parties to the contract are bound to act.
6. During the period of time after a real estate sales contract is signed, but before title actually passes, the status of the contract is:
- A. Voidable.
 - B. Executory.
 - C. Unilateral.
 - D. Implied.
7. A contract for the sale of real estate that does not state the consideration to be paid for the property and is not signed by the parties is considered to be:
- A. Voidable.
 - B. Executory.
 - C. Void.
 - D. Enforceable.
8. A buyer makes an offer to purchase certain property listed with a broker and leaves a deposit with the broker to show good faith. The broker should:
- A. Immediately apply the deposit to the listing expenses.
 - B. Put the deposit in an account, as provided by state law.
 - C. Give the deposit to the seller when the offer is presented.
 - D. Put the deposit in his or her personal checking account.
9. In a standard sales contract, several words were crossed out; others were inserted. To eliminate future controversy as to whether the changes were made before or after the contract was signed, the usual procedure is to:
- A. Write a letter to each party listing the changes.
 - B. Have each party write a letter to the other approving the changes.
 - C. Redraw the entire contract.
 - D. Have both parties initial or sign in the margin near each change.
10. Under the statute of frauds, all contracts for the sale of real estate must be:
- A. Originated by a real estate broker.
 - B. On preprinted forms.
 - C. In writing to be enforceable.
 - D. Accompanied by earnest money deposits.

Answers: 1-B, 2-C, 3-D, 4-C, 5-D, 6-B, 7-C, 8-B, 9-D, 10-C

CHAPTER 6: AGENCY LAW



Preview

The relationship between a real estate licensee and the parties involved in a real estate transaction is not a simple one. In addition to the parties' assumptions and expectations, the licensee is subject to a wide range of legal and ethical requirements designed to protect the seller, the buyer and the transaction itself. Agency is the word used to describe that special relationship between a real estate licensee and the person he or she represents. Agency is governed by two kinds of law: common *law* (the rules of a society established by tradition and court decisions) and *statutory law* (the laws, rules and regulations enacted by legislatures and other governing bodies).

☞ ***Court decisions expand the meaning of law through interpretation and form the basis for legal precedents***

AGENCY LAW

Whenever one person represents another in a business transaction, the Law of Agency applies. The law of agency defines agents' duties and responsibilities of the principal and the agent. The law of agency is found in the California Civil Code. Further, since the broker is a licensed real estate agent, he or she must comply with the laws and regulations of California Department of Real Estate, and also the contract law discussed earlier. The law of agency is a common-law concept; it may be (and increasingly is) superseded by state statute.

THE HISTORY OF AGENCY

The basic framework of the law that governs the legal responsibilities of the broker to the people he or she represents is known as the **common-law law of agency**. The fundamentals of agency law have remained largely unchanged for hundreds of years. However, the application of the law has changed dramatically, particularly in residential transactions and especially in recent years. As states enact legislation that defines and governs the broker-client relationship, brokers are reevaluating their services. They must determine whether they will represent the seller, the buyer or both in a transaction. They must also decide how they will cooperate with other brokers, depending on which party each broker represents. In short, the brokerage business is undergoing many changes as brokers focus on ways to enhance their services to buyers and sellers.



REAL ESTATE PRACTICE

Even as the laws change, however, the underlying assumptions that govern the agency relationship remain intact. The principal-agent relationship evolved from the master-servant relationship under English common law. In that relationship, the servant owed absolute loyalty to the master. This loyalty superseded the servant's personal interests as well as any loyalty the servant might owe to others. In a modern-day agency relationship, the agent owes the principal similar loyalty. As masters used the services of servants to accomplish what they could not or did not want to do for themselves, principals use the services of agents. The agent is regarded as an expert on whom the principal can rely for specialized professional advice.

Definitions

Real estate brokers and salespersons are commonly called *agents*. Legally, however, the term refers to strictly defined legal relationships. In the case of real estate, it is a relationship with buyers and sellers or with landlords and tenants. In the law of agency, the body of law that governs these relationships, the following terms have specific definitions:

Agent

The individual who is authorized and consents to represent the interests of another person. In the real estate business, a firm's broker is the agent, and he or she shares this responsibility with the licensees who work for the firm.

 ***An agent is a person authorized to act on behalf of another.***

Subagent

The agent of an agent. If the original agency agreement permits it, an agent may delegate some of his or her authority or responsibility to a third party. The subagent is also an agent of the principal.

Principal

The individual who hires the agent and delegates to him or her the responsibility of representing the principal's interests. In the real estate business, the principal is the buyer or seller, landlord or tenant.

Agency

Agency is the authority to act for a principal (client) in a specified capacity for a stated period of time. It is the fiduciary relationship between the principal and the agent

Fiduciary

The relationship in which the agent is held in a position of special trust and confidence by the principal.

Client

The client is the principal.

Customer

6: AGENCY LAW

The third party for whom some level of service is provided and who is entitled to fairness and honesty.

CLIENT SERVICE VS CUSTOMER SERVICE

It should be noted, however, that many agency statutes make the common-law duties a matter of statutory law rather than (or in addition to) creating totally new legal relationships. This chapter will provide an overview of current agency legislation; nonetheless, a licensee should be familiar with the specific terms of any agency statute adopted by his or her state legislature.

☞ ***An agent works for the client and with the customer.***

There is a distinction between the level of services an agent provides to a client and those services the agent provides to a customer. The **client** is the principal to whom the agent gives *advice and counsel*. The agent is entrusted with certain *confidential information* and has *fiduciary responsibilities* (discussed in greater detail later) to the principal. In contrast, the **customer** is entitled to factual information and fair and honest dealings as a consumer, but does not receive advice and counsel or confidential information about the principal. The agent works *for* the principal and *with* the customer. Essentially, the agent is an *advocate* for the principal, not for the customer.

The relationship between the principal and agent must be **consensual**, that is, the principal *delegates* authority, and the agent *consents* to act. The parties must agree to form the relationship. An agent may be authorized by the principal to use the assistance of others, who become **subagents** of the principal.

Just as the agent owes certain duties to the principal, the principal has responsibilities toward the agent. The principal's primary duties are to comply with the agency agreement and cooperate with the agent; that is, the principal must not hinder the agent and must deal with the agent in good faith. The principal also must compensate the agent according to the terms of the agency agreement.

TYPES OF AGENCY RELATIONSHIPS

ACTUAL AGENCY (BY AGREEMENT)

Actual agency occurs when a principal intentionally confers upon the agent, or by want of ordinary care, allows the agent to believe he possesses certain authority.

OSTENSIBLE AGENCY (QUASI/APPEARANT)

Ostensible agency occurs when a principal intentionally or by want of ordinary care, causes or allows third persons to believe that the agent possesses authority to act on principals behalf. A principal is liable to third persons who have, in good faith and without want of ordinary care, relied upon the ostensible authority of the agent to their detriment. (The Principle of Estoppel will bar the principal from denying the agency).

What an agent may do as the principal's representative depends solely on what the principal authorizes the agent to do.



REAL ESTATE PRACTICE

AGENCY CREATION

An agency relationship may be created based on a formal agreement between the parties (an **express agency**), or it may result from the parties' behavior (**an implied agency**), and **may** come in following ways: (1) agreement, (2) ratification or (3) estoppel.

An agreement may be **express** or **implied**. The real estate agency is generally created by express written contract.

- A. A unilateral contract occurs when the principal promises to pay a commission when the broker makes no promises.
- B. A bilateral contract is created when the broker promises to use **“due diligence.”**

EXPRESS AGENCY

The principal and agent may enter into a contract, or an *express agreement*, in which the parties formally express their intention to establish an agency and state its terms and conditions. The agreement may be either oral or written. An agency relationship between a seller and a broker is generally created by a written employment contract, commonly referred to as a **listing agreement**, which authorizes the broker to *locate a buyer and obtain an offer* or tenant for the owner's property. Although a written listing agreement is usually preferred, some states consider an oral agreement binding. An express agency relationship between a buyer and a broker is created by a *buyer agency agreement*. Similar to a listing agreement, it stipulates the activities and responsibilities the buyer expects from the broker in finding the appropriate property for purchase or rent.

IMPLIED AGENCY

An agency may also be created by *implied agreement*. This occurs when the actions of the parties indicate that they have mutually consented to an agency. A person acts on behalf of another as agent; the other person, as principal, delegates the authority to act. The parties may not have consciously planned to create an agency relationship. Nonetheless, one can result *unintentionally, inadvertently or accidentally* by their actions.

☞ ***Example: A tells B, a real estate broker, that she is thinking about selling her home. B immediately contacts several prospective buyers. One of them makes an attractive offer without even seeing the property. B goes to A's house and presents the offer, which A accepts. Although no formal agency agreement was entered into either orally or in writing, B's actions implied to prospective buyers that B was acting as A's agent. If B made any misrepresentations to the buyer, A may be held liable.***

Even though licensees may be required to disclose to the parties whom they represent, it is often difficult for customers to understand the complexities of the law of agency. A buyer can easily assume that when he or she contacts a salesperson to show the buyer property, the salesperson becomes his or her agent, even though, under a listing contract, the salesperson may *legally* represent the seller. An implied agency with the buyer can result if the words and conduct of the salesperson do not dispel this assumption. Otherwise, one

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agency relationship is created in conflict with another. Dual representation, which will be discussed in greater detail later, may occur even though it was not intended.

Ratification

Ratification is defined as affirming a prior act which was not legally binding; the affirmation gives the act legal effect. Occur when an unauthorized agent acts, and the principal later affirms the action, giving authority retroactively. A principal may become bound by ratifying acts of an agent who acted beyond his authority or a person who acted as an agent without any authority.

When you authorize an agent to have acted for you after he or she has already done so, the action is called ratification.

Estoppel (Stop, Prevent)

Another way to form an agency by operation of law is by estoppel.

Estoppel means that a person is prohibited by virtue of his own past actions (e.g. a waiver), from claiming a right that would work to the detriment of another person who relied on the past conduct. Estoppel often works in conjunction with a waiver.

The legal idea is that if a principal has knowledge that a person is acting on your behalf and takes no steps to correct the representation, the principal cannot later say the agent did it without your consent. The principal may be barred from denying the agency based on the doctrine of estoppel.

This kind of agency creation is also called an **ostensible**, or **implied, agency**.

☞ ***Estoppel stops inconsistencies, and is seldom possible in real estate dealing since a written contract is needed.***

TYPES OF AGENTS

General Agent

A general agent represents the principal *generally*. A **general agent** has the authority to perform all necessary acts for the principal within a specified area. For example, a property manager who has authority to rent or lease, collect rents, hire and fire personnel and make repairs and/or improvements would likely be a general agent.

This type of agency can be created by a general power of attorney, which makes the agent an attorney-in-fact. A real estate broker typically does *not* have this scope of authority as an agent in a real estate transaction.

Special agent

While general agent has broad powers to act for his or her principal, a **special agent** is limited to those acts specifically set forth in the agency agreement. For example, a real



REAL ESTATE PRACTICE

estate licensee is normally a special agent of an owner. The agent normally has no power to contractually bind the owner.

A **special agent** is authorized to represent the principal in *one specific act or business transaction only, under detailed instructions*. A real estate broker is usually a special agent. If hired by a seller, the broker is limited to finding a ready, willing and able buyer for the property. A special agent for a buyer would have the limited responsibility of finding a property that fit the buyer's criteria. As a special agent, the broker may not bind the principal to any contract. A *special power of attorney* is another means of authorizing an agent to carry out only a specified act or acts.

POWER OF ATTORNEY

A **power of attorney** is a written agreement whereby a principal appoints an agent to act in his or her place, known as an attorney-in-fact (not to be confused with attorney at law). There are two categories under power of attorney:

1. General Power of Attorney
2. Special Power of Attorney

General Power of Attorney

A **general power of attorney** allows the person so authorized to perform any act the principal could perform. The person thus authorized to act on behalf of the principal is called the general attorney in fact.

The specific powers conferred must be set down in writing, duly acknowledged and recorded with the county recorders office, in the county where the property is located, in order for the agency to take effect.

Special Power of Attorney

A **special power of attorney** allows the person so authorized to perform only a specific act, for example, sells the house.

The person thus authorized to act on behalf of the principal is call the special attorney in fact.

A listing agent is a "*special attorney in fact*," who is usually authorized to find a ready, able, and willing buyer.

Figure 6-2 shows a Special Power of Attorney, and Figure 6-3 shows a Revocation of a Special Power of Attorney form.

☞ ***Death of either party, or an acknowledged declaration from the principal, may revoke the power of attorney.***

☞ ***The Power of Attorney must be recorded in the county where the property is located in order to be valid.***

SINGLE VERSUS DUAL AGENCY

Single Agency

In single agency, the agent represents only one party in any single transaction. The agent owes fiduciary duties exclusively to one principal, who may be *either* the buyer *or* the seller (or the landlord or tenant) in a transaction. Any third party is a customer.

While a single agency broker may represent both sellers and buyers, he or she cannot represent both in the same transaction. This avoids conflicts and results in client-based service and loyalty to only one client. On the other hand, it precludes the sale of in-house listings to represented buyers. The broker must establish policies for the firm that define for whom the client services are performed.

☞ ***In a single agency, an agent represents only one principal. Each principal in a transaction may be represented by a different broker.***

Seller as Principal

If a seller contracts with a broker to market the seller's real estate, the broker becomes an **agent** of the seller; the seller is the **principal**, the broker's *client*. In single agency, a buyer who contacts the broker to review properties listed with the broker's firm is the broker's *customer*. Though obligated to deal fairly with all parties to a transaction and to comply with all aspects of the license law, the broker is strictly accountable only to the principal-in this case, the seller. The customer (in this case, the buyer) represents himself or herself.

The listing contract usually authorizes the broker to use licensees employed by the broker, as well as the services of other, cooperating brokers in marketing the seller's real estate. These cooperating brokers may assist the broker (agent) as **subagents** or may be the agents for other parties. It is important to note that not all cooperating brokers are subagents.

The relationship of a salesperson or an associate broker to an employing broker is also an agency. These licensees are thus agents of the broker in addition to being subagents of the principal.

Subagency

A **subagency** is created when one broker, usually the seller's agent, appoints other brokers ('with the seller's permission) to help perform client-based functions on the principal's behalf. These cooperating brokers have the same fiduciary obligation to the seller as does the listing broker, helping produce a ready, 'willing and able buyer for the property. This arrangement may be created through an offer of cooperation and compensation made in a multiple-listing service. However, participation in a multiple-listing service, by itself, does not necessarily create a subagency relationship. Because of widespread agency reforms, a cooperating broker cannot be presumed to be a subagent. The listing broker is liable for the conduct of all of the subagents and their salespersons.



Buyer as Principal

When a buyer contracts with a broker to locate property and represent his or her interests in a transaction, the buyer is the principal - the broker's client. The broker, as agent, is strictly accountable to the buyer. The seller is the customer.

In the past, it was simple: brokers always represented sellers, and buyers were expected to look out for themselves. With the widespread use of multiple-listing services and subagency, a buyer often had the mistaken impression that the subagent was the buyer's agent, although the reality was that both agent and subagent represented the seller's interests.

Today, however, many residential brokers and salespersons are discovering opportunities of buyer representation. Some brokers and salespersons have become specialists in the emerging field of buyer brokerage, representing buyers exclusively. Real estate commissions across the country have developed rules and procedures to regulate such buyer's brokers, and local real estate associations develop agency representation forms and other materials for them to use. Professional organizations offer assistance, certification, training and networking opportunities for buyer's agents.

A buyer agency relationship is established in the same way as any other agency relationship: by contract or agreement. The buyer's agent may receive a flat fee or a share of the commission or both, depending on the terms of the agency agreement.

Owner as Principal

An owner may employ a broker to market, lease, maintain or manage the owner's property. Such an arrangement is known as property management. The broker is made the agent of the property owner through a property management agreement. As in any other agency relationship, the broker has a fiduciary responsibility to the client-owner. Sometimes, an owner may employ a broker for the sole purpose of marketing the property to prospective tenants. In this case, the broker's responsibility is limited to finding suitable tenants for the owner's property. Property management is discussed further in Chapter 14.

Dual Agency

In a **dual agency**, the same agent represents both principals in the same transaction. A dual agency may be created when a real estate broker works as the agent of the seller, perhaps through a multiple listing service, while at the same time acting as the buyers' agent.

Any agent who acts on behalf of both parties to a transaction is required by law to inform both parties and obtain their written consent to the dual representation. Otherwise, the agent faces suspension or even revocation of the real estate license. A party acting without knowledge of the dual agency could ask the court to *rescind* any contract that results.

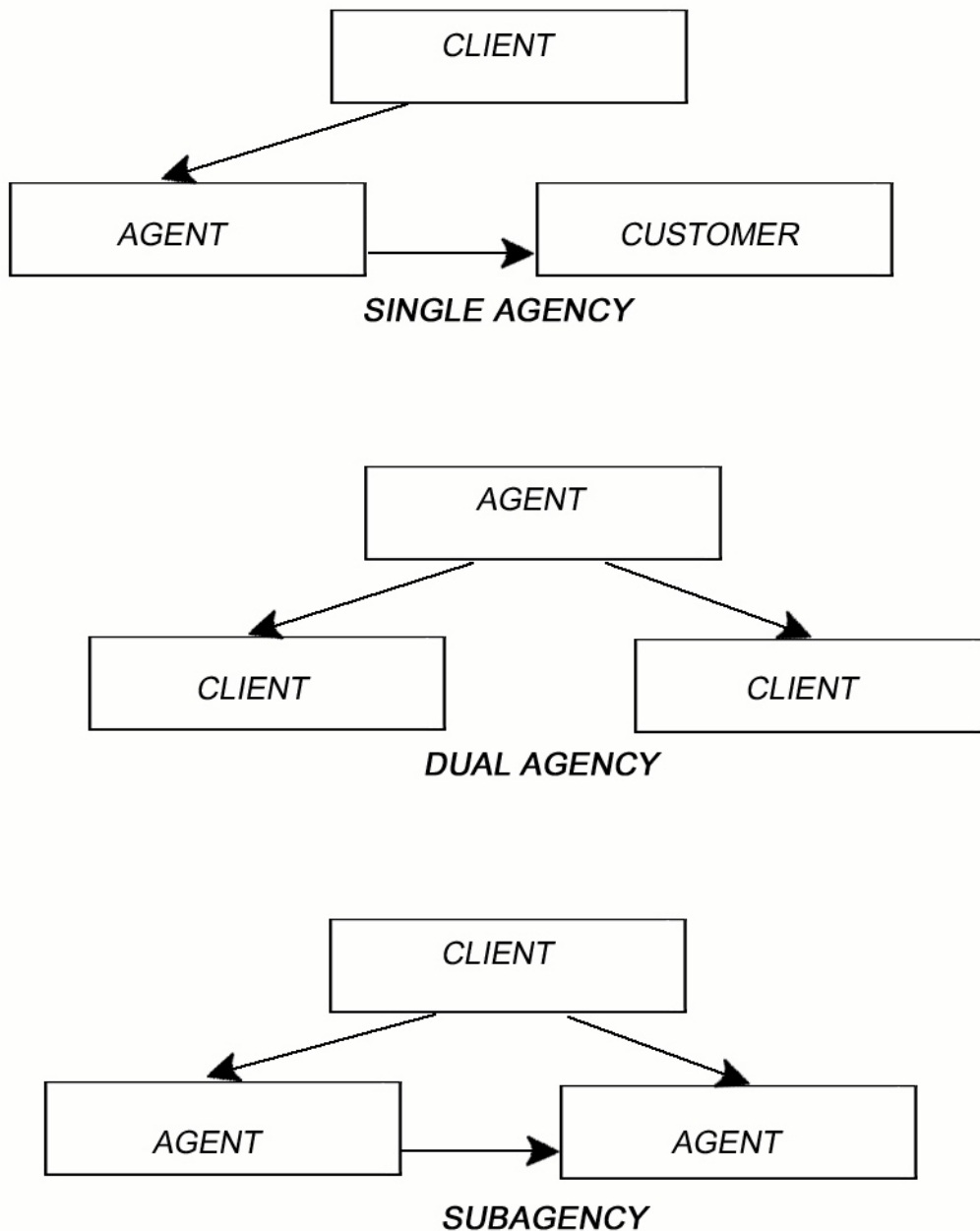
Dual agency requires equal loyalty to two separate principals at the same time. Because agency originates with the broker, dual agency arises when the broker is the agent of the buyer and either the agent or subagent of the seller. The salespersons, as agents of the broker, have fiduciary responsibilities to the same principals as well. The challenge is to fulfill the fiduciary obligations to one principal without compromising the interests of the

6: AGENCY LAW

other, especially when the parties' interests may not only be separate, but even opposite. While practical methods of ensuring fairness and equal representation may exist, it should be noted that a dual agent can never fully represent either party's interests.

Because of the obvious risks inherent in dual agency - ranging from conflicts of interest to outright abuse of trust-the practice is illegal in some states. In California, where dual agency is permitted, however, all parties must consent to it. (See Figure 6-1.)

Figure 6-1: Single Agency, Dual Agency & Sub Agency



Compensation



REAL ESTATE PRACTICE

The source of compensation does not determine agency. An agent does not necessarily represent the person who pays his or her commission. In fact, agency can exist even if no fee is involved (called a **gratuitous agency**). Buyers and sellers can agree however they choose to compensate the broker, regardless of which is the agent's principal. For instance, a seller could agree to pay a commission to the buyer's agent. The written agency agreement should state how the agent is being compensated and explain all the alternatives available.

☞ ***The broker's commission is negotiated with seller.***

DISCLOSURE OF AGENCY RELATIONSHIP

The **Agency Disclosure Law** of January 1, 1988 states that the first thing an agent must do is to establish his or her relationship with his principal.

The law states that both the listing broker and the selling broker must declare in writing, as soon as possible, who it is they represent:

1. The seller (Listing agent)
2. The buyer (Selling agent, or cooperating agent), or
3. Both the seller and buyer (Dual agency).

☞ ***This type of law, which differs from state to state, will profoundly affect the way brokers represent their clients and the way we as an industry are perceived by the public at large.***

Form 6-1 shows an "Agency Disclosure Form" used by the California Association of Realtors. Civil law requires that both parties to a transaction be informed of the various options they have regarding agency representation. Both the buyer and seller must sign this form as an acknowledgment that they understand their rights and have received a copy of this disclosure. In addition, agency disclosure must again be confirmed on the Residential Purchase Agreement (Deposit Receipt). If it is not confirmed on the Deposit Receipt, then it must be confirmed on a separate form. This confirmation will protect the licensee against any future charges of misrepresentation in the agency relationship.

Form 6-1: Agency Relationship Disclosure

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CALIFORNIA
ASSOCIATION
OF REALTORS®

DISCLOSURE REGARDING REAL ESTATE AGENCY RELATIONSHIPS

(As required by the Civil Code)
(C.A.R. Form AD-11, Revised 10/01)

When you enter into a discussion with a real estate agent regarding a real estate transaction, you should from the outset understand what type of agency relationship or representation you wish to have with the agent in the transaction.

SELLER'S AGENT

A Seller's agent under a listing agreement with the Seller acts as the agent for the Seller only. A Seller's agent or a subagent of that agent has the following affirmative obligations:

To the Seller:

A Fiduciary duty of utmost care, integrity, honesty, and loyalty in dealing with the Seller.

To the Buyer and the Seller:

- (a) Diligent exercise of reasonable skill and care in performance of the agent's duties.
- (b) A duty of honest and fair dealing and good faith.
- (c) A duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, the parties.

An agent is not obligated to reveal to either party any confidential information obtained from the other party that does not involve the affirmative duties set forth above.

BUYER'S AGENT

A selling agent can, with a Buyer's consent, agree to act as agent for the Buyer only. In these situations, the agent is not the Seller's agent, even if by agreement the agent may receive compensation for services rendered, either in full or in part from the Seller. An agent acting only for a Buyer has the following affirmative obligations:

To the Buyer:

A fiduciary duty of utmost care, integrity, honesty, and loyalty in dealings with the Buyer.

To the Buyer and the Seller:

- (a) Diligent exercise of reasonable skill and care in performance of the agent's duties.
- (b) A duty of honest and fair dealing and good faith.
- (c) A duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, the parties.

An agent is not obligated to reveal to either party any confidential information obtained from the other party that does not involve the affirmative duties set forth above.

AGENT REPRESENTING BOTH SELLER AND BUYER

A real estate agent, either acting directly or through one or more associate licensees, can legally be the agent of both the Seller and the Buyer in a transaction, but only with the knowledge and consent of both the Seller and the Buyer.

In a dual agency situation, the agent has the following affirmative obligations to both the Seller and the Buyer:

- (a) A fiduciary duty of utmost care, integrity, honesty and loyalty in the dealings with either Seller or the Buyer.
- (b) Other duties to the Seller and the Buyer as stated above in their respective sections.

In representing both Seller and Buyer, the agent may not, without the express permission of the respective party, disclose to the other party that the Seller will accept a price less than the listing price or that the Buyer will pay a price greater than the price offered.

The above duties of the agent in a real estate transaction do not relieve a Seller or Buyer from the responsibility to protect his or her own interests. You should carefully read all agreements to assure that they adequately express your understanding of the transaction. A real estate agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional.

Throughout your real property transaction you may receive more than one disclosure form, depending upon the number of agents assisting in the transaction. The law requires each agent with whom you have more than a casual relationship to present you with this disclosure form. You should read its contents each time it is presented to you, considering the relationship between you and the real estate agent in your specific transaction.

This disclosure form includes the provisions of Sections 2079.13 to 2079.24, inclusive, of the Civil Code set forth on the reverse hereof. Read it carefully.

I/WE ACKNOWLEDGE RECEIPT OF A COPY OF THIS DISCLOSURE.

BUYER/SELLER _____ Date _____ Time _____ ☐ AM ☐ PM

BUYER/SELLER _____ Date _____ Time _____ ☐ AM ☐ PM

AGENT _____ By _____ Date _____
(Please Print) (Associate-Licensee or Broker Signature)

THIS FORM SHALL BE PROVIDED AND ACKNOWLEDGED AS FOLLOWS (Civil Code §2079.14):

- When the listing brokerage company also represents the Buyer, the Listing Agent shall give one AD-11 form to the Seller and one to the Buyer.
- When Buyer and Seller are represented by different brokerage companies, then the Listing Agent shall give one AD-11 form to the Seller and the Buyer's Agent shall give one AD-11 form to the Buyer and one AD-11 form to the Seller.

SEE REVERSE SIDE FOR FURTHER INFORMATION

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525 South Virgil Avenue, Los Angeles, California 90020

Reviewed by _____
Broker or Designee _____ Date _____



AD-11 REVISED 10/01 (PAGE 1 OF 1)

DISCLOSURE REGARDING REAL ESTATE AGENCY RELATIONSHIPS (AD-11 PAGE 1 OF 1)

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T5933855.ZFX



REAL ESTATE PRACTICE

Form 6-2: Agency Relationship Disclosure

CHAPTER 2 OF TITLE 9 OF PART 4 OF DIVISION 3 OF THE CIVIL CODE

2079.13 As used in Sections 2079.14 to 2079.24, inclusive, the following terms have the following meanings:

(a) "Agent" means a person acting under provisions of title 9 (commencing with Section 2295) in a real property transaction, and includes a person who is licensed as a real estate broker under Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code, and under whose license a listing is executed or an offer to purchase is obtained. (b) "Associate licensee" means a person who is licensed as a real broker or salesperson under Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code and who is either licensed under a broker or has entered into a written contract with a broker to act as the broker's agent in connection with acts requiring a real estate license and to function under the broker's supervision in the capacity of an associate licensee. The agent in the real property transaction bears responsibility for his or her associate licensees who perform as agents of the agent. When an associate licensee owes a duty to any principal, or to any buyer or seller who is not a principal, in a real property transaction, that duty is equivalent to the duty owed to that party by the broker for whom the associate licensee functions. (c) "Buyer" means a transferee in a real property transaction, and includes a person who executes an offer to purchase real property from a seller through an agent, or who seeks the services of an agent in more than a casual, transitory, or preliminary manner, with the object of entering into a real property transaction. "Buyer" includes vendee or lessee. (d) "Dual agent" means an agent acting, either directly or through an associate licensee, as agent for both the seller and the buyer in a real property transaction. (e) "Listing agreement" means a contract between an owner of real property and an agent, by which the agent has been authorized to sell the real property or to find or obtain a buyer. (f) "Listing agent" means a person who has obtained a listing of real property to act as an agent for compensation. (g) "Listing price" is the amount expressed in dollars specified in the listing for which the seller is willing to sell the real property through the listing agent. (h) "Offering price" is the amount expressed in dollars specified in an offer to purchase for which the buyer is willing to buy the real property. (i) "Offer to purchase" means a written contract executed by a buyer acting through a selling agent which becomes the contract for the sale of the real property upon acceptance by the seller. (j) "Real property" means any estate specified by subdivision (1) or (2) of Section 761 in property which constitutes or is improved with one to four dwelling units, any leasehold in this type of property exceeding one year's duration, and mobilehomes, when offered for sale or sold through an agent pursuant to the authority contained in Section 10131.6 of the Business and Professions Code. (k) "Real property transaction" means a transaction for the sale of real property in which an agent is employed by one or more of the principals to act in that transaction, and includes a listing or an offer to purchase. (l) "Sell," "sale," or "sold" refers to a transaction for the transfer of real property from the seller to the buyer, and includes exchanges of real property between the seller and buyer, transactions for the creation of a real property sales contract within the meaning of Section 2985, and transactions for the creation of a leasehold exceeding one year's duration. (m) "Seller" means the transferor in a real property transaction, and includes an owner who lists real property with an agent, whether or not a transfer results, or who receives an offer to purchase real property of which he or she is the owner from an agent on behalf of another. "Seller" includes both a vendor and a lessor. (n) "Selling agent" means a listing agent who acts alone, or an agent who acts in cooperation with a listing agent, and who sells or finds and obtains a buyer for the real property, or an agent who locates property for a buyer or who finds a buyer for a property for which no listing exists and presents an offer to purchase to the seller. (o) "Subagent" means a person to whom an agent delegates agency powers as provided in Article 5 (commencing with Section 2349) of Chapter 1 of Title 9. However, "subagent" does not include an associate licensee who is acting under the supervision of an agent in a real property transaction.

2079.14 Listing agents and selling agents shall provide the seller and buyer in a real property transaction with a copy of the disclosure form specified in Section 2079.16, and, except as provided in subdivision (c), shall obtain a signed acknowledgement of receipt from that seller or buyer, except as provided in this section or Section 2079.15, as follows: (a) The listing agent, if any, shall provide the disclosure form to the seller prior to entering into the listing agreement. (b) The selling agent shall provide the disclosure form to the seller as soon as practicable prior to presenting the seller with an offer to purchase, unless the selling agent previously provided the seller with a copy of the disclosure form pursuant to subdivision (a). (c) Where the selling agent does not deal on a face-to-face basis with the seller, the disclosure form prepared by the selling agent may be delivered to the seller (and acknowledgement of receipt obtained for the selling agent from the seller) by the listing agent, or the selling agent may deliver the disclosure form by certified mail addressed to the seller at his or her last known address, in which case no signed acknowledgement of receipt is required. (d) The selling agent shall provide the disclosure form to the buyer as soon as practicable prior to execution of the buyer's offer to purchase, except that if the offer to purchase is not prepared by the selling agent, the selling agent shall present the disclosure form to the buyer not later than the next business day after the selling agent receives the offer to purchase from the buyer.

2079.15 In any circumstance in which the seller or buyer refuses to sign an acknowledgement of receipt pursuant to Section 2079.14, the agent, or an associate licensee acting for an agent, shall set forth, sign, and date a written declaration of the facts of the refusal.

2079.17 (a) As soon as practicable, the selling agent shall disclose to the buyer and seller whether the selling agent is acting in the real property transaction exclusively as the buyer's agent, exclusively as the seller's agent, or as a dual agent representing both the buyer and the seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller, the buyer, and the selling agent prior to or coincident with execution of that contract by the buyer and the seller, respectively. (b) As soon as practicable, the listing agent shall disclose to the seller whether the listing agent is acting in the real property transaction exclusively as the seller's agent, or as a dual agent representing both the buyer and seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller and the listing agent prior to or coincident with the execution of that contract by the seller.

(c) The confirmation required by subdivisions (a) and (b) shall be in the following form.

_____ is the agent of (check one): ☐ the seller exclusively; or ☐ both the buyer and seller.
(Name of Listing Agent)

_____ is the agent of (check one): ☐ the buyer exclusively; or ☐ the seller exclusively; or
☐ both the buyer and seller.
(Name of Selling Agent if not the same as the Listing Agent)

(d) The disclosures and confirmation required by this section shall be in addition to the disclosure required by Section 2079.14.

2079.18 No selling agent in a real property transaction may act as an agent for the buyer only, when the selling agent is also acting as the listing agent in the transaction.

2079.19 The payment of compensation or the obligation to pay compensation to an agent by the seller or buyer is not necessarily determinative of a particular agency relationship between an agent and the seller or buyer. A listing agent and a selling agent may agree to share any compensation or commission paid, or any right to any compensation or commission for which an obligation arises as the result of a real estate transaction, and the terms of any such agreement shall not necessarily be determinative of a particular relationship.

2079.20 Nothing in this article prevents an agent from selecting, as a condition of the agent's employment, a specific form of agency relationship not specifically prohibited by this article if the requirements of Section 2079.14 and Section 2079.17 are complied with.

2079.21 A dual agent shall not disclose to the buyer that the seller is willing to sell the property at a price less than the listing price, without the express written consent of the seller. A dual agent shall not disclose to the seller that the buyer is willing to pay a price greater than the offering price, without the express written consent of the buyer. This section does not alter in any way the duty or responsibility of a dual agent to any principal with respect to confidential information other than price.

2079.22 Nothing in this article precludes a listing agent from also being a selling agent, and the combination of these functions in one agent does not, of itself, make that agent a dual agent.

2079.23 A contract between the principal and agent may be modified or altered to change the agency relationship at any time before the performance of the act which is the object of the agency with the written consent of the parties to the agency relationship.

2079.24 Nothing in this article shall be construed to either diminish the duty of disclosure owed buyers and sellers by agents and their associate licensees, subagents, and employees or to relieve agents and their associate licensees, subagents, and employees from liability for their conduct in connection with acts governed by this article or for any breach of a fiduciary duty or a duty of disclosure.

FORM AD-11 Page 2

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AD-11 REVISED 10/01 (PAGE 1 OF 1)

DISCLOSURE REGARDING REAL ESTATE AGENCY RELATIONSHIPS (AD-11 PAGE 1 OF 1)

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6: AGENCY LAW

In California, it is legal for an agent to represent both the buyer and seller (dual agency). The agent must have acknowledgment and consent of all parties to the transaction.

Whether or not the law requires it, licensees should explain to both buyers and sellers what agency alternatives exist, how client and customer services differ and how these services affect the interests of each party. Once a client-based relationship is established, it is critical that customers understand how this affects their interests. If the broker represents two principals in the same transaction, the impact on both parties must be explained. A general rule of thumb is to make the disclosure before any confidential information is disclosed about an individual's motivation or financial situation.

Disclosed Dual Agency

Real estate licensing laws may permit dual agency only if the buyer and seller are informed and consent to the broker's representation of both in the same transaction. Although the possibility of conflict of interest still exists, disclosure is intended to minimize the risk for the broker by ensuring that both principals are aware of the effect of dual agency on their respective interests. The disclosure alerts the principals that they may have to assume greater responsibility for protecting their interests than they would if they had independent representation. The broker must reconcile how, as agent, he or she will discharge the fiduciary duties on behalf of both principals, particularly providing loyalty and protecting confidential information.

Considerable debate focuses on whether brokers can properly represent both the buyer and seller in the same transaction, even though the dual agency is disclosed. As discussed previously, several states have passed laws that permit a broker to designate certain licensees within the firm who act as the legal representatives of a principal—a practice known as designated agency. The broker is not considered a dual agent as long as the designated agent for each principal in the transaction is not the same salesperson. In effect, these laws create a split-interest agency, which is quite a departure from the traditional common law. It is likely that there will be additional legislative developments as the states wrestle with this issue.

Undisclosed Dual Agency

A broker may not intend to create a dual agency. However, like any other agency, it may occur unintentionally or inadvertently. Sometimes the cause is carelessness. Other times a salesperson does not fully understand his or her fiduciary responsibilities. Some salespersons lose sight of other responsibilities when they focus intensely on bringing buyers and sellers together. For instance, a salesperson representing the seller might suggest to a buyer that the seller will accept less than the listing price. Or that same salesperson might promise to persuade the seller to accept an offer that is in the buyer's best interests. Giving a buyer any specific advice on how much to offer can lead him or her to believe that the said person represents the buyer's interests and is acting as the buyer's advocate.

Any of these actions can create an implied agency with the buyer and violate the duties of loyalty and confidentiality to the principal-seller. Because neither party has been informed of the situation and been given the opportunity to seek separate representation, the interests of both are jeopardized. This undisclosed dual agency violates licensing laws. It can result in



REAL ESTATE PRACTICE

the rescission of the sales contract, forfeiture of a commission, a lawsuit for damages and possible license problems.

A more common example of dual agency would be if *broker J* employed two salespersons, *R* and *S*. *R* is the listing salesperson for seller, and *S* meets and begins representing the buyer, *Y*. Because both *R* and *S* are associated with *J*'s real estate brokerage, *J* may be construed as a dual agent and will have to enter into a disclosed dual agency agreement with the parties.

EMPLOYMENT CONTRACT

As required by the Real Estate Commissioners Regulations, brokers must have a written contract with each licensed member of the sales staff.

All parties must retain a copy of this contract for three years from the date of termination.

Also required of salespeople who are themselves brokers but are working under another brokers license.

Form 6.2 shows the CAR's "Broker-Associate License Contract." It outlines the duties, responsibilities and compensation to be provided and must be signed and dated by both the broker and the salesperson.

Form 6-2: Broker-Associate License Contract

6: AGENCY LAW



CALIFORNIA
ASSOCIATION
OF REALTORS®

INDEPENDENT CONTRACTOR AGREEMENT (Between Broker and Associate-Licensee)

This Agreement, dated _____ is made between _____ ("Broker") and _____ ("Associate-Licensee").

In consideration of the covenants and representations contained in this Agreement, Broker and Associate-Licensee agree as follows:

1. **Broker:** Broker represents that Broker is duly licensed as a real estate broker by the State of California, ☐ doing business as _____ (firm name), ☐ a sole proprietorship, ☐ a partnership, ☐ a corporation.

Broker is a member of the _____ Association(s) of REALTORS®, and a subscriber to the _____ multiple listing service(s). Broker shall keep Broker's license current during the term of this Agreement.

2. **ASSOCIATE-LICENSEE:** Associate-Licensee represents that, (a) he/she is duly licensed by the State of California as a ☐ real estate broker, ☐ real estate salesperson, and (b) he/she has not used any other names within the past five years, except _____. Associate-Licensee shall keep his/her license current during the term of this Agreement, including satisfying all applicable continuing education and provisional license requirements.

3. **INDEPENDENT CONTRACTOR RELATIONSHIP:**

- A. Broker and Associate-Licensee intend that, to the maximum extent permissible by law: (i) This Agreement does not constitute an employment agreement by either party; (ii) Broker and Associate-Licensee are independent contracting parties with respect to all services rendered under this Agreement; (iii) This Agreement shall not be construed as a partnership.
- B. Broker shall not: (i) restrict Associate-Licensee's activities to particular geographical areas or, (ii) dictate Associate-Licensee's activities with regard to hours, leads, open houses, opportunity or floor time, production, prospects, sales meetings, schedule, inventory, time off, vacation, or similar activities, except to the extent required by law.
- C. Associate-Licensee shall not be required to accept an assignment by Broker to service any particular current or prospective listing or parties.
- D. Except as required by law: (i) Associate-Licensee retains sole and absolute discretion and judgment in the methods, techniques, and procedures to be used in soliciting and obtaining listings, sales, exchanges, leases, rentals, or other transactions, and in carrying out Associate-Licensee's selling and soliciting activities, (ii) Associate-Licensee is under the control of Broker as to the results of Associate-Licensee's work only, and not as to the means by which those results are accomplished, (iii) Associate-Licensee has no authority to bind Broker by any promise or representation and (iv) Broker shall not be liable for any obligation or liability incurred by Associate-Licensee.
- E. Associate-Licensee's only remuneration shall be the compensation specified in paragraph 8.
- F. Associate-Licensee shall not be treated as an employee with respect to services performed as a real estate agent, for state and federal tax purposes.
- G. The fact the Broker may carry worker compensation insurance for Broker's own benefit and for the mutual benefit of Broker and licensees associated with Broker, including Associate-Licensee, shall not create an inference of employment.

4. **LICENSED ACTIVITY:** All listings of property, and all agreements, acts or actions for performance of licensed acts, which are taken or performed in connection with this Agreement, shall be taken and performed in the name of Broker. Associate-Licensee agrees to and does hereby contribute all right and title to such listings to Broker for the benefit and use of Broker, Associate-Licensee, and other licensees associated with Broker. Broker shall make available to Associate-Licensee, equally with other licensees associated with Broker, all current listings in Broker's office, except any listing which Broker may choose to place in the exclusive servicing of Associate-Licensee or one or more other specific licensees associated with Broker. Associate-Licensee shall provide and pay for all professional licenses, supplies, services, and other items required in connection with Associate-Licensee's activities under this Agreement, or any listing or transaction, without reimbursement from Broker except as required by law. Associate-Licensee shall work diligently and with his/her best efforts: (a) To sell, exchange, lease, or rent properties listed with Broker or other cooperating Brokers; (b) To solicit additional listings, clients, and customers; and (c) To otherwise promote the business of serving the public in real estate transactions to the end that Broker and Associate-Licensee may derive the greatest benefit possible, in accordance with law. Associate-Licensee shall not commit any unlawful act under federal, state or local law or regulation while conducting licensed activity. Associate-Licensee shall at all times be familiar, and comply, with all applicable federal, state and local laws, including, but not limited to, anti-discrimination laws and restrictions against the giving or accepting a fee, or other thing of value, for the referral of business to title companies, escrow companies, home inspection companies, pest control companies and other settlement service providers pursuant to the California Business and Professions Code and the Real Estate Settlement Procedures Acts (RESPA). Broker shall make available for Associate-Licensee's use, along with other licensees associated with Broker, the facilities of the real estate office operated by Broker at _____ and the facilities of any other office

locations made available by Broker pursuant to this Agreement.

Broker and Associate-Licensee acknowledge receipt of copy of this page, which constitutes Page 1 of _____ Pages.

Broker's Initials (_____) (_____) Associate-Licensee's Initials (_____) (_____)

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Date _____



INDEPENDENT CONTRACTOR AGREEMENT (ICA-11 PAGE 1 OF 3)

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T5938782.ZFX



REAL ESTATE PRACTICE

5. **PROPRIETARY INFORMATION AND FILES:** (a) All files and documents pertaining to listings, leads and transactions are the property of Broker and shall be delivered to Broker by Associate-Licensee immediately upon request or termination of their relationship under this Agreement. (b) Associate Licensee acknowledges that Broker's method of conducting business is a protected trade secret. (c) Associate-Licensee shall not use to his/her own advantage, or the advantage of any other person, business, or entity, except as specifically agreed in writing, either during Associate-Licensee's association with Broker, or thereafter, any information gained for or from the business, or files of Broker.
6. **SUPERVISION:** Associate-Licensee, within 24 hours (or ☐ _____) after preparing, signing, or receiving same, shall submit to Broker, or Broker's designated licensee: (a) All documents which may have a material effect upon the rights and duties of principals in a transaction, (b) Any documents or other items connected with a transaction pursuant to this Agreement in the possession of or available to Associate-Licensee and, (c) All documents associated with any real estate transaction in which Associate-Licensee is a principal.
7. **TRUST FUNDS:** All trust funds shall be handled in compliance with the Business and Professions Code, and other applicable laws.
8. **COMPENSATION:**
- A. **TO BROKER:** Compensation shall be charged to parties who enter into a listing or other agreements for services requiring a real estate license: ☐ as shown in "Exhibit A" attached, which is incorporated as a part of this Agreement by reference, or ☐ as follows: _____
- Any deviation which is not approved in writing in advance by Broker, shall be (1) deducted from Associate-Licensee's compensation, if lower than the amount or rate approved above; and, (2) subject to Broker approval, if higher than the amount approved above. Any permanent change in commission schedule shall be disseminated by Broker to Associate-Licensee.
- B. **TO ASSOCIATE-LICENSEE:** Associate-Licensee shall receive a share of compensation actually collected by Broker, on listings or other agreements for services requiring a real estate license, which are solicited and obtained by Associate-Licensee, and on transactions of which Associate-Licensee's activities are the procuring cause, as follows: ☐ as shown in "Exhibit B" attached, which is incorporated as a part of this Agreement by reference, or ☐ other: _____
- C. **PARTNERS, TEAMS, AND AGREEMENTS WITH OTHER ASSOCIATE-LICENSEES IN OFFICE:** If Associate-Licensee and one or more other Associate-Licensees affiliated with Broker participate on the same side (either listing or selling) of a transaction, the commission allocated to their combined activities shall be divided by Broker and paid to them according to their written agreement. Broker shall have the right to withhold total compensation if there is a dispute between associate-licensees, or if there is no written agreement, or if no written agreement has been provided to Broker.
- D. **EXPENSES AND OFFSETS:** If Broker elects to advance funds to pay expenses or liabilities of Associate-Licensee, or for an advance payment of, or draw upon, future compensation, Broker may deduct the full amount advanced from compensation payable to Associate-Licensee on any transaction without notice. If Associate-Licensee's compensation is subject to a lien, garnishment or other restriction on payment, Broker shall charge Associate-Licensee a fee for complying with such restriction.
- E. **PAYMENT:** (1) All compensation collected by Broker and due to Associate-Licensee shall be paid to Associate-Licensee, after deduction of expenses and offsets, immediately or as soon thereafter as practicable, except as otherwise provided in this Agreement, or a separate written agreement between Broker and Associate-Licensee. (2) Compensation shall not be paid to Associate-Licensee until both the transaction and file are complete. (3) Broker is under no obligation to pursue collection of compensation from any person or entity responsible for payment. Associate-Licensee does not have the independent right to pursue collection of compensation for activities which require a real estate license which were done in the name of Broker. (4) Expenses which are incurred in the attempt to collect compensation shall be paid by Broker and Associate-Licensee in the same proportion as set forth for the division of compensation (paragraph 8(B)). (5) If there is a known or pending claim against Broker or Associate-Licensee on transactions for which Associate-Licensee has not yet been paid, Broker may withhold from compensation due Associate-Licensee on that transaction amounts for which Associate-Licensee could be responsible under paragraph 14, until such claim is resolved. (6) Associate-Licensee shall not be entitled to any advance payment from Broker upon future compensation.
- F. **UPON OR AFTER TERMINATION:** If this Agreement is terminated while Associate-Licensee has listings or pending transactions that require further work normally rendered by Associate-Licensee, Broker shall make arrangements with another associate-licensee to perform the required work, or Broker shall perform the work him/herself. The licensee performing the work shall be reasonably compensated for completing work on those listings or transactions, and such reasonable compensation shall be deducted from Associate-Licensee's share of compensation. Except for such offset, Associate-Licensee shall receive the compensation due as specified above.
9. **TERMINATION OF RELATIONSHIP:** Broker or Associate-Licensee may terminate their relationship under this Agreement at any time, with or without cause. After termination, Associate-Licensee shall not solicit (a) prospective or existing clients or customers based upon company-generated leads obtained during the time Associate-Licensee was affiliated with Broker, or (b) any principal with existing contractual obligations to Broker, or (c) any principal with a contractual transactional obligation for which Broker is entitled to be compensated. Even after termination, this Agreement shall govern all disputes and claims between Broker and Associate-Licensee connected with their relationship under this Agreement, including obligations and liabilities arising from existing and completed listings, transactions, and services.

Broker and Associate-Licensee acknowledge receipt of copy of this page, which constitutes Page 2 of _____ Pages.

Broker's Initials (_____) (_____) Associate-Licensee's Initials (_____) (_____)

REVISED 10/98
Page 2 of _____ Pages.

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Reviewed by Broker
or Designee _____
Date _____



INDEPENDENT CONTRACTOR AGREEMENT (ICA-11 PAGE 2 OF 3)

T5938782 ZFX

6: AGENCY LAW



CALIFORNIA
ASSOCIATION
OF REALTORS®

INDEPENDENT CONTRACTOR AGREEMENT (Between Broker and Associate-Licensee)

This Agreement, dated _____ is made between _____ ("Broker") and _____ ("Associate-Licensee").

In consideration of the covenants and representations contained in this Agreement, Broker and Associate-Licensee agree as follows:

1. **Broker:** Broker represents that Broker is duly licensed as a real estate broker by the State of California, ☐ doing business as _____ (firm name), ☐ a sole proprietorship, ☐ a partnership, ☐ a corporation.

Broker is a member of the _____ Association(s) of REALTORS®, and a subscriber to the _____ multiple listing service(s). Broker shall keep Broker's license current during the term of this Agreement.

2. **ASSOCIATE-LICENSEE:** Associate-Licensee represents that, (a) he/she is duly licensed by the State of California as a ☐ real estate broker, ☐ real estate salesperson, and (b) he/she has not used any other names within the past five years, except _____. Associate-Licensee shall keep his/her license current during the term of this Agreement, including satisfying all applicable continuing education and provisional license requirements.

3. **INDEPENDENT CONTRACTOR RELATIONSHIP:**

- A. Broker and Associate-Licensee intend that, to the maximum extent permissible by law: (i) This Agreement does not constitute an employment agreement by either party; (ii) Broker and Associate-Licensee are independent contracting parties with respect to all services rendered under this Agreement; (iii) This Agreement shall not be construed as a partnership.
- B. Broker shall not: (i) restrict Associate-Licensee's activities to particular geographical areas or, (ii) dictate Associate-Licensee's activities with regard to hours, leads, open houses, opportunity or floor time, production, prospects, sales meetings, schedule, inventory, time off, vacation, or similar activities, except to the extent required by law.
- C. Associate-Licensee shall not be required to accept an assignment by Broker to service any particular current or prospective listing or parties.
- D. Except as required by law: (i) Associate-Licensee retains sole and absolute discretion and judgment in the methods, techniques, and procedures to be used in soliciting and obtaining listings, sales, exchanges, leases, rentals, or other transactions, and in carrying out Associate-Licensee's selling and soliciting activities, (ii) Associate-Licensee is under the control of Broker as to the results of Associate-Licensee's work only, and not as to the means by which those results are accomplished, (iii) Associate-Licensee has no authority to bind Broker by any promise or representation and (iv) Broker shall not be liable for any obligation or liability incurred by Associate-Licensee.
- E. Associate-Licensee's only remuneration shall be the compensation specified in paragraph 8.
- F. Associate-Licensee shall not be treated as an employee with respect to services performed as a real estate agent, for state and federal tax purposes.
- G. The fact the Broker may carry worker compensation insurance for Broker's own benefit and for the mutual benefit of Broker and licensees associated with Broker, including Associate-Licensee, shall not create an inference of employment.

4. **LICENSED ACTIVITY:** All listings of property, and all agreements, acts or actions for performance of licensed acts, which are taken or performed in connection with this Agreement, shall be taken and performed in the name of Broker. Associate-Licensee agrees to and does hereby contribute all right and title to such listings to Broker for the benefit and use of Broker, Associate-Licensee, and other licensees associated with Broker. Broker shall make available to Associate-Licensee, equally with other licensees associated with Broker, all current listings in Broker's office, except any listing which Broker may choose to place in the exclusive servicing of Associate-Licensee or one or more other specific licensees associated with Broker. Associate-Licensee shall provide and pay for all professional licenses, supplies, services, and other items required in connection with Associate-Licensee's activities under this Agreement, or any listing or transaction, without reimbursement from Broker except as required by law. Associate-Licensee shall work diligently and with his/her best efforts: (a) To sell, exchange, lease, or rent properties listed with Broker or other cooperating Brokers; (b) To solicit additional listings, clients, and customers; and (c) To otherwise promote the business of serving the public in real estate transactions to the end that Broker and Associate-Licensee may derive the greatest benefit possible, in accordance with law. Associate-Licensee shall not commit any unlawful act under federal, state or local law or regulation while conducting licensed activity. Associate-Licensee shall at all times be familiar, and comply, with all applicable federal, state and local laws, including, but not limited to, anti-discrimination laws and restrictions against the giving or accepting a fee, or other thing of value, for the referral of business to title companies, escrow companies, home inspection companies, pest control companies and other settlement service providers pursuant to the California Business and Professions Code and the Real Estate Settlement Procedures Acts (RESPA). Broker shall make available for Associate-Licensee's use, along with other licensees associated with Broker, the facilities of the real estate office operated by Broker at _____ and the facilities of any other office

locations made available by Broker pursuant to this Agreement.

Broker and Associate-Licensee acknowledge receipt of copy of this page, which constitutes Page 1 of _____ Pages.

Broker's Initials (_____) (_____) Associate-Licensee's Initials (_____) (_____)

THIS FORM HAS BEEN APPROVED BY THE CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.). NO REPRESENTATION IS MADE AS TO THE LEGAL VALIDITY OR ADEQUACY OF ANY PROVISION IN ANY SPECIFIC TRANSACTION. A REAL ESTATE BROKER IS THE PERSON QUALIFIED TO ADVISE ON REAL ESTATE TRANSACTIONS. IF YOU DESIRE LEGAL OR TAX ADVICE, CONSULT AN APPROPRIATE PROFESSIONAL.

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525 South Virgil Avenue, Los Angeles, California 90020

REVISED 10/98

OFFICE USE ONLY
Reviewed by Broker
or Designee _____
Date _____



INDEPENDENT CONTRACTOR AGREEMENT (ICA-11 PAGE 1 OF 3)

JF 2373 S Hacienda Blvd
Phone: (626)336-6191

Hacienda Heights CA 91745
Fax: (626)336-8565
jerry fung

T5938782.ZFX



REAL ESTATE PRACTICE

10. DISPUTE RESOLUTION:

- A. Mediation:** Mediation is recommended as a method of resolving disputes arising out of this Agreement between Broker and Associate-Licensee.
- B. Arbitration:** All disputes or claims between Associate-Licensee and other licensee(s) associated with Broker, or between Associate-Licensee and Broker, arising from or connected in any way with this Agreement, which cannot be adjusted between the parties involved, shall be submitted to the Association of REALTORS® of which all such disputing parties are members for arbitration pursuant to the provisions of its Bylaws, as may be amended from time to time, which are incorporated as a part of this Agreement by reference. If the Bylaws of the Association do not cover arbitration of the dispute, or if the Association declines jurisdiction over the dispute, then arbitration shall be pursuant to the rules of California law. The Federal Arbitration Act, Title 9, U.S. Code, Section 1, et seq., shall govern this Agreement.

- 11. AUTOMOBILE:** Associate-Licensee shall maintain automobile insurance coverage for liability and property damage in the following amounts \$ _____ / \$ _____. Broker shall be named as an additional insured party on Associate-Licensee's policies. A copy of the endorsement showing Broker as an additional insured shall be provided to Broker.

- 12. PERSONAL ASSISTANTS:** Associate-Licensee may make use of a personal assistant, provided the following requirements are satisfied. Associate-Licensee shall have a written agreement with the personal assistant which establishes the terms and responsibilities of the parties to the employment agreement, including, but not limited to, compensation, supervision and compliance with applicable law. The agreement shall be subject to Broker's review and approval. Unless otherwise agreed, if the personal assistant has a real estate license, that license must be provided to the Broker. Both Associate-Licensee and personal assistant must sign any agreement that Broker has established for such purposes.

- 13. OFFICE POLICY MANUAL:** If Broker's office policy manual, now or as modified in the future, conflicts with or differs from the terms of this Agreement, the terms of the office policy manual shall govern the relationship between Broker and Associate-Licensee.

- 14. INDEMNITY AND HOLD HARMLESS:** Associate-Licensee agrees to indemnify, defend and hold Broker harmless from all claims, disputes, litigation, judgments, awards, costs and attorney's fees, arising from any action taken or omitted by Associate-Licensee, or others working through, or on behalf of Associate-Licensee in connection with services rendered. Any such claims or costs payable pursuant to this Agreement, are due as follows:

- ☐ Paid in full by Associate-Licensee, who hereby agrees to indemnify and hold harmless Broker for all such sums, or
- ☐ In the same ratio as the compensation split as it existed at the time the compensation was earned by Associate-Licensee
- ☐ Other: _____

Payment from Associate-Licensee is due at the time Broker makes such payment and can be offset from any compensation due Associate-Licensee as above. Broker retains the authority to settle claims or disputes, whether or not Associate-Licensee consents to such settlement.

15. ADDITIONAL PROVISIONS:

16. DEFINITIONS: As used in this Agreement, the following terms have the meanings indicated:

- (A) "Listing" means an agreement with a property owner or other party to locate a buyer, exchange party, lessee, or other party to a transaction involving real property, a mobilehome, or other property or transaction which may be brokered by a real estate licensee, or an agreement with a party to locate or negotiate for any such property or transaction.
- (B) "Compensation" means compensation for acts requiring a real estate license, regardless of whether calculated as a percentage of transaction price, flat fee, hourly rate, or in any other manner.
- (C) "Transaction" means a sale, exchange, lease, or rental of real property, a business opportunity, or a manufactured home, which may lawfully be brokered by a real estate licensee.

- 17. ATTORNEY FEES:** In any action, proceeding, or arbitration between Broker and Associate-Licensee arising from or related to this Agreement, the prevailing Broker or Associate-Licensee shall be entitled to reasonable attorney fees and costs.

- 18. ENTIRE AGREEMENT; MODIFICATION:** All prior agreements between the parties concerning their relationship as Broker and Associate-Licensee are incorporated in this Agreement, which constitutes the entire contract. Its terms are intended by the parties as a final and complete expression of their agreement with respect to its subject matter, and may not be contradicted by evidence of any prior agreement or contemporaneous oral agreement. This Agreement may not be amended, modified, altered, or changed except by a further agreement in writing executed by Broker and Associate-Licensee.

Broker:

(Brokerage firm name)
By _____
Its ☐ Broker ☐ Office manager (check one)

(Print name)

(Address)

(City, State, Zip)

(Telephone) _____ (Fax)

Associate-Licensee:

(Signature)

(Print name)

(Address)

(City, State, Zip)

(Telephone) _____ (Fax)

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Page 3 of _____ Pages.

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Reviewed by Broker
or Designee _____
Date _____



INDEPENDENT CONTRACTOR AGREEMENT (ICA-11 PAGE 3 OF 3)

T5938782 ZFX

6: AGENCY LAW

INDEPENDENT CONTRACTOR

Real estate agents generally act as *independent contractors* in their dealings with clients as well as in their dealings with each other.

An **independent contractor** sells results rather than time, is under no supervision and his or her conduct is not subject to the control of another.

An **employee**, on the other hand, works under the direct control and supervision of the employer.

An independent contractor gets paid by commission (lump-sum of money), where as employee gets paid by salary.

The California Real Estate Law will always treat a salesperson as an employee of a broker in considering his or her rights and responsibilities to buyers, sellers and other parties to a real estate transaction, even if broker and salesperson structure work responsibilities and compensation as those of an independent contractor.

This makes the broker responsible and liable for the activities of the salesperson.

AGENCY STATUTES

A rapidly growing number of state legislatures are enacting agency reform legislation. Such laws are either in place or under consideration in most states. While each state's agency statute is different, many still incorporate the common-law fiduciary principles discussed here. For instance, most statutes contain language requiring agents to:

Exercise reasonable care and skill in performing his or her duties;

Obey the client's specific directions;

Account for all money and property received;

Loyalty, i.e., promote the client's best interests at all times;

Disclose material facts concerning the transaction;

Perform according to the terms of the brokerage agreement;

Keep confidential all confidential information received from the client; and

Generally comply with the terms of the statute.

If a state's agency law does not specifically supersede the common law of agency, a licensee will be subject to the requirements of both the statute and common law.

WARRANTY OF AUTHORITY

An agent warrant to do everything necessary to effect the purpose of the agency and to make representations of fact on behalf of the principal.

As an agent, the broker warrants that he or she has the authority to represent another person. If there is a written listing between the seller and the broker, he or she has an *expressed warranty of authority*. When a broker has no listing contract and offers to sell a property to an buyer, who relies on the fact that the agent has certain authority, the broker could be liable for this untrue representation. A broker gives *implied warranty of authority* to



REAL ESTATE PRACTICE

act for a seller by the mere fact that he or she shows the seller's property. The agency agreement usually authorizes the broker to act for the principal.

Receipt of Deposits

Most listing contracts authorize the broker to accept a deposit.

- A. If a broker is not authorized, the broker becomes the buyer's agent for deposits.
- B. A broker cannot hold uncashed checks unless directed to do so.
- C. A deposit never belongs to the broker.

DUTIES OF AN AGENT (FIDUCIARY)

The California Civil Code boils the law of agency down to couple basic rules applying to licensed agent. The agent:

- ♦ Must inform his client of all facts pertaining to the handling of the clients' case. Agent must put clients interest above interest of self or others.
- ♦ May not gain any monetary interest in the transaction without clients' prior knowledge and consent.

DUTIES TOWARD THE PRINCIPAL

The real estate agent owes a definite duty of **fiduciary** relationship to his principal. A fiduciary relationship requires *loyalty, good faith, honest, integrity, obedience, full disclosure* and use of *utmost care and skill* to their clients and are placed in a position of trust. They may not obtain any advantage over the principal by the slightest misrepresentation, concealment, duress, or adverse pressure of any kind.

The agent's **fiduciary relationship** of trust and confidence with the principal means that the broker owes the principal certain specific duties. These duties are not simply moral or ethical; they are the law - the common law of agency or the statutory law governing real estate transactions. Under the common law of agency, an agent owes the principal the five duties of *care, obedience, accounting, loyalty* (including confidentiality) and *disclosure*.

Care

The agent must exercise a reasonable degree of care while transacting the business entrusted to him or her by the principal. The principal expects the agent's skill and expertise in real estate matters to be superior to that of the average person. The most fundamental way in which the agent exercises care is to use that skill and knowledge in the principal's behalf. The agent should know all facts pertinent to the principal's affairs, such as the physical characteristics of the property being transferred and the type of financing being used.

If the agent represents the seller, care and skill include helping the seller arrive at an appropriate and realistic listing price, discovering and disclosing facts that affect the seller and properly presenting the contracts that the seller signs. It also means making reasonable

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efforts to market the property, such as advertising and holding open houses, and helping the seller evaluate the terms and conditions of offers to purchase.

An agent who represents the buyer is expected to help the buyer locate suitable property and evaluate property values, neighborhood and property conditions, financing alternatives and offers and counteroffers with the buyer's interest in mind.

Negligent

An agent who does not make a reasonable effort to properly represent the interests of the principal could be found by a court to have been **negligent**. The agent is liable to the principal for any loss resulting from the agent's negligence or carelessness. The standard of care will vary from market to market and depends on the expected behavior for a particular type of transaction in a particular area.

An **agent** is one who is authorized to represent his principal in business dealings with third persons. This places the agent in a position of highest good faith towards the principal and creates a "**fiduciary**" (*entrusted*) relationship. The Statute of Frauds dictates that a contract that authorizes an agent to find a purchaser or lessee (for more than one year) of real estate - a Listing Agreement be in writing. The California Real Estate Law requires that the employment agreement between a real estate broker and a salesperson be in writing.

☞ ***Because real estate licensees have, under the law, enormous exposure to liability, some brokers purchase what are known as errors and omissions insurance policies for their firms. Similar to malpractice insurance in the medical and legal fields, E&O policies cover liability for errors and negligence in the usual listing and selling activities of a real estate office. Individual salespersons might also be insured. Licensing laws in several states now require E&O insurance for brokers and, in some cases, for individual salespersons as well. However, no insurance policy will protect a licensee from litigation arising from criminal acts. Insurance companies normally exclude coverage for violation of civil rights laws as well.***

Obedience

The fiduciary relationship obligates the agent to act in good faith at all times, obeying the principal's instructions in accordance with the contract.

☞ ***However, that obedience is not absolute.***

The agent may not obey instructions that are unlawful or unethical. Because illegal acts do not serve the principal's best interests, obeying such instructions violates the broker's duty of loyalty. On the other hand, an agent who exceeds the authority assigned in the contract will be liable for any losses that the principal suffers as a result.

☞ ***Example: A seller tells the listing agent, "I don't want you to show this house to any, you know, minorities." Because refusing to show a property to someone on the basis of race is illegal, the agent may not follow the seller's instructions.***

Accounting

The agent must be able to report the status of all funds received from or on behalf of the principal. Most state real estate license laws require a broker to give accurate copies of all



REAL ESTATE PRACTICE

documents to all parties affected by them and to keep copies on file for a specified period of time. Most license laws also require the broker to deposit immediately, or within 24 to 48 hours, all funds entrusted to the broker (such as earnest money deposits) in a special trust, or escrow, account. Commingling such monies with the broker's personal or general business funds is strictly illegal. Trust Funds will be discussed in detail in this book.

Loyalty

The duty of loyalty requires the agent to place the principal's interests above those of all others, including the agent's own self-interest. The agent must be particularly sensitive to any possible conflicts of interest. *Confidentiality* about the principal's personal affairs is a key element of loyalty. An agent may not, for example, disclose the principal's financial condition. When the principal is the seller, the agent may not reveal such things as the principal's willingness to accept less than the listing price or his or her anxiousness to sell unless the principal has authorized the disclosure. If the principal is the buyer, the agent may not disclose, for instance, that the buyer will pay more than the offered price if necessary, or that the buyer is under a tight moving schedule or any other fact that might harm the principal's bargaining position. Under the law of most states, the agent *must* disclose material facts about the condition of the property itself. Some states, however, permit a seller disclaimer.

Because the agent may not act out of self-interest, the negotiation of a sales contract must be conducted without regard to how much the agent will earn in commission. All states forbid agents to buy property listed with them for their own accounts or for accounts in which they have a personal interest without first disclosing that interest and receiving the principal's consent. Neither brokers nor salespersons may sell property in which they have a personal interest without informing the purchaser of that interest.

Disclosure

It is the agent's duty to keep the principal informed of all facts or information that could affect a transaction. Duty of disclosure includes relevant information or **material facts** that the agent **knows** or **should have known**.

The agent is obligated to discover facts that a reasonable person would feel are important in choosing a course of action, regardless of whether those facts are favorable or unfavorable to the principal's position. The agent may be held liable for damages for failing to disclose such information. For example, an agent for the seller has a duty to disclose:

- all offers;
- the identity of the prospective purchasers, including any relationship the agent has to them (such as when the licensee or a relative is a participating purchaser);
- the purchaser's ability to complete the sale or offer a higher price;
- any interest the agent has in the buyer (such as the broker's agreement to manage the property after it is purchased); and
- the buyer's intention to resell the property for a profit.

An agent for the buyer must disclose deficiencies of a property as well as sales contract provisions and financing that do not suit the buyer's needs. The agent would suggest the lowest price the buyer should pay based on comparable values, regardless of the listing

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price. The agent also would disclose information about how long a property has been listed or why the owner is selling that would affect the buyer's ability to negotiate the lowest purchase price possible. If the agent represents the seller, of course, disclosure of any of this information would violate the agent's fiduciary duty to the seller.

The agent:

- ♦ Cannot use a confidential relationship for his own benefit; Not use the position of trust to take advantage of the principal. There must be no secret profits.
- ♦ Must disclose all material facts to the principal, including the existence of an imminent offer.
- ♦ Must submit all offers.
- ♦ Must use reasonable care and skill.
- ♦ Must obey the law instructions of his principal, if broker does not he is liable for damages.
- ♦ May not act for two principals in negotiations with each other without knowledge and consent of both.

PRINCIPAL AND AGENT'S DUTIES TOWARD THE THIRD PARTIES

Both principal and agent owe certain duties to third persons. Both must disclose all material facts and defects affecting the desirability of the property. Both must inspect the property and reveal its condition to the potential buyer. The agent must not make a secret profit at the expense of a third person and must be careful when puffing, or exaggerating, the benefits of a property.

As of January 1, 1987, the seller of residential property of one to four units must provide the buyer with a written **Real Estate Transfer Disclosure Statement** detailing the mechanical and structural health aspects of the property.

Form 6-3: Real Estate Transfer Disclosure Statement (3 pages)



REAL ESTATE PRACTICE



CALIFORNIA
ASSOCIATION
OF REALTORS®

REAL ESTATE TRANSFER DISCLOSURE STATEMENT (CALIFORNIA CIVIL CODE 1102, ET SEQ) (C.A.R. Form TDS, Revised 10/01)

THIS DISCLOSURE STATEMENT CONCERNS THE REAL PROPERTY SITUATED IN THE CITY OF Hacienda Heights, COUNTY OF Los Angeles, STATE OF CALIFORNIA, DESCRIBED AS 123 Main St., Hacienda Heights, 91745. THIS STATEMENT IS A DISCLOSURE OF THE CONDITION OF THE ABOVE DESCRIBED PROPERTY IN COMPLIANCE WITH SECTION 1102 OF THE CIVIL CODE AS OF (date) August 1, 2002. IT IS NOT A WARRANTY OF ANY KIND BY THE SELLER(S) OR ANY AGENT(S) REPRESENTING ANY PRINCIPAL(S) IN THIS TRANSACTION, AND IS NOT A SUBSTITUTE FOR ANY INSPECTIONS OR WARRANTIES THE PRINCIPAL(S) MAY WISH TO OBTAIN.

I. COORDINATION WITH OTHER DISCLOSURE FORMS

This Real Estate Transfer Disclosure Statement is made pursuant to Section 1102 of the Civil Code. Other statutes require disclosures, depending upon the details of the particular real estate transaction (for example: special study zone and purchase-money liens on residential property).

Substituted Disclosures: The following disclosures have or will be made in connection with this real estate transfer, and are intended to satisfy the disclosure obligations on this form, where the subject matter is the same:

- ☐ Inspection reports completed pursuant to the contract of sale or receipt for deposit.
☐ Additional inspection reports or disclosures: _____

II. SELLER'S INFORMATION

The Seller discloses the following information with the knowledge that even though this is not a warranty, prospective Buyers may rely on this information in deciding whether and on what terms to purchase the subject property. Seller hereby authorizes any agent(s) representing any principal(s) in this transaction to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY THE SELLER(S) AND ARE NOT THE REPRESENTATIONS OF THE AGENT(S), IF ANY. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN THE BUYER AND SELLER.

Seller ☐ is ☐ is not occupying the property.

A. The subject property has the items checked below (read across)

- | | | |
|---------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------|
| <input type="checkbox"/> Range | <input type="checkbox"/> Oven | <input type="checkbox"/> Microwave |
| <input type="checkbox"/> Dishwasher | <input type="checkbox"/> Trash Compactor | <input type="checkbox"/> Garbage Disposal |
| <input type="checkbox"/> Washer/Dryer Hookups | <input type="checkbox"/> Smoke Detector(s) | <input type="checkbox"/> Rain Gutters |
| <input type="checkbox"/> Burglar Alarms | <input type="checkbox"/> Satellite Dish | <input type="checkbox"/> Fire Alarm |
| <input type="checkbox"/> T.V. Antenna | <input type="checkbox"/> Central Air Conditioning | <input type="checkbox"/> Intercom |
| <input type="checkbox"/> Central Heating | <input type="checkbox"/> Sprinklers | <input type="checkbox"/> Evaporator Cooler(s) |
| <input type="checkbox"/> Wall/Window Air Conditioning | <input type="checkbox"/> Sump Pump | <input type="checkbox"/> Public Sewer System |
| <input type="checkbox"/> Septic Tank | <input type="checkbox"/> Built-in Barbecue | <input type="checkbox"/> Water Softener |
| <input type="checkbox"/> Patio/Decking | <input type="checkbox"/> Pool <input type="checkbox"/> Child Resistant Barrier* | <input type="checkbox"/> Gazebo |
| <input type="checkbox"/> Sauna | <input type="checkbox"/> Automatic Garage Door Opener(s)* | <input type="checkbox"/> Spa <input type="checkbox"/> Locking Safety Cover* |
| <input type="checkbox"/> Hot Tub <input type="checkbox"/> Locking Safety Cover* | <input type="checkbox"/> Not Attached | <input type="checkbox"/> Number Remote Controls _____ |
| <input type="checkbox"/> Security Gate(s) | <input type="checkbox"/> Solar | <input type="checkbox"/> Carport |
| Garage: <input type="checkbox"/> Attached | <input type="checkbox"/> Water Heater Anchored, Braced, or Strapped* | <input type="checkbox"/> Electric |
| Pool/Spa Heater: <input type="checkbox"/> Gas | <input type="checkbox"/> Well | <input type="checkbox"/> Private Utility or Other _____ |
| Water Heater: <input type="checkbox"/> Gas | <input type="checkbox"/> Bottled | |
| Water Supply: <input type="checkbox"/> City | <input type="checkbox"/> Window Security Bars <input type="checkbox"/> Quick Release Mechanism on Bedroom Windows* | |
| Gas Supply: <input type="checkbox"/> Utility | | |
| <input type="checkbox"/> Window Screens | | |

Exhaust Fan(s) in _____ 220 Volt Wiring in _____ Fireplace(s) in _____
☐ Gas Starter _____ ☐ Roof(s): Type: _____ Age: _____ (approx.)
☐ Other: _____

Are there, to the best of your (Seller's) knowledge, any of the above that are not in operating condition? ☐ Yes ☐ No. If yes, then describe. (Attach additional sheets if necessary): _____

(*see footnote on page 2)

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Buyer and Seller acknowledge receipt of a copy of this page.

Buyer's Initials (_____) (_____)
Seller's Initials (_____) (_____)

Reviewed by _____ Date _____
Broker or Designee _____



TDS-11 REVISED 10/01 (PAGE 1 OF 3)

REAL ESTATE TRANSFER DISCLOSURE STATEMENT (TDS-11 PAGE 1 OF 3)

Jerry fung
JF 2373 S Hacienda Blvd, Hacienda Heights CA 91745

Phone: (626)336.6191

Fax: (626)336.8565

T9737505 ZFX

6: AGENCY LAW

Property Address: 123 Main St., Hacienda Heights, 91745 Date: _____

B. Are you (Seller) aware of any significant defects/malfunctions in any of the following? ☐ Yes ☐ No. If yes, check appropriate space(s) below.

☐ Interior Walls ☐ Ceilings ☐ Floors ☐ Exterior Walls ☐ Insulation ☐ Roof(s) ☐ Windows ☐ Doors ☐ Foundation ☐ Slab(s)
☐ Driveways ☐ Sidewalks ☐ Walls/Fences ☐ Electrical Systems ☐ Plumbing/Sewers/Septics ☐ Other Structural Components
(Describe: _____)

If any of the above is checked, explain. (Attach additional sheets if necessary): _____

*This garage door opener or child resistant pool barrier may not be in compliance with the safety standards relating to automatic reversing devices as set forth in Chapter 12.5 (commencing with Section 19890) of Part 3 of Division 13 of, or with the pool safety standards of Article 2.5 (commencing with Section 115920) of Chapter 5 of Part 10 of Division 104 of, the Health and Safety Code. The water heater may not be anchored, braced, or strapped in accordance with Section 19211 of the Health and Safety Code. Window security bars may not have quick release mechanisms in compliance with the 1995 Edition of the California Building Standards Code.

C. Are you (Seller) aware of any the following:

1. Substances, materials, or products which may be an environmental hazard such as, but not limited to, asbestos, formaldehyde, radon gas, lead-based paint, mold, fuel or chemical storage tanks, and contaminated soil or water on the subject property ☐ Yes ☐ No
2. Features of the property shared in common with adjoining landowners, such as walls, fences, and driveways, whose use or responsibility for maintenance may have an effect on the subject property ☐ Yes ☐ No
3. Any encroachments, easements or similar matters that may affect your interest in the subject property ☐ Yes ☐ No
4. Room additions, structural modifications, or other alterations or repairs made without necessary permits. ☐ Yes ☐ No
5. Room additions, structural modifications, or other alterations or repairs not in compliance with building codes. ☐ Yes ☐ No
6. Fill (compacted or otherwise) on the property or any portion thereof ☐ Yes ☐ No
7. Any settling from any cause, or slippage, sliding, or other soil problems ☐ Yes ☐ No
8. Flooding, drainage or grading problems ☐ Yes ☐ No
9. Major damage to the property or any of the structures from fire, earthquake, floods, or landslides ☐ Yes ☐ No
10. Any zoning violations, nonconforming uses, violations of "setback" requirements ☐ Yes ☐ No
11. Neighborhood noise problems or other nuisances ☐ Yes ☐ No
12. CC&R's or other deed restrictions or obligations ☐ Yes ☐ No
13. Homeowners' Association which has any authority over the subject property ☐ Yes ☐ No
14. Any "common area" (facilities such as pools, tennis courts, walkways, or other areas co-owned in undivided interest with others) ☐ Yes ☐ No
15. Any notices of abatement or citations against the property ☐ Yes ☐ No
16. Any lawsuits by or against the seller threatening to or affecting this real property, including any lawsuits alleging a defect or deficiency in this real property or "common areas" (facilities such as pools, tennis courts, walkways, or other areas, co-owned in undivided interest with others) ☐ Yes ☐ No

If the answer to any of these is yes, explain. (Attach additional sheets if necessary): _____

Seller certifies that the information herein is true and correct to the best of the Seller's knowledge as of the date signed by the Seller.

Seller _____ Date _____

Seller _____ Date _____

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Buyer's Initials (_____) (_____)

Seller's Initials (_____) (_____)

Reviewed by _____ Date _____
Broker or Designee _____



REAL ESTATE TRANSFER DISCLOSURE STATEMENT (TDS-11 PAGE 2 OF 3)

T9737505 ZFX



REAL ESTATE PRACTICE

Property Address: 123 Main St., Hacienda Heights, 91745 Date: _____

III. AGENT'S INSPECTION DISCLOSURE

(To be completed only if the Seller is represented by an agent in this transaction.)

THE UNDERSIGNED, BASED ON THE ABOVE INQUIRY OF THE SELLER(S) AS TO THE CONDITION OF THE PROPERTY AND BASED ON A REASONABLY COMPETENT AND DILIGENT VISUAL INSPECTION OF THE ACCESSIBLE AREAS OF THE PROPERTY IN CONJUNCTION WITH THAT INQUIRY, STATES THE FOLLOWING:

- ☐ Agent notes no items for disclosure.
☐ Agent notes the following items: _____

Agent (Broker Representing Seller) _____ By _____ Date _____
 (Please Print) (Associate-License or Broker Signature)

IV. AGENT'S INSPECTION DISCLOSURE

(To be completed only if the agent who has obtained the offer is other than the agent above.)

THE UNDERSIGNED, BASED ON A REASONABLY COMPETENT AND DILIGENT VISUAL INSPECTION OF THE ACCESSIBLE AREAS OF THE PROPERTY, STATES THE FOLLOWING:

- ☐ Agent notes no items for disclosure.
☐ Agent notes the following items: _____

Agent (Broker Obtaining the Offer) _____ By _____ Date _____
 (Please Print) (Associate-License or Broker Signature)

V. BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE AND/OR INSPECTIONS OF THE PROPERTY AND TO PROVIDE FOR APPROPRIATE PROVISIONS IN A CONTRACT BETWEEN BUYER AND SELLER(S) WITH RESPECT TO ANY ADVICE/INSPECTIONS/DEFECTS.

I/WE ACKNOWLEDGE RECEIPT OF A COPY OF THIS STATEMENT.

Seller _____ Date _____ Buyer _____ Date _____
 Seller _____ Date _____ Buyer _____ Date _____

Agent (Broker Representing Seller) _____ By _____ Date _____
 (Associate-License or Broker Signature)

Agent (Broker Obtaining the Offer) _____ By _____ Date _____
 (Associate-License or Broker Signature)

SECTION 1102.3 OF THE CIVIL CODE PROVIDES A BUYER WITH THE RIGHT TO RESCIND A PURCHASE CONTRACT FOR AT LEAST THREE DAYS AFTER THE DELIVERY OF THIS DISCLOSURE IF DELIVERY OCCURS AFTER THE SIGNING OF AN OFFER TO PURCHASE. IF YOU WISH TO RESCIND THE CONTRACT, YOU MUST ACT WITHIN THE PRESCRIBED PERIOD.

A REAL ESTATE BROKER IS QUALIFIED TO ADVISE ON REAL ESTATE. IF YOU DESIRE LEGAL ADVICE, CONSULT YOUR ATTORNEY.

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TDS REVISED 10/01 (PAGE 3 OF 3)

Reviewed by _____
 Broker or Designee _____ Date _____



T9737505 ZFX

REAL ESTATE TRANSFER DISCLOSURE STATEMENT (TDS-11 PAGE 3 OF 3)

6: AGENCY LAW

Even though an agent's primary responsibility is to the principal, the agent also has duties to third parties. Any time a licensee works with a third party, or customer; the licensee is responsible for adhering to state and federal consumer protection laws as well as the ethical requirements imposed by professional associations and state regulators. In addition, the licensee's duties to the customer include

Reasonable care and skill in performance;

Honest and fair dealing; and

Disclosure of all facts that the licensee knows or should reasonably be expected to know that materially affect the value or desirability of the property.

As part of the recent trend toward public protection of purchasers, many states now have statutes requiring disclosure of property conditions to prospective buyers. Prepurchase structural inspections, termite infestation reports or other protective documentation may also be used. The actual disclosures that sellers are required to make vary according to each state's law.

☞ ***An agent owes a customer the duties of reasonable care and skill; honest and fair dealing; and disclosure of known facts.***

PRINCIPAL AND AGENT'S LIABILITIES TOWARD THIRD PARTIES

The principal is liable for the principal's own acts, as well as those of the agent performed on the principal's behalf. The principal is liable for torts (physical injury or property damage) committed by an agent who is an employee (not an independent contractor) and is acting in the scope of the employment.

An agent will be liable to third persons for any tort or other act such as a fraudulent misrepresentation that the agent performs. The agent also will be liable for tortious or other acts of the principal in which the agent **"acquiesces"** (**silence**) whether the agent does so by act or omission.

The agent would be liable for:

- ♦ Injury to the victims' property or person.
- ♦ Negligent and fraudulent misrepresentation:
- ♦ May be a statement made recklessly and carelessly without sufficient knowledge to justify the statement.
- ♦ May be from **"silence"** or known material facts that the broker should disclose whether asked or not. If the principal supplies the agent with false information and the agent repeats such misrepresentations, the agent is not liable.
- ♦ An **"As Is Clause"** in the deposit receipt does not eliminate the duty to disclose material facts.
- ♦ An agent incurs no liability if agent fails to disclose (not a material fact) that:
 - Occupant died in the house more than 3 years before;



REAL ESTATE PRACTICE

- Previous occupant had or died of AIDS death.
- An occupant's death from AIDS or AIDS related illness, or any other contagious disease, is a highly emotional issue. Brokers must strive to balance the principle of full disclosure against the right to privacy. Disclosing casually that a occupant or former occupant died, or is dying, from AIDS might very well in violation of that persons civil rights and might expose the broker to civil or criminal penalties. By law sellers, brokers and landlords have no liability for failure to disclose a prior occupants death or its cause after three years.
- ♦ The broker does not have to disclose cause of death unless there is a direct inquiry.
- ♦ If a broker misrepresents a property to a buyer, he could cause the buyer to be subjected to a rescission of the contract and a civil suit for damages because of the fraud.
- ♦ If a broker relies on false information give by seller and buyer rescinds, broker is entitled to a full commission and indemnity from legal action by the buyer.

RIGHTS OF THE AGENT AGAINST THE PRINCIPAL (MAY ENTITLE COMMISSION)

The broker is entitled to a commission when:

- ♦ He secures a valid binding contract upon terms and conditions agreeable to the seller. If the seller and buyer later rescind, the broker still earns a commission based on the listing contract.
- ♦ He produces a buyer **“ready, willing and able to purchase”** upon the exact terms of the listing.
- ♦ **“Ready and Willing Buyer”** means a buyer is willing to enter into a binding contract. **“Able”** means a buyer is financially able to buy.

☞ ***In the event, when a seller is awarded liquidated damages on a purchase deposit, the seller (maximum 3% of purchase price), the damages are usually split 50%-50% between the seller and listing agent.***

TERMINATION OF AGENCY

An agency may be terminated for any of the following reasons:

The agency relationship between a seller and a real estate broker can be terminated either by

Death or incapacity of either party (notice of death is not necessary)

Destruction or condemnation of the property

Expiration of the terms of the agency

Mutual agreement by all parties to the contract

6: AGENCY LAW

Breach by one of the parties, such as abandonment by the agent or revocation by the principal (in which case the breaching party might be liable for damages)

By operation of law, as in bankruptcy of the principal (bankruptcy terminates the agency contract, and title to the property transfers to a court appointed receiver)

Completion, performance or fulfillment of the purpose for which the agency was created

An agency coupled with an interest is an agency relationship in which the agent is given an interest in the subject of the agency, such as the property being sold. An agency coupled with an interest cannot be revoked by the principal or be terminated upon the principal's death.

☞ ***Example: A broker agrees to provide the financing for a condominium building being constructed by a developer in exchange for the exclusive right to sell the units once the building is completed. The developer may not revoke the listing agreement once the broker has provided the financing because this is an agency coupled with an interest.***

Acts of the parties

When both parties have fulfilled their duties of the agreement, the agency relationship is terminated even before the specified termination date in the listing.

Mutual agreement to terminate

If both parties agree to terminate, it is considered termination by mutual agreement.

Unilateral cancellation

The seller or agent may terminate the agency unilaterally but he or she might be liable for damages to the other party. When the seller revokes the listing before it expires, but he or she may be liable for the expenses incurred by the listing agent or a commission, if there is "ready and willing buyer."

Expiration of the term of the listing agreement

The "Exclusive Agency Listing Agreement" and the "Exclusive Authorization and Right to Sell Listing Agreement" have a definite termination date. These listings will end automatically on the stated date if not terminated in some other way before that date. The other type of listing, an open listing, does not require a termination date because it can be terminated in any time.

Extinction / Destruction of the subject

If the property is destroyed or damaged by certain causes, such as fire or earthquake, the listing agreement is terminated.

Death or Incapacity of either the principal or the agent

If either the agent or seller is incapable to complete the agency relationship (personal contract) it is terminated.

Environmental Hazards



REAL ESTATE PRACTICE

Disclosure of environmental health hazards, which can render properties unusable for the buyer's intended purpose, may be required. For instance, federal law requires the disclosure of lead-based paint hazards. Frequently, the buyer or the buyer's mortgage lender requests inspections or tests to determine the presence or level of risk.

- ☞ ***Licensees are urged to obtain advice from state and local authorities responsible for environmental regulation whenever the following conditions may be present: toxic waste dumping; underground storage tanks; contaminated soil or water; nearby chemical or nuclear facilities; and health hazards such as radon, asbestos and lead paint.***

Opinion versus Fact

Brokers, salespersons and other staff members must always be careful about the statements they make. They must be sure that the customer understands whether the statement is an opinion or a fact. Statements of opinion are permissible only as long as they are offered as *opinions* and without any intention to deceive.

Statements of fact, however, must be accurate. Exaggeration of a property's benefits is called puffing. While puffing is legal, licensees must ensure that none of their statements can be interpreted as fraudulent.

Fraud is the *intentional misrepresentation* of a material fact in such a way as to harm or take advantage of another person. That includes not only making false statements about a property, but also intentionally concealing or failing to disclose important facts.

The misrepresentation or omission does not have to be intentional to result in broker liability. A **negligent misrepresentation** occurs when the broker *should have known* that a statement about a material fact was false. The fact that the broker may actually be ignorant about the issue is no excuse. If the buyer relies on the broker's statement, the broker is liable for any damages that result. Similarly, if a broker accidentally fails to perform some act - for instance, he or she forgets to deliver a counter offer - the broker may be liable for damages that result from such a negligent omission.

- ☞ ***Example1: While showing a potential buyer a very average looking house, broker Q described even its plainest features as "charming" and "beautiful." Because the statements were obviously Q's personal opinions, designed to encourage a positive feeling about the property (or puff it up), their truth or falsity is not an issue.***
- ☞ ***Example 2: Broker G was asked by a potential buyer if a particular neighborhood was safe. Although G knew that the area was experiencing a skyrocketing rate of violent crime, G assured the buyer that no problem existed. G also neglected to inform the buyer that the lot next to the house the buyer was considering had been sold to a waste disposal company for use as a toxic dump. Both are examples of fraudulent misrepresentation***

If a contract to purchase real estate is obtained as a result of fraudulent misstatements, the contract may be disaffirmed or renounced by the purchaser. In such a case, the broker not

6: AGENCY LAW

only loses a commission, but can be liable for damages if either party suffers loss because of the misrepresentation. If the licensee's misstatements were based on the owner's own inaccurate statements and the licensee had no independent duty to investigate their accuracy, the broker may be entitled to a commission, even if the buyer rescinds the sales contract.

Latent Defects

The seller has a duty to discover and disclose any known latent defects that threaten structural soundness or personal safety. A **latent defect** is a *hidden structural defect that would not be discovered by ordinary inspection*. Buyers have been able to either rescind the sales contract or receive damages when a seller fails to reveal known latent defects. For instance, sellers were found liable where a house was built over a ditch covered with decaying timber; a buried drain tile caused water to accumulate; and a driveway was built partly on adjoining property. The courts have also decided in favor of the buyer when the seller neglected to reveal violations of zoning or building codes.

In addition to the seller's duty to disclose latent defects, in some states the agent has an independent duty to conduct a reasonably competent and diligent inspection of the property. It is the licensee's duty to discover any material facts that may affect the property's value or desirability, whether or not they are known to or disclosed by the seller. Any such material facts discovered by the licensee must be disclosed to prospective buyers. If the licensee should have known about a substantial defect that is detected later by the buyer, the agent may be liable to the buyer for any damages resulting from that defect.

☞ ***Example: Broker K knew that a house had been built on a landfill. A few days after the house was listed, one of K's salespersons noticed that the living room floor was uneven and sagging in places. Both K and the salesperson have a duty to conduct further investigations into the structural soundness of the property. They cannot simply ignore the problem or place throw rugs over particularly bad spots and hope buyers won't look underneath.***

Stigmatized Properties

Stigmatized properties are properties that society has branded undesirable because of events that occurred there. Typically, the stigma is a criminal event, such as homicide, illegal drug manufacturing or gang-related activity, or a tragedy, such as suicide. However, properties have even been stigmatized by rumors that they are haunted. Because of the potential liability to a licensee for inadequately researching and disclosing material facts concerning a property's condition, licensees should seek competent counsel when dealing with a stigmatized property. Some states have laws regarding the disclosure of information about such properties, designed to protect sellers and local property values against a baseless psychological reaction. In other states, the licensee's responsibility may be difficult to define because the issue is not a physical defect, but merely a perception that a property is undesirable.

☞ ***A disclosure that a property's previous owner or occupant died of AIDS or was HIV-positive constitutes illegal discrimination against the handicapped under the Federal Fair Housing Act.***



LISTINGS (AUTHORIZATION TO SELL)

Listings are employment contracts by which a principal employs an agent to do certain things for the principal. All real estate transactions originate from one form or another of listing contracts. This may authorize the agent to sell, lease or exchange or to negotiate a loan. There are three basic types of listings used in California. They are:

1. Exclusive Right to Sell Listing
2. Exclusive Agency Listing
3. Open Listing.

A **net listing** exists and must be used with other listing. It is seldom used.

☞ ***Listings are not assignable and death of either party cancels a listing, unless the seller is a corporation (which lives forever). A listing agreement signed by one spouse is enforceable.***

All real estate listings must be in writing, and must be in writing to be enforceable.

All listings belong to the broker, not the salesperson. If you move, most brokers allow you to take your listings.

A listing may be for any period of time. Real Estate law requires that exclusive listings must have a definite, final termination date.

EXCLUSIVE RIGHT TO SELL LISTING (ALWAYS COMMISSION)

Exclusive right to sell is the most common type of listing. It is a contract in which the seller agrees to pay the broker a commission regardless of who sells the property, even if the owner, himself/herself sells the property. It:

1. Must have a definite termination date.
2. Usually contains a **“safety clause”** that provides for a commission if the sale is made within a specified time after the listing expires to a buyer introduced during the listing period. This is included in a written list submitted prior to the expiration of the contract.
3. This would not apply if seller enters into a valid listing agreement with another broker after the termination of this Agreement.
4. This type of agreement is an example of executory bilateral contract.

EXCLUSIVE AGENCY LISTING (NO COMMISSION IF SOLD BY SELLER)

An **exclusive agency listing** is a contract in which the seller agrees to pay a commission if the property is sold by the broker or any other broker, the seller however,

1. Reserves the right to sell the property himself and pay no commission.
2. There must be a definite termination date.

6: AGENCY LAW

The drawback of this listing is that the broker is, or could be, in competition with the owner for the sale.

Form 6-4: Exclusive Right to Sells Listing Form.



REAL ESTATE PRACTICE



CALIFORNIA
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EXCLUSIVE AUTHORIZATION AND RIGHT TO SELL

1. **EXCLUSIVE RIGHT TO SELL:** _____ ("Seller") hereby employs and grants _____ ("Broker") the exclusive and irrevocable right, commencing on (date) _____ and expiring at 11:59 P.M. on (date) _____ ("Listing Period") to sell or exchange the real property in the City of _____, County of _____, California, described as: _____ ("Property").
2. **TERMS OF SALE:**
 - A. **LIST PRICE:** The listing price shall be _____ (\$ _____).
 - B. **PERSONAL PROPERTY:** The following items of personal property are included in the above price: _____
 - C. **ADDITIONAL TERMS:** _____
3. **MULTIPLE LISTING SERVICE:** Information about this listing ☐ will, ☐ will not, be provided to a multiple listing service ("MLS") of Broker's selection and the Property sale, price, terms, and financing will be provided to the MLS for publication, dissemination and use by persons and entities on terms approved by the MLS. Seller authorizes Broker to comply with all applicable MLS rules.
4. **TITLE:** Seller warrants that Seller and no other persons have title to the Property, except as follows: _____
5. **COMPENSATION TO BROKER:**
Notice: The amount or rate of real estate commissions is not fixed by law. They are set by each Broker individually and may be negotiable between Seller and Broker.
 - A. Seller agrees to pay to Broker as compensation for services irrespective of agency relationship(s), either ☐ _____ percent of the listing price (or if a sales contract is entered into, of the sales price), or ☐ \$ _____ as follows:
 1. If Broker, Seller, cooperating broker, or any other person, produces a buyer(s) who offers to purchase the Property on the above price and terms, or on any price and terms acceptable to Seller during the Listing Period, or any extension;
 2. If within _____ calendar days after expiration of the Listing Period or any extension, the Property is sold, conveyed, leased, or otherwise transferred to anyone with whom Broker or a cooperating broker has had negotiations, provided that Broker gives Seller, prior to or within 5 calendar days after expiration of the Listing Period or any extension, a written notice with the name(s) of the prospective purchaser(s);
 3. If, without Broker's prior written consent, the Property is withdrawn from sale, conveyed, leased, rented, otherwise transferred, or made unmarketable by a voluntary act of Seller during the Listing Period, or any extension.
 - B. If completion of the sale is prevented by a party to the transaction other than Seller, then compensation due under paragraph 5A shall be payable only if and when Seller collects damages by suit, settlement, or otherwise, and then in an amount equal to the lesser of one-half of the damages recovered or the above compensation, after first deducting title and escrow expenses and the expenses of collection, if any.
 - C. In addition, Seller agrees to pay: _____
 - D. Broker is authorized to cooperate with other brokers, and divide with other brokers the above compensation in any manner acceptable to Broker;
 - E. Seller hereby irrevocably assigns to Broker the above compensation from Seller's funds and proceeds in escrow.
 - F. Seller warrants that Seller has no obligation to pay compensation to any other broker regarding the transfer of the Property except: _____

If the Property is sold to anyone listed above during the time Seller is obligated to compensate another broker: (a) Broker is not entitled to compensation under this Agreement and (b) Broker is not obligated to represent Seller with respect to such transaction.
6. **BROKER'S AND SELLER'S DUTIES:** Broker agrees to exercise reasonable effort and due diligence to achieve the purposes of this Agreement, and is authorized to advertise and market the Property in any medium selected by Broker. Seller agrees to consider offers presented by Broker, and to act in good faith toward accomplishing the sale of the Property. Seller further agrees, regardless of responsibility, to indemnify, defend and hold Broker harmless from all claims, disputes, litigation, judgments and attorney's fees arising from any incorrect information supplied by Seller, whether contained in any document, omitted therefrom, or otherwise, or from any material facts which Seller knows but fails to disclose.
7. **AGENCY RELATIONSHIPS:** Broker shall act as the agent for Seller in any resulting transaction. Depending upon the circumstances, it may be necessary or appropriate for Broker to act as an agent for both Seller and buyer, exchange party, or one or more additional parties ("Buyer"). Broker shall, as soon as practicable, disclose to Seller any election to act as a dual agent representing both Seller and Buyer. If a Buyer is procured directly by Broker or an associate licensee in Broker's firm, Seller hereby consents to Broker acting as a dual agent for Seller and such Buyer. In the event of an exchange, Seller hereby consents to Broker collecting compensation from additional parties for services rendered, provided there is disclosure to all parties of such agency and compensation. Seller understands that Broker may have or obtain listings on other properties, and that potential buyers may consider, make offers on, or purchase through Broker, property the same as or similar to Seller's Property. Seller consents to Broker's representation of sellers and buyers of other properties before, during, and after the expiration of this Agreement.
8. **DEPOSIT:** Broker is authorized to accept and hold on Seller's behalf a deposit to be applied toward the sales price.

Seller and Broker acknowledge receipt of copy of this page, which constitutes Page 1 of _____ Pages.
 Seller's Initials (_____) (_____) Broker's Initials (_____) (_____)

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PRINT DATE
 8 MAY '98

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 or Designee _____
 Date _____



BROKER'S COPY

Property Address: _____

9. LOCKBOX:

- A. A lockbox is designed to hold a key to the Property to permit access to the Property by Broker, cooperating brokers, MLS participants, their authorized licensees and representatives, and accompanied prospective buyers.
- B. Broker, cooperating brokers, MLS and Associations/Boards of REALTORS® are not insurers against theft, loss, vandalism, or damage attributed to the use of a lockbox. Seller is advised to verify the existence of, or obtain, appropriate insurance through Seller's own insurance broker.
- C. (If checked:) ☐ Seller authorizes Broker to install a lockbox. If Seller does not occupy the Property, Seller shall be responsible for obtaining occupant(s)' written permission for use of a lockbox.

10. SIGN: (If checked:) ☐ Seller authorizes Broker to install a FOR SALE/SOLD sign on the Property.

11. DISPUTE RESOLUTION:

- A. **MEDIATION:** Seller and Broker agree to mediate any dispute or claim arising between them out of this Agreement, or any resulting transaction, before resorting to arbitration or court action, subject to paragraph 11C below. Mediation fees, if any, shall be divided equally among the parties involved. If any party commences an action based on a dispute or claim to which this paragraph applies, without first attempting to resolve the matter through mediation, then that party shall not be entitled to recover attorney's fees, even if they would otherwise be available to that party in any such action. THIS MEDIATION PROVISION APPLIES WHETHER OR NOT THE ARBITRATION PROVISION IS INITIALED.
- B. **ARBITRATION OF DISPUTES:** Seller and Broker agree that any dispute or claim arising between them regarding the obligation to pay compensation under this Agreement, which is not settled through mediation, shall be decided by neutral, binding arbitration, subject to paragraph 11C below. The arbitrator shall be a retired judge or justice, or an attorney with at least five years of residential real estate experience, unless the parties mutually agree to a different arbitrator, who shall render an award in accordance with substantive California Law. In all other respects, the arbitration shall be conducted in accordance with Part III, Title 9 of the California Code of Civil Procedure. Judgment upon the award of the arbitrator(s) may be entered in any court having jurisdiction. The parties shall have the right to discovery in accordance with Code of Civil Procedure §1283.05.

"NOTICE: BY INITIALING IN THE SPACE BELOW YOU ARE AGREEING TO HAVE ANY DISPUTE ARISING OUT OF THE MATTERS INCLUDED IN THE 'ARBITRATION OF DISPUTES' PROVISION DECIDED BY NEUTRAL ARBITRATION AS PROVIDED BY CALIFORNIA LAW AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. BY INITIALING IN THE SPACE BELOW YOU ARE GIVING UP YOUR JUDICIAL RIGHTS TO DISCOVERY AND APPEAL, UNLESS THOSE RIGHTS ARE SPECIFICALLY INCLUDED IN THE 'ARBITRATION OF DISPUTES' PROVISION. IF YOU REFUSE TO SUBMIT TO ARBITRATION AFTER AGREEING TO THIS PROVISION, YOU MAY BE COMPELLED TO ARBITRATE UNDER THE AUTHORITY OF THE CALIFORNIA CODE OF CIVIL PROCEDURE. YOUR AGREEMENT TO THIS ARBITRATION PROVISION IS VOLUNTARY."

"WE HAVE READ AND UNDERSTAND THE FOREGOING AND AGREE TO SUBMIT DISPUTES ARISING OUT OF THE MATTERS INCLUDED IN THE 'ARBITRATION OF DISPUTES' PROVISION TO NEUTRAL ARBITRATION."

Seller's Initials _____

Broker's Initials _____

- C. **EXCLUSIONS FROM MEDIATION AND ARBITRATION:** The following matters are excluded from Mediation and Arbitration hereunder: (a) A judicial or non-judicial foreclosure or other action or proceeding to enforce a deed of trust, mortgage, or installment land sale contract as defined in Civil Code §2985; (b) An unlawful detainer action; (c) The filing or enforcement of a mechanic's lien; (d) Any matter which is within the jurisdiction of a probate, small claims, or bankruptcy court; and (e) An action for bodily injury or wrongful death, or for latent or patent defects to which Code of Civil Procedure §337.1 or §337.15 applies. The filing of a court action to enable the recording of a notice of pending action, for order of attachment, receivership, injunction, or other provisional remedies, shall not constitute a violation of the mediation and arbitration provisions.

12. **EQUAL HOUSING OPPORTUNITY:** The Property is offered in compliance with federal, state, and local anti-discrimination laws.

13. **ATTORNEY'S FEES:** In any action, proceeding, or arbitration between Seller and Broker regarding the obligation to pay compensation under this Agreement, the prevailing Seller or Broker shall be entitled to reasonable attorney's fees and costs, except as provided in paragraph 11A.

14. **ADDITIONAL TERMS:** _____

15. **ENTIRE CONTRACT:** All prior discussions, negotiations, and agreements between the parties concerning the subject matter of this Agreement are superseded by this Agreement, which constitutes the entire contract and a complete and exclusive expression of their agreement, and may not be contradicted by evidence of any prior agreement or contemporaneous oral agreement. This Agreement and any supplement, addendum, or modification, including any photocopy or facsimile, may be executed in counterparts.

Seller warrants that Seller is the owner of the Property or has the authority to execute this contract. Seller acknowledges that Seller has read and understands this Agreement, and has received a copy.

Seller _____ Date _____ Seller _____ Date _____

Address _____ Address _____

City _____ State _____ Zip _____ City _____ State _____ Zip _____

Real Estate Broker (Firm) _____ By (Agent) _____ Date _____

Address _____ Telephone _____ Fax _____

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R MAY '96

Page 2 of _____ Pages.

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or Designee _____
Date _____





OPEN LISTING (SELLING AGENT EARNS COMMISSION)

An **open listing** is a contract signed by the seller authorizing the broker to act as agent on a **non-exclusive** basis. Not popular.

- ♦ Open listing is unilateral, only seller promises. Exclusive listings are bilateral.
- ♦ Usually, *no termination date* is given.
- ♦ There is no limit to the number of brokers that may be hired.
- ♦ The seller is not required to notify agent in event of sale.
- ♦ The sale cancels all open listings.
- ♦ The seller may sell the property himself without liability for commission to any broker.
- ♦ The broker who is **“procuring cause”** is the one who earns a commission.

NET LISTING (SELLER GETS NET)

A **net listing** is a contract in which the compensation is not definitely determined. The broker's commission is any amount above the selling price set by the seller.

- ♦ A net listing must be used with one of the other three listings. Seldom used and not recommended to novice agents.
- ♦ The agent must disclose the amount of compensation prior to or at the same time the principal binds himself to the transaction.
- ♦ Although perfectly legitimate, but the principal should be fully informed of compensation to avoid a charge of fraud or misrepresentation.

MULTIPLE LISTING SERVICE

A **multiple listing service** is an association pooled by a group of brokers who submit all listings (sales, rentals) to a central bureau which makes the entire list available to all its members to find an interested buyer.

1. The listing form is usually an “Exclusive Right to Sell.”
2. Members (cooperating brokers) share commission specified in the listing.

Seller will receive a wider market exposure because it will be shown by other cooperating brokers.

MISCELLANEOUS PROVISIONS

- ♦ The broker must be licensed at the time the authorized act is to be performed. But, not necessarily when a commission is paid.
- ♦ A **pocket listing** is the unethical practice of not giving a new listing to the MLS until the listing broker first tries to sell it within the company or by him/herself.

6: AGENCY LAW

- ♦ Commission rates are negotiable; No documents can imply commissions are not negotiable.
- ♦ If an offer meets the exact terms of the listing, the agent has earned the commission even if the owner refuses to sell to the buyer.
- ♦ Copies of listings must be given to each party who signs the contracts at the time of signing.

SELLER TRANSFER DISCLOSURE ACT

A 1984 California Court of Appeals ruling in the case of *Easton vs. Strassburger* greatly extended the liability of brokers engaged in real estate sales.

The agent has a duty to inspect and disclose. Both the listing and selling agents must conduct a reasonable, competent and diligent inspection of residential property. They must disclose, on the Transfer Disclosure Statement (TDS), any relevant facts that materially affect the value or desirability of the property.

The law requires sellers of residential property to provide prospective buyers with **Real Estate Transfer Disclosure Statement**. This statement (Form 6-3) identifies items of value attached to the structure or land and states whether these items are operational. It also asks the seller to identify any structural or material defects. The obligation to prepare and deliver the TDS to the prospective buyer is imposed upon the seller and the seller's broker.

Requirements

- ♦ Seller and agents must provide buyer with detailed statement about the condition of the real property, including soil conditions.
- ♦ Applies to sales and lease of one-to-four units of residential property.
- ♦ Not required for probate sales, trustee sales, husband-wife transfers, or bankruptcies.
- ♦ Brokers are allowed to visually inspect property and disclose pertinent information.
- ♦ The Special Studies Zone Act requires disclosure on properties located close to earthquake fault lines.

Summary

The law of agency governs the principal-agent relationship. Agency relationships may be expressed either by the words of the parties or by written agreement or may be implied by the parties' actions. In single agency relationships, the broker or agent represents one party, either the buyer or the seller, in the transaction. If the agent elicits the assistance of other brokers who cooperate in the transaction, the other brokers may become subagents of the principal. Many states have adopted statutes that replace the common law of agency and that establish the responsibilities and duties of the parties.

Representing two opposing parties in the same transaction constitutes dual agency. Licensees must be careful not to create dual agency when none was intended. This unintentional or inadvertent dual agency can result in the sales contract being rescinded and the commission being forfeited or in a lawsuit. Disclosed dual agency requires that both principals be informed of and consent to the broker's multiple representations. In any case, the prospective parties in the transaction should be informed about the agency alternatives and how client-level versus customer-level services differ. Many states have mandatory



REAL ESTATE PRACTICE

agency disclosure laws. The source of compensation for the client services does not determine which party is represented.

Licensees have certain duties and obligations to their customers as well. Consumers are entitled to fair and honest dealings and to the information necessary for them to make informed decisions. This includes accurate information about the property. Some states have mandatory property disclosure laws.

6: AGENCY LAW

Figure 6-2: Power of Attorney - Special

RECORDING REQUESTED BY:
AND WHEN RECORDED MAIL TO:
NAME:
ADDRESS:

POWER OF ATTORNEY - SPECIAL

KNOW ALL MEN BY THESE PRESENTS: That I, _____, the undersigned (jointly and severally if more than one, hereinafter collectively principal), hereby make, constitute and appoint _____

principal(s) true and lawful attorney to act for principal and in principal(s) name, place and stead and for principal(s) use and benefit:

To: _____

Principal hereby grants to said attorney in fact full power and authority to do and perform each and every act and thing which may be necessary, or convenient, in connection with any of the foregoing, as fully, to all intents and purposes, as principal might or could do if personally present, hereby ratifying and confirming all that our said attorney in fact shall lawfully do so cause to be done by authority hereof.

Wherever the context so requires, the singular number includes the plural.

Dated _____

STATE OF CALIFORNIA

COUNTY OF _____}SS

On _____ before me, a Notary Public in and for State, personally appeared.

Personally known to me or proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature _____



REAL ESTATE PRACTICE

Figure 6-3: Revocation of Power of Attorney

RECORDING REQUESTED BY:
AND WHEN RECORDED MAIL TO:
NAME:
ADDRESS:
CITY:
STATE & ZIP:

REVOCATION OF POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS: That the _____

Power of Attorney executed by _____ On the ____ day of ____ and
recorded in Book _____, at Page _____ Of _____ County, State of _____

By which _____ constituted _____ Attorney for the
purpose in said Power of Attorney set forth, is hereby wholly revoked, cancelled and annulled.

In Witness Whereof, _____ has (have) hereunto set _____
hand(s) and seal(s) this _____ day of _ _____

STATE OF CALIFORNIA

COUNTY OF _____ }SS

On _____ before me, a Notary Public in and for State, personally appeared.

Personally known to me or proved to me on the basis of satisfactory evidence to be the person(s)
whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they
executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on
the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the
instrument.

WITNESS my hand and official seal.

Signature _____

6: AGENCY LAW

CHAPTER QUIZ

1. The relationship between broker and seller is generally what type of agency?
 - A. Special
 - B. General
 - C. Implied
 - D. Universal
2. The term **fiduciary** refers to the:
 - A. Sale of real property.
 - B. Person who gives someone else the legal power to act on his or her behalf.
 - C. Person who has legal power to act on behalf of another.
 - D. Principal-agent relationship.
3. Which of the following statements is true of a real estate broker acting as the agent of the seller?
 - A. The broker is obligated to render faithful service to the seller.
 - B. The broker can disclose personal information to a buyer if it increases the likelihood of a sale.
 - C. The broker can agree to a change in price without the seller's approval.
 - D. The broker can accept a commission from the buyer without the seller's approval.
4. Y is a real estate broker. W lists a home with Y for \$89,500. Later that same day, Q comes into Y's office and asks for general information about homes for sale in the \$30,000 to \$40,000 price range. Based on these facts, which of the following statements is true?
 - A. Both W and Q are Y's customers.
 - B. W is Y's client; Q is a customer.
 - C. Y owes fiduciary duties to both W and Q.
 - D. If Q asks Y to be Q's buyer representative, Y must decline because of the preexisting agreement with W.
5. In a dual agency situation, a broker may collect a commission from both the seller and the buyer if:
 - A. The broker holds a state license.
 - B. The buyer and the seller are related by blood or marriage.
 - C. Both parties give their informed consent to the dual compensation.
 - D. Both parties are represented by attorneys.
6. Which of the following events will terminate an agency in a broker-seller relationship?
 - A. The broker discovers that the market value of the property is such that he or she will not make an adequate commission.
 - B. The owner declares personal bankruptcy.
 - C. The owner abandons the property.
 - D. The broker appoints other brokers to help sell the property.
7. Under the law of agency, a real estate broker owes all of the following duties to the principal **except**:



REAL ESTATE PRACTICE

- A. Care
 - B. Obedience
 - C. Disclosure
 - D. Advertising
8. A real estate broker hired by an owner to sell a parcel of real estate must comply with:
- A. The common law of agency, even if a state agency statute exists that abrogates common law.
 - B. Dual agency requirements.
 - C. The concept of caveat emptor.
 - D. All lawful instructions of the owner.
9. Broker D lists K's residence. For various reasons, K must sell the house quickly. To expedite the sale, D tells a prospective purchaser that K will accept at least \$5,000 less than the asking price for the property. Based on these facts, which of the following statements is true?
- A. D has not violated his agency responsibilities to K.
 - B. D should have disclosed this information, regardless of its accuracy.
 - C. The disclosure was improper, regardless of D's motive.
 - D. The relationship between *D* and *K* is referred to as a *general agency relationship*.
10. What does the phrase the law of agency is a common-law doctrine mean?
- A. It is a legal doctrine that is not unusual.
 - B. It is one of the rules of society enacted by legislatures and other governing bodies.
 - C. It is a body of law established by tradition and court decisions.
 - D. It may not be superseded by statutory law.

Answers: 1-A, 2-D, 3-A, 4-B, 5-C, 6-B, 7-D, 8-D, 9-C, 10-C

CHAPTER 7: TRUST FUNDS & FAIR HOUSING



Preview

A trust fund is defined as either money, or things of value, given to another (mortgage loan broker) on behalf of a person (principal) in the performance of an act on behalf of that person (principal) which are being held for the benefit of others (principal or third parties). The trust funds may be paid out to the escrow, lender, credit bureau, appraiser, or the mortgage loan broker. In this chapter we discuss the legal requirements for receiving and handling trust funds in a real estate transaction.

When you have completed this chapter you should be able to:

- ♦ Differentiate trust funds from nontrust funds.
- ♦ Outline trust fund bank account requirements.
- ♦ Discuss trust account items, such as interest, reconciliation, and forms.
- ♦ Describe violations of trust fund handling and audit procedures.

TRUST FUND

Real estate mortgage loan brokers receive trust funds in the normal course of doing business. They receive these funds on behalf of others and must handle and oversee these funds in accordance with legal standards.

In a real estate transaction the licensee handles the funds of another in the following cases:

- ♦ Borrower's deposit on a loan that may pay for the credit report and/or appraisal fee
- ♦ Principal's funds that would pay points, fees, charges, and costs

The broker is responsible for all trust fund items of value received by the broker or by any licensee working under the broker's license, such as a broker, salesperson, or loan agent. The item received may be cash, a loan note, a check, or other items. The item may be payable to the broker, an escrow company, a lender, a title company, an abstract attorney, or another principal. Proper records of all items received must be maintained by the broker.

Trust funds must be placed in a neutral escrow depository, unless written instruction and authorization from the principal states instructions to the contrary. If the principal instructs the broker or another party, such as an escrow agent, the funds may be deposited into an interest-



REAL ESTATE PRACTICE

bearing account (Business and Professions Code 10145). The broker may also obtain written authorization from the principal for any length of time exceeding the next business day should the principal establish other business practices.

For many years a trust fund bank account could be opened with a maximum of \$100 of the broker's funds. In 1996 the real estate commissioner held hearings and increased the maximum amount to \$200. These funds are not considered the funds of any principal. The purpose of this exception about mixing broker and principal funds is to allow the broker to pay for bank fees and similar charges from the broker's funds rather than from the principal funds. These items may include the costs for printing checks, endorsement stamps, deposit slips, return check fees, and similar. It should be noted, however, that no minimum amount is required and the broker may wish to have none of their funds in the trust account. Some brokers direct the bank to debit a separate bank account, such as the general business account of the broker, for any charges or fees incurred by the trust account.

Receiving funds on behalf of others creates a fiduciary responsibility. Compliance with established legal standards may not necessarily have a direct bearing on the financial success of the transaction. However, noncompliance may result in unfavorable business consequences. Improper handling of trust funds is cause for revocation or suspension of a real estate license in addition to the possibility of being held financially liable for damages incurred by a principal.

Trust funds are not the funds of the agent. Nontrust funds are funds received by the licensee that are not held for the benefit of another. Typically, nontrust funds are the real estate commission, general operating funds of the business office, and the rents and deposits from broker-owned real estate. These other types of funds are not subject to the real estate law nor the DRE's regulations. DRE, however, may have jurisdiction to look into these funds to determine that they are in fact non-trust funds.

As of January 1, 1996, Assembly Bill 1902 requires California licensees to take a continuing education credit course on the subject of trust fund handling for each 4-year license renewal. The purpose of this course requirement for both salesperson and broker licensees is to define responsibilities and liabilities where trust funds are involved. The DRE wants licensees to gain knowledge and understanding of the laws and regulations pertaining to the handling of trust funds or to the property that belongs to another person (principal).

ADVANCE FEE TRUST FUNDS

Advance fees are amounts of money collected by a broker to cover the cost of services to be performed in arranging a loan. The advance fee is any amount claimed, demanded, charged, received, collected, contracted, or issued for the purpose of soliciting borrowers or lenders or to negotiate loans on real property.

DRE Regulation 2970 sets forth the basic requirements of advance fee agreements. In California advance-fees may be collected when an advance-fee agreement has been approved by the DRE. The commissioner may require that any or all materials used in obtaining advance fee agreements be submitted to the DRE at least 10 calendar days before they are used. This would include the contract form and letters or cards used to solicit prospective principals. If the commissioner determines that the material(s) would tend to mislead a prospective principal, the DRE may order that it not be used, disseminated, or published. Notice from the DRE is given within 10 calendar days of receipt of the materials.

7: TRUST FUNDS & FAIR HOUSING

No person, except a broker; may claim, demand, charge, receive, collect, or contract for an advance fee for Soliciting lenders on behalf of borrowers. No person, except a broker, may perform services for borrowers in connection with loans to be secured directly or collaterally by a lien on real property before the borrower becomes obligated to complete the loan. Exempt from this section is an advance fee by a bank, savings association, credit union, title insurer, or controlled escrow company. Appraisal fees and credit fees are not advance fees provided that the broker collect only an amount reasonably close to the actual cost, *and* refund any amount collected that is over and above the actual amount spent when that sum is known.

TRUST FUND BANK ACCOUNTS

Any real estate broker who contracts for, or collects an advance fee from any other person, must deposit the fee into a trust account. The account may be at a bank or any other recognized depository. Withdrawals may only be expended for the benefit of the principal according to Business and Professions Code 10146. Earned commissions may remain in a trust bank account for no more than 30 days. Failure to remove earned commissions within that time is a violation of the real estate law.

The trust account must meet the following criteria to be in compliance with the Business and Professions Code Section 10145 and DRE 2830:

- ♦ Designated as a trust account in the name of the broker, as *trustee*
- ♦ Maintained with a bank or recognized depository located in California
- ♦ Not an interest-bearing account for which prior written notice can by law or regulation be required by the financial institution as a condition to withdraw the funds-in other words, a “demand deposit” account

Trust fund records must be kept for 3 years. The period may begin from one of two dates: (1) close of escrow, or (2) employment agreement, if the transaction is not consummated, such as a loan arrangement agreement when no loan is *funded*.

Only certain persons may access the broker’s trust account DRE 2834:

- ♦ A corporate officer of a licensed real estate company
- ♦ A salesperson employed by the broker
- ♦ An unlicensed employee of the broker, who is bonded

A fidelity bond is required for each unlicensed employee who has access to the broker’s trust account. The bond must be held in the highest amount of the bank balance that each trust account would have at the beginning of each month. No bond is necessary for persons making deposits into a trust account, even though it would still be wise to have one. Employees who are authorized to make trust fund withdrawals must be bonded if they are not licensed.

No law exists that requires a licensee to have a trust fund bank account. Salespersons may not have a trust account for a principal. A broker who has such accounts must identify the parties who own the trust funds. Many licensees have principal funds payable directly to a third party, such as an escrow company, title company, or holding company rather than to the broker or mortgage loan broker firm. If principal trust funds are not placed into a broker’s trust fund account. However, the licensee is required to log the funds that were received and passed along. A computer accounting or a manual accounting system requires that the following information be documented:



REAL ESTATE PRACTICE

- ♦ Date the funds were received
- ♦ Name of the party from whom the funds were received
- ♦ Amount of funds received
- ♦ The form of funds received, such as cash, money order, note, etc.
- ♦ Identity of the entity to whom the funds were forwarded and the date.

Figure 7-1: Records of All Trust Funds Received

NOT PLACED IN BROKER'S TRUST ACCOUNT

Date Received	Form of Receipt (Cash, note, etc)	Amount	Received From	Description of Property or Other Identification	Disposition of Funds (To escrow, principal, trust account, or returned)	Date of Disposition

ACCOUNTING RECORDS AND DOCUMENTATION REQUIREMENTS

When a broker maintains a trust account, certain records must be kept. Brokers are instructed to maintain generally accepted accounting principles in the handling of a trust account to be in compliance with DRE Regulation 2831. The record should set forth in chronological order the following information in columnar form (Figure 7.2):

- ♦ Date funds were received
- ♦ Name of party from whom funds were received
- ♦ Amount of funds received
- ♦ Date of deposit of the trust funds
- ♦ Check number and date of trust fund disbursement
- ♦ Name of entity to whom trust funds were disbursed
- ♦ Daily balance for each separate principal's funds
- ♦ Daily balance of trust account

7: TRUST FUNDS & FAIR HOUSING

Figure 7-2: Trust Bank Account Record for All Trust Funds Deposited and Withdrawn (TAA-11)



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TRUST BANK ACCOUNT RECORD FOR ALL TRUST FUNDS DEPOSITED AND WITHDRAWN

Broker: _____

Address: _____

DATE	DEPOSIT (Received From)	OR	WITHDRAWAL (Paid To)	AMOUNT	BALANCE
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____

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OFFICE USE ONLY
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or Designee _____
Date _____



FORM TAA-11 REVISED 10/99

Jerry Fung
JF 2373 S Hacienda Blvd , Hacienda Heights CA 91745

Phone (626)336.6191

Fax: (626)336.8565

TS275011 ZFX



REAL ESTATE PRACTICE

In addition to keeping records for all funds received, the broker must keep a separate record for each beneficiary and transaction. The broker must account for all funds that have been deposited into the broker's trust account and any interest earned on the trust funds on deposit. Information for each record must be sufficient to identify both the parties to the transaction and the specific transaction. One party may have several different transactions with the broker, and each must have an individual accounting. One transaction may have several different principals, so that individual accounting records must be accounted for to each principal. Each accounting record should contain the following information in columnar form in chronological order (Figure 7.3):

- ◆ Date deposit received
- ◆ Amount of deposit received
- ◆ Date of each disbursement
- ◆ Check number of each disbursement
- ◆ Amount of each disbursement
- ◆ Balance after posting each transaction

Documents routinely involved in a brokerage transaction include all those involving the funds of a principal. The broker should have these documents available for inspection by the DRE. This would include a purchase contract, deposit receipt, and advance funds which must show when the deposit was received by the broker, as well as collection receipts from rental income or note collections. Bank deposit slips with the bank stamp and date along with escrow receipts must be documented. Canceled trust fund account checks and itemized check stubs are proper record keeping documents. Bank statements must be available with reconciliation data.

An example of the transaction in the samples shown for the broker trust records using Figures 7.1, 7.2, and 7.3 is shown in Figure 7.4. The mortgage loan broker received a \$50 check from the prospective purchasers on September 2, 2001. This event happened when the sales licensee and the Buyers asked for a pre-qualification. Their check 2104 was never deposited in the broker's trust account. Rather, it was forwarded directly to the credit company. The check was made payable to the broker, "American Funding Loan Services, Inc." and received by a DRE-licensed sales- person, the agent handling the Buyer transaction. This check was endorsed on the back of the check as follows:

American Funding Loan Services, by Jeffrey Pops, Without Recourse

Figure 7-3: Trust Bank Account Record for Each Beneficiary (TAB-11)

7: TRUST FUNDS & FAIR HOUSING



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TRUST BANK ACCOUNT RECORD FOR EACH BENEFICIARY

Owner: _____

Address: _____

Remarks: _____

DATE	DEPOSIT (Received From)	OR	WITHDRAWAL (Paid To)	AMOUNT	BALANCE
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____

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FORM TAB-11 REVISED 10/99

Jerry Fung
JF 2373 S Hacienda Blvd., Hacienda Heights CA 91745

Phone (626)336 6191

Fax: (626)336 8565

TS293624 ZFX



REAL ESTATE PRACTICE

On September 10, 2001, American Funding Loan Services, Inc. received funds that were placed into the broker's trust account. The event occurred after the Buyers and their sales licensee found a property and negotiated a contract with the sellers. Escrow opened on September 7 and the appraisal was ordered on September 15. The appraisal fee of \$250 was collected directly from the borrowers and deposited on September 11. The appraiser was not paid until the appraisal was delivered to American Funding Loan Services, Inc. by the appraiser on September 15, 2001. The purchasers earnest money deposit of \$2000 was placed directly into escrow by the sales licensee, with which the mortgage loan broker is not concerned.

Figure 7-4: Example of Trust Fund Records

RECORD OF ALL TRUST FUNDS RECEIVED

NOT PLACED IN BROKER'S TRUST ACCOUNT (see Figure 7.1)

Date Received	Form of Receipt (Cash, note, etc)	Amount	Received From	Description of Property or Other Identification	Disposition of Funds (To escrow, principal, trust account, or returned)	Date of Disposition
9/1/01	#2104	\$50.00	Jeffrey Pops & Steven Craps	Purchase loan on Walnut Canyon Road	Credit Report	9/3/01

Columnar Record Of All Trust Funds Received And Paid Out (see Figure 7.2)

Date Received	Form Whom Received or To Whom Paid	For (Description)	DEPOSIT (Received From)	WITHDRAWAL (Paid To)	Balance
			Amount Received <input type="checkbox"/> check <input type="checkbox"/> cash	Amount Paid Out <input type="checkbox"/> check <input type="checkbox"/> cash	
9/10/01	Jeffrey Pops and Steven Crapes	Walnut Canyon Road	\$250.00		\$6002.97
9/15/02	AIA Appraisal	Appraisal Report		\$250	\$5752.97

RECONCILIATION OF ACCOUNTING RECORDS

Each verified accounting to a principal or to the commissioner must include the following information (Business and Professions Code 10146):

- ♦ Name of the agent
- ♦ Name of the principal
- ♦ Description of the services rendered or to be rendered
- ♦ Identification of the trust fund account into which the advance fee has been deposited
- ♦ The amount of the advance fee collected

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- ♦ A list of the names and addresses of persons to whom information pertaining to the principal's loan requirements was submitted and the dates of submittal when an advance fee arranged is used
- ♦ The amount allocated or disbursed from the advance fee for:
 - A. Services rendered
 - B. Commissions paid to field agents and representatives
 - C. Overhead costs and profit

Trust fund accounts must be reviewed by the broker at least once each month. The DRE requires a broker to reconcile the trust account at least once a month (Business and Professions 10145, DRE Regulation 2831; Figure 7.4;).

A new DRE regulation, Section 2833, was adopted effective August 11, 1991, dealing with trust fund bank account over-ages. Entitled “**Unexplained Trust Account Overages,**” it defines such an amount, as funds that exceed the aggregate trust fund liability of accounts where the broker is unable to determine the ownership of the excess funds. The following are conditions for such funds:

1. Unless the broker can establish the ownership of such funds, the overage must be maintained in the broker's trust fund account or may be placed in a separate trust fund account established to hold such funds.
2. Overages may not be used to offset or cover shortages that may otherwise exist in the trust account.
3. A separate record of unexplained trust overages, including a separate subsidiary ledger to record the potential trust fund liability, must be maintained. The record must include the date of recording such funds as they are discovered as unexplained overage, and the broker must perform a monthly reconciliation of such funds.

THRESHOLD REPORTING REQUIREMENT

A broker meets the threshold of business activity when one of the following occurs: (1) 20 or more loans aggregating \$2 million, or (2) loan collections aggregating \$500,000 on behalf of nonexempt lenders (Business and Professions Code 10232). A threshold broker must file the following reports:



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Figure 7-5: Trust Bank Account Record for Each Property Managed (TAP-11)



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TRUST BANK ACCOUNT RECORD FOR ALL TRUST FUNDS DEPOSITED AND WITHDRAWN

Broker: _____

Address: _____

DATE	DEPOSIT (Received From)	OR	WITHDRAWAL (Paid To)	AMOUNT	BALANCE
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____
	Name: _____ <input type="checkbox"/> check <input type="checkbox"/> cash <input type="checkbox"/> _____ For: _____		Name: _____ Check # _____ For: _____	\$ _____	\$ _____

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Date _____



FORM TAA-11 REVISED 10/99

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TS275011 ZFX

7: TRUST FUNDS & FAIR HOUSING

Figure 7-6: RE 856: Trust Fund Bank Account Reconciliation

STATE OF CALIFORNIA

DEPARTMENT OF REAL ESTATE
MORTGAGE LENDING

TRUST FUND BANK ACCOUNT RECONCILIATION

REPORT DATE (DATE QUARTER ENDED)

RE 856 (Rev. 2/90)

GENERAL INFORMATION

- Complete *one* form for *each* trust fund bank account.
- Attach this form and copy of the corresponding bank statement to Trust Fund Status Report (RE 855).
- Refer to mailing instructions on RE 855.

NAME OF BROKER

REAL ESTATE ID#

NAME OF BANK

ACCOUNT NAME

ACCOUNT NUMBER

BANK BUSINESS ADDRESS (STREET, CITY, STATE, ZIP CODE)

REPORT PERIOD

DATE QUARTER ENDED (MM/DD/YY)

☐ FIRST QUARTER ☐ SECOND QUARTER ☐ THIRD QUARTER

BANK ACCOUNT RECONCILIATION

1. **Account Balance** as of _____ (per appended bank statement). \$ _____

Plus: Deposits in transit (deposits made through end of fiscal quarter not reflected in bank statement). + _____

Number of deposits in transit: _____

Less: Outstanding (uncleared) checks (checks issued through end of fiscal quarter not reflected in bank statement). - _____

Number of outstanding checks: _____

2. **SubTotal:** _____

3. **Other Adjustments (describe)**

4. **Adjusted Trust Fund Bank Account Balance** (as of end of the report quarter) \$ _____

5. The balance on line #4 ☐ agreed ☐ did not agree with the balance reflected in the broker's records. Attach explanation if different.



REAL ESTATE PRACTICE

1. Quarterly trust fund status report (Business and Professions Code 10232.25, DRE Regulation 2846.8; see Figure 7.5, RE 855 next two pages).
2. Annual trust fund report (Business and Professions Code 10232.2; DRE Regulation 2846.5; see Figure 7.6). The annual report of a review of trust fund financial statements requires confirmation by an independent accountant that (1) the broker maintains the records and reconciles the records; (2) each trust fund bank account is maintained by the broker in compliance with real estate law; (3) the accountant has reviewed the balances, receipts, and disbursements of trust fund accounts as of the last day of the year; (4) the accountant is not aware of any material modifications that should be made to the trust fund financial statements for them to conform with general accounting principles; (5) the adjusted balance(s) of the trust accounts shown in financial statements are on deposit as of the financial statement date; (6) the trust fund bank account receipts, disbursements and balances agree with the amounts on the cash records; and (7) the trust fund liability balance for each open account shown on financial statements agrees with the amounts shown on the separate beneficiary records.
3. Annual review of trust fund financial statements [Business and Professions Code 10232.2(a)].

Each principal shall be furnished with a verified copy of accountings at the end of each calendar quarter and when the contract has been completed by the licensee (Figure below: Trust Fund Status Report). In the case of multiple beneficiaries, the broker has special rules. Every principal who is an owner of the funds in the trust account must have given prior written consent if the disbursement will reduce the balance of funds in the account to an amount less than the existing aggregate trust fund liability of the broker to all owners of the funds. The written consent must be obtained prior to each such disbursement (DRE 2832.1). When determining whether mortgage loan transactions are to be counted toward the threshold criteria, two guidelines are considered: (1) Advertising for review prior to use must be submitted to DRE, and (2) reporting business activity and trust fund handling.

Figure 7-7: RE 855: Trust Fund Status Report (2 pages)

7: TRUST FUNDS & FAIR HOUSING

STATE OF CALIFORNIA

DEPARTMENT OF REAL ESTATE
MORTGAGE LENDING

TRUST FUND STATUS REPORT

RE 855 (Rev. 4/96)

GENERAL INFORMATION

- This report is required from all real estate brokers who engage in mortgage loan activities as specified in §10131(d) and (e) of the B&P Code. If the threshold criteria of §10232 is met, a copy of this report is to be mailed to DRE, otherwise the report is to be retained in file in the broker's office per §10232.25(e).
- If completed per §10232 (*threshold criteria is met*) mail to: Department of Real Estate, Mortgage Loan Unit, P. O. Box 187000, Sacramento, CA 95818-7000
- If completed per §10232.25(e), retain in file subject to DRE inspection. Refer to full text of §10232.25 on reverse side.
- Only one report is needed even if you have two or more bank accounts.
- Attach the following to this report: (*whether mailing or retaining*)
 - Trust Fund Bank Account Reconciliation (RE 856) and
 - a copy of the bank statement for *each* trust fund bank account.

REPORT INFORMATION

NAME OF BROKER		LICENSE TYPE <input type="checkbox"/> INDIVIDUAL BROKER <input type="checkbox"/> CORPORATION	REAL ESTATE ID#
FICTITIOUS BUSINESS NAME(S) (IF ANY)			
MAIN OFFICE ADDRESS (STREET, CITY, STATE, ZIP CODE)			TELEPHONE NUMBER ()
REPORT PERIOD (CHECK ONE) <input type="checkbox"/> 1ST QUAR. <input type="checkbox"/> 2ND QUAR. <input type="checkbox"/> 3RD QUAR. <input type="checkbox"/> 4TH QUARTER — NON-THRESHOLD BROKERS ONLY	DATE QUARTER ENDED (M/D/Y)	START OF FISCAL YEAR (M/D/Y)	END OF FISCAL YEAR (M/D/Y)

1. As of the end of the report quarter, the broker's aggregate trust fund accountability was: \$ _____

Did this amount agree with the total of all positive balances as reflected on the separate beneficiary records as of end of report quarter? ☐ Yes ☐ No
If NO, explain on reverse side.
2. The total of trust funds on deposit in the broker's trust fund bank account(s), as of the end of the report quarter, was: \$ _____

The number of trust fund bank accounts where the funds were on deposit:
Attach RE 856 and bank statement for each of these accounts.
3. Explain on the reverse side any difference between the total accountability (line #1) and the total adjusted bank account(s) balance(s):

REPORT PREPARED BY	POSITION OR CAPACITY WITH BROKER
BUSINESS ADDRESS	

Declaration

I/We declare that: a) the form and content of the trust account records of the above-named real estate broker were in conformance with Sections 2831 and 2831.1 of the Real Estate Commissioner's Regulations, and b) all trust fund bank account(s) of the above-named broker were maintained in compliance with Sections 2830, 2832.1 and 2834 of the Real Estate Commissioner's Regulations.

I/We declare under penalty of perjury that the information in this report is true and correct to the best of my/our knowledge and belief.

SIGNATURE OF BROKER OR BROKER-OFFICER OF CORPORATION »	DATE
PRINTED NAME OF SIGNER	
SIGNATURE OF CORPORATE C.E.O. (LEAVE BLANK IF C.E.O. IS THE BROKER OFFICER) »	DATE



REAL ESTATE PRACTICE

RE 855

Page 2 of 2

EXPLANATION OF DIFFERENCES

- The difference between the accountability (line #1) and the total of all positive balances as reflected on the separate beneficiary records which total was \$ _____, is attributable to:

- The difference between the total accountability (line #1) and the total adjusted bank account(s) balance(s) (line #2) is attributable to:

Section 10232.25. Business and Professions Code

- (a) A real estate broker who meets the criteria of subdivision (a) of Section 10232 shall, within 30 days after the end of each of the first three fiscal quarters of the broker's fiscal year, or within such additional time as the Real Estate Commissioner may allow for good cause, file with the commissioner a trust funds status report as of the last day of the fiscal quarter which shall include the following:
- (1) A representation that the form and content of the trust account records of the broker are in compliance with the regulations of the Real Estate Commissioner.
 - (2) A representation that the broker's trust fund bank account is maintained in compliance with the regulations of the Real Estate Commissioner.
 - (3) A statement of the broker's aggregate accountability for trust funds.
 - (4) A report of trust funds in the broker's custody consisting of the trust account bank statements as of the bank's accounting date immediately preceding the end of the fiscal quarter and a schedule of withdrawals and deposits adjusting the account to its true balance as of the end of the fiscal quarter.
 - (5) A statement explaining any difference in amount between the broker's total accountability under paragraph (3) above and the adjusted trust account bank balance under paragraph (4) above.
- (b) Each report made pursuant to subdivision (a) shall include the following:
- (1) The name, address, and position or capacity of the person who prepared the report.
 - (2) A declaration under penalty of perjury by the broker that the information and representations in the report are true, complete, and correct to the best of the broker's knowledge and belief. The declaration in a report submitted on behalf of a corporate broker shall be signed by a broker-officer through whom the corporation is licensed as a real estate broker and by the chief executive officer of the corporation if he or she is not the signing broker-officer.
- (c) If a broker fails to file a report required under subdivision (a) within the time permitted the commissioner may cause an examination and report to be made and may charge the broker one and one-half times the cost of making the examination and report.
- (d) A broker who meets the criteria of Section 10232, but who, in carrying on the activities described in subdivisions (d) and (e) of Section 10131, did not during a fiscal quarter, accept for the benefit of a person to whom the broker is trustee, any payment or remittance in a form convertible to cash by the broker, need not comply with the provisions of subdivision (a). In lieu thereof, the broker shall submit to the commissioner within 30 days after the end of the fiscal quarter or within such additional time as the commissioner may allow for good cause, a statement under penalty of perjury on a form provided by the department attesting to the fact that the broker did not receive any trust funds in cash or convertible to cash during the fiscal quarter.
- (e) Any real estate broker who engages in any of the activities specified in subdivision (d) or (e) of Section 10131, but who is not required by this section to file trust funds status reports with the commissioner and who is not exempt therefrom under subdivision (d), shall complete trust funds status reports in accordance with the requirements of subdivisions (a) and (b) applicable to trust funds status reports filed with the commissioner. The broker shall retain all trust funds status reports prepared under that subdivision on file at the broker's offices, where they shall be subject to inspection by representatives of the commissioner upon 24 hours' notice.

7: TRUST FUNDS & FAIR HOUSING

AUDIT AND EXAMINATION

Upon request of the DRE commissioner, a broker must furnish an authorization for examination of financial records of the trust account (Government Code, Section 7473). An example is shown in Figure 7.7. The commissioner may issue rules and regulations regulating the method of accounting of trust funds to accomplish the purpose of the advance fee code.

Effective January 1, 1989, the DRE has been required to charge a broker for the cost of an audit if in a final desist and refrain order or final decision following a disciplinary hearing the broker has been found in violation of real estate law. The commissioner may maintain an action for the recovery of the cost of an audit in any court of competent jurisdiction. The commissioner may use the estimated average hourly cost for all persons performing audits of real estate brokers to determine the cost incurred by the DRE for the audit.

CONSEQUENCES

A violation of the DRE required advance-fee agreement approval is a public offense. Punishment may be a fine not to exceed \$10,000 or imprisonment in a county jail not to exceed 6 months, or both. If the offender is a corporation, the punishment increases to a fine not to exceed \$50,000. In addition, the real estate commissioner may revoke or suspend licensing.

A violation for a licensee not placing a principal's advance fee into a trust account may result in the principal recovering treble damages for amounts misapplied in addition to attorneys' fees in any action brought to recover such funds. Trust fund conversion is the misappropriation and use of a principal's fund(s). The real estate law treats this as a serious offense that is covered by two penal code sections:

Penal Code, Section 506. Every broker entrusted with or having control of property for the use of any other person, who fraudulently appropriates it to any use or purpose not in the duty and lawful execution of his trust, or secretes it with a fraudulent intent to appropriate it to any use or purpose, is guilty of embezzlement.

Penal Code, Section 506a. Any person who is acting in any capacity in or about a business conducted for the collection of accounts or debts owing by another person who violates Section 506 of the Penal Code shall be deemed to be an agent or person subject to be prosecuted, tried, and punished in accordance with law. Note that a collector is a person who collects or has in possession or control the property or money for use of another person.

FAIR HOUSING LAWS

Various states and federal laws have been enacted to prohibit discrimination in the sale, leasing or financing of housing. California first passed the Unruh Civil Rights Act that prohibits discrimination in business, then the Rumford Act, which prohibits discrimination in Housing, and later these were reinforced by the Federal Civil Rights Act of 1968.

UNRUH CIVIL RIGHTS ACT

State law makes it unlawful for persons engaged in business in California, including real estate agents, to discriminate when providing business products and services.

- ◆ This applies to all real estate activities.
- ◆ Violators are liable for up to 3 times of actual damages, and \$250 punitive damages.



REAL ESTATE PRACTICE

- ◆ Prohibits “steering” and “block busting” as a real estate business practice.

California passed the first Unruh Civil Rights Act that declares:

☞ ***“All persons within the jurisdiction of this state are free and equal, and no matter what their race, color, religion, ancestry or national origin, they are entitled to the full and equal accommodations, advantages, facilities, privileges or services in all business establishments of every kind whatsoever...”***

CALIFORNIA FAIR EMPLOYMENT & HOUSING ACT (RUMFORD ACT)

State Health and Safety Code that prohibits discrimination in the selling, renting, leasing, or financing of many types of housing because of race, color, religion, sex, age, family status, marital status, national origin, or ancestry.

☞ ***Complaints are submitted to the Department of Fair Employment and Housing (FEH).***

Violators must:

- ◆ Proceed with the sale or lease,
- ◆ Make the next vacancy available, or
- ◆ Pay up to \$1000 in damages if either of the above remedies is not possible.

☞ ***Exception: An owner of Single Family residence may bring in 1 roommate and be exempt from the act.***

HOUSING FINANCIAL DISCRIMINATION ACT (HOLDEN ACT)

Financial institutions are prohibited from discriminating in lending practices based upon the character of the neighborhood, i.e., “**redlining**”. Apply to residential property of 1-4 units. Redlining is the practice of rejecting real estate loan applications because of the location of the property involved. Complaints of violations of the Housing Financial Discrimination may be brought to the Secretary for Business and Transportation.

- ◆ Each violation may be required to pay damages up to \$1,000.

FEDERAL CIVIL RIGHTS ACT OF 1968

At the federal level, the Federal Civil Rights Act of 1968 reinforced the Unruh and Rumford Acts:

Any discrimination that the two acts did not prohibit was explicitly outlawed. There are no exceptions.

It makes it illegal to real estate licensees or real estate boards to engage in discriminatory acts regardless of any instructions the agent may have received from the seller or landlord. If asked to discriminate, the salesperson must refuse.

7: TRUST FUNDS & FAIR HOUSING

It requires a fair housing poster to be displayed at all real estate offices and subdivision model homes. The poster must also be displayed at all financial institutions or by mortgage lenders who make loans to the general public.

Complaints must be filed within 180 days of violation to:

US Department of Housing and Urban Development
Secretary for Fair Housing and Equal Opportunity
Washington, D.C. 20410, or your local HUD Office.

Or visit their website at  www.hud.gov

- ♦ HUD (Housing and Urban Development) is a Federal Agency that oversees all aspects of housing including FHA programs, redevelopment, fair housing, etc.
- ♦ Fines of up to \$10,000 have been authorized for first time violators.
- ♦ Up to \$25,000 for second time violators within five years and up to \$50,000 for a third offense within seven years.

Those accused of violating this tough statute would face an administrative judge unless they specifically requested a jury trial.

Categories protected by the Fair Employment and Housing Act:

- ♦ Race
- ♦ Religion
- ♦ Creed (Belief)
- ♦ Color
- ♦ National Origin
- ♦ Ancestry
- ♦ Physical Handicap
- ♦ Medical Condition
- ♦ Family Status
- ♦ Sex
- ♦ Age

Jones vs. Mayer

A landmark 1968 Supreme Court case where the court interpreted and applied an 1866 Act of Congress which prohibited racial discrimination by anyone in the US in the sale, or rental of a property.

Remedies for Fair Housing Violations: Sale of Property – Agent asked to Discriminate
Agent must refuse the listing, or inform client it is against the fair housing laws to discriminate.

Race Discrimination; Not to Show to Minority

Such restriction is unenforceable. It has no legal effect upon a transaction. The agent is relieved of the duty to show the property to anyone, including minority who has interest or requested to see the property.

Buyer Being Discriminated

Advise the buyer of the right to complain to the Fair Employment and Housing (FEH) and warn seller that he or she has violated laws.

Panic Selling / Blockbusting and Panic Peddling



REAL ESTATE PRACTICE

An agent intentionally incites existing homeowners to sell their properties by saying that property values will fall because persons of a different race or religion have targeted a move into their neighborhood.

Redlining

Redlining is the practice of rejecting real estate loan applications because of the location of the property involved.

Steering (Misleading)

Steering is the process of influencing a clients choice of housing. The agent recommends neighborhoods that he feels would be best for the prospective buyer. Such as showing a Caucasian buyer in a Caucasian neighborhood. The process is often illegal, no matter how well-intentioned the agent is.

Summary

All licensed real estate agents must comply with California trust fund real estate law as set forth by the DRE and the Business and Professions Code. Any item held on behalf of another is to be handled according to trust fund guidelines. The broker must maintain records to show compliance with trust funds for audit, accounting, and documentation purposes.

INTERNET WEB LINKS

www.courtinfo.ca.gov	California Courts information
www.hud.gov	US Dept of Housing and Urban Development
www.leginfo.ca.gov/calaw.html	California Law

CHAPTER QUIZ

- Which one of the following would be considered trust funds?
 - The buyer's initial deposit
 - Monies to pay for credit report(s) and/or appraisal(s)
 - Points and fees advanced by the borrower
 - All of the above
- The broker of record is only responsible for trust fund items of value received by:
 - Any licensee working under a broker's license
 - A broker associate
 - A real estate agent or loan agent working under a broker's license
 - All of the above
- Receiving trust funds on behalf of others creates _____ responsibility.
 - Only fiduciary
 - Only legal

7: TRUST FUNDS & FAIR HOUSING

- C. Both A and B
 - D. Neither A nor B
4. As of January 1, 1996, California licenses will be required to take continuing education credits for each ____ year license renewal on trust fund handling.
- A. 3
 - B. 4
 - C. 5
 - C. 6
5. California law requires the broker of record to have:
- A. A trust fund bank account
 - B. A trust fund bank account with a minimum \$1000 balance
 - C. No trust fund bank account is required by law in California
 - D. Either a broker or a salesperson may open a trust account
6. All deposit monies received from a principal are to be made out to:
- A. An escrow or title company
 - B. The seller
 - C. A third party
 - D. Any of the above
7. Which one of the following is not required to comply with the California trust fund laws?
- A. The broker of record
 - B. The principal to the transaction
 - C. All sales agents within the office
 - D. All of the above
8. Trust funds must be placed in the broker trust account:
- A. If not directed by the principal to be held until the occurrence of an event.
 - B. Unless forwarded to the title or escrow company.
 - C. Both A and B
 - D. Neither A nor B
9. Trust funds are the funds:
- A. Of the broker of record
 - B. Of the title company
 - C. That are held on behalf of a principal
 - D. Of the escrow company
10. Trust fund accounts must be reviewed by the broker of record, or designatee, at least once each:
- A. Month
 - B. 3 months
 - C. 6 months
 - D. 12 months



REAL ESTATE PRACTICE

Answers: 1-D, 2-D, 3-C, 4-B, 5-C, 6-D, 7-B, 8-C, 9-C, 10-A

CHAPTER 8: REAL ESTATE BROKERAGE



Preview

The nature of real estate brokerage services, particularly those provided in residential sales transactions, has changed significantly in recent years. Throughout the 1950s, real estate brokerage firms were primarily one-office, minimally staffed, family-run operations. The broker listed an owner's property for sale and found a buyer without assistance from other brokerage companies. The sale was eventually negotiated and closed. It was relatively clear that the broker represented the seller's interests. The common-law ***doctrine of caveat emptor*** ("let the buyer beware") was the rule; buyers were pretty much on their own.

While this arrangement benefited sellers, buyers came to question whether their interests were being protected. They began to demand not only accurate, factual information, but also objective advice, particularly in the face of increasingly complex real estate transactions. Buyers view the real estate licensee as the expert on whom they can rely for guidance. In short, buyers have begun to seek not only protection, but representation as well.

REAL ESTATE BROKERAGE

Brokerage is simply the business of bringing parties together. Mortgage brokers match lenders with borrowers; stock brokers bring together investors and corporations; customs brokers help importers navigate through complex customs procedures. A real estate broker is defined as a person licensed to buy, sell, exchange or lease real property for others and to charge a fee for these services.

A brokerage business may take many forms. It may be a sole proprietorship (a single-owner company), a corporation or a partnership with another broker. The office may be independent or part of a regional or national franchise. The business may consist of a single office or multiple branches. The broker's office may be located in a downtown highrise, a suburban shopping center or the broker's home. A typical real estate brokerage may specialize in one kind of transaction or service or may offer an array of services.

No matter what form it takes, however, a real estate brokerage has the same demands, expenses and rewards as any other small business. The real estate industry, after all, is made up of thousands of small businesses operating in defined local markets. A real estate broker faces the same challenges as an entrepreneur in any other industry. In addition to mastering the complexities of real estate transactions, the broker must be able to handle the day-to-day details of running a business. He or she must set effective policies for every aspect of the



REAL ESTATE PRACTICE

brokerage operation: maintaining space and equipment, hiring employees and salespersons, determining compensation, directing staff and sales activities and implementing procedures to follow in carrying out agency duties. Each state's real estate license laws and regulations establish the business activities and methods of doing business that are permitted.

☞ At each step in a real estate transaction the broker should advise the parties to secure legal counsel to protect their interests. Although real estate brokers and salespersons may bring buyers and sellers together; and in most states may fill in preprinted blank purchase agreement forms, only an attorney may offer legal advice or prepare legal documents. Licensees who are not attorneys are prohibited from practicing law.

REAL ESTATE TECHNOLOGIES

Real estate brokers find it all too easy to get bogged down with paperwork, telephone calls, meetings, schedules, office management and the numerous small but vital details of running a business. While all these things are important, they keep the broker from the real focus of his or her job and what he or she does best - *brokerage*. In recent years, two developments have begun to lighten the broker's load: real estate assistants and real estate technologies.

A real estate assistant is a combination office manager, marketer, organizer and facilitator with a fundamental understanding of the real estate industry. An assistant may or may not have a real estate license. An assistant may perform duties ranging from clerical and secretarial functions to office management, telemarketing, market strategy development. A licensed assistant can set up and host open houses and assist in all aspects of a real estate transaction.

In addition to assistants, a wide range of technologies is available to help a real estate licensee do his or her job more efficiently and effectively. Computers are a necessary ingredient in any modern real estate brokerage. Multiple-listing services and mortgage information are accessible online directly through the Internet.

Numerous software packages have been designed specifically for real estate professionals, and generic word-processing and spreadsheet software is available. Some of these programs help real estate brokers and salespersons with such office management tasks as billing, accounting and timekeeping. Other software assists with marketing and advertising properties and services. In some states, continuing education requirements can be met through the use of specially designed continuing education software. Real estate web sites home pages and computer networks help licensees keep in touch and some cable and satellite television channels are dedicated solely to real estate programming for both consumers and professionals.

Most real estate brokers and salespersons carry laptop computers with portable modems that link them with their offices, an MLS or mortgage company from virtually anywhere. Portable fax machines, pagers and cellular phones make licensees available to their offices and clients 24 hours a day. Voicemail systems can track caller response to advertisements and give callers information about specific properties when the broker or salesperson is unavailable. And yard signs are available that broadcast details about a property on an AM radio band, so drivers passing by can tune in for tempting information.

All this technology is a great boon to practitioners, but real estate brokers and salespersons must make careful decisions about which technologies best suit their needs. Furthermore, they

8: REAL ESTATE BROKERAGE

must keep up with the rapidly changing world of high-tech real estate tools to remain competitive.

☞ *Home listings are becoming available to the general public on the Internet, through such web sites as www.realtors.com. By accessing these services, brokers can preview photographs of properties and narrow their searches by price range, number of bedrooms, amenities neighborhood or school district.*

BROKER-SALESPERSON RELATIONSHIP

Although brokerage firms vary widely in size, few brokers today perform their duties without the assistance of salespersons. Consequently, much of the business's success hinges on the broker-salesperson relationship.

A *real estate salesperson* is any person licensed to perform real estate activities on behalf of a licensed real estate broker. The broker is fully responsible for the actions performed in the course of the real estate business by all persons licensed under the broker. In turn, all of a salesperson's activities must be performed in the name of the supervising broker. The salesperson can carry out only those responsibilities assigned by the broker with whom he or she is licensed and can receive compensation only from that broker. As an agent of the broker, the salesperson has no authority to make contracts with or receive compensation from any other party. The broker is liable for the acts of the salesperson within the scope of the employment agreement.

INDEPENDENT CONTRACTOR VERSUS EMPLOYEE

The employment agreement between a broker and a salesperson should define the nature, obligations and responsibilities of the relationship. Essentially, the salesperson may be an *employee* or an *independent contractor*. State license laws generally treat the salesperson as the employee of the broker, regardless of whether the salesperson is considered to be an employee or an independent contractor for income tax purposes. Whether a salesperson is treated as an employee or an independent contractor affects the structure of the salesperson's responsibilities and the broker's liability to pay and withhold taxes from the salesperson's earnings.

A broker can exercise certain controls over salespersons who are employees. The broker may require an employee to follow rules governing such matters as working hours, office routine, attendance at sales meetings, assignment of sales quotas and adherence to dress codes. As an employer, a broker is required by the federal government to withhold Social Security tax and income tax from wages paid to employees. The broker is also required to pay unemployment compensation tax on wages paid to one or more employees, as defined by state and federal laws. In addition, employees might receive benefits such as health insurance, profit-sharing plans and worker's compensation.

A broker's relationship with a salesperson who is an independent contractor is very different. As the name implies, an independent contractor operates more independently than an employee, and a broker may not exercise the same degree of control over the salesperson's activities. While the broker may control *what* the independent contractor does, the broker cannot dictate how to do it. The broker cannot *require* the independent contractor to keep specific office hours or attend sales meetings. Independent contractors are responsible for paying their own income and Social Security taxes and receive nothing from brokers that could be construed as an employee benefit, such as health insurance or paid vacation time. As a rule, independent contractors use their own materials and equipment.



REAL ESTATE PRACTICE

The Internal Revenue Service often investigates the independent contractor/employee situation in real estate offices. Under the qualified real estate agent category in the Internal Revenue Code, meeting three requirements can establish an independent contractor status:

1. The Individual must have a current real estate license.
2. He or she must have a written contract with the broker that specifies that the salesperson will not be treated as an employee for federal tax purposes.
3. At least 90 percent of the individual's income as a licensee must be based on sales production and not on the number of hours worked.

A broker should have a standardized employment agreement drafted and reviewed by an attorney to ensure its compliance with federal law. The broker should also be aware that written agreements carry little weight with an IRS auditor if the actions of the parties contradict the provisions of the contract. Specific legal and tax questions regarding independent contractors should be referred to a competent attorney or accountant.

Figure 8-1 Employee or Independent Contractor? IRS Considerations

FACTORS INDICATING CONTROL		Employee	Independent contractor
<i>These factors are only possible indicators of a worker's status. Each case must be determined on its own facts, based on all the information.</i>			
Is the worker required to comply with employer instructions about when, where and how work is to be performed?	Yes	No	
Is the worker required to undergo training?	Yes	No	
Does the worker hire, supervise and pay others to perform work for which he or she is responsible?	No	Yes	
Must the worker's job be performed during certain set hours?	Yes	No	
Must the worker devote full time to the job?	Yes	No	
Must the work be performed on the employer's property?	Yes	No	
Must tasks be performed in a certain order set by the employer?	Yes	No	
Is the individual required to submit regular written or oral reports to the employer?	Yes	No	
Is payment by the hour, week or month?	Yes	No	
Is payment in a lump sum?	No	Yes	
Are the worker's business and travel expenses paid by the employer?	Yes	No	
Does the employer furnish the tools and materials required for the job?	Yes	No	
Does the worker rent his or her own office or working space?	No	Yes	
Will the worker realize a profit or loss as a result of his or her services?	No	Yes	
Does the individual work for more than one firm at a time?	No	Yes	
Does the worker make his or her services available to the general public?	No	Yes	
Does the employer have the right to fire the worker?	Yes	No	
Does the worker have the right to quit the job at any time, whether or	Yes	No	

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not a particular task is complete?

BROKER'S COMPENSATION

The broker's compensation is specified in the contract with the principal. License laws may stipulate that a written agreement must establish the compensation to be paid. Compensation can be in the form of a commission or brokerage fee (computed as a percentage of the total sales price), a flat fee or an hourly rate. *The amount of a broker's commission is negotiable in every case.* Attempting, however subtly, to impose uniform commission rates is a clear violation of state and federal antitrust laws (discussed later in this chapter). A broker may, however, set the minimum rate acceptable for that broker's firm. The important point is for broker and client to agree on a rate before the agency relationship is established.

A commission is usually considered *earned* when the work for which the broker was hired has been accomplished. Most sales commissions are payable when the sale is consummated by *delivery of the seller's deed*. This provision is generally included in the listing agreement. When the sales or listing agreement specifies no time for the payment of the broker's commission, the commission is usually earned when a completed sales contract has:

- ♦ Been executed by a ready, willing and able buyer;
- ♦ The contract has been accepted and executed by the seller; and
- ♦ Copies of the contract are in the possession of all parties.

To be entitled to a sales commission, an individual must be

- ♦ A licensed broker;
- ♦ The procuring cause of the sale; and
- ♦ Employed by the buyer or seller under a valid contract.

To be considered the procuring cause of a sale, the broker must have started or caused a chain of events that resulted in the sale. A broker who causes or completes such an action without a contract or without having been promised payment is a volunteer and may not legally claim compensation. Many other factors affect a broker's status as procuring cause. For instance, if the agent abandons the transaction, he or she may not be able to return and claim to have been the procuring cause. In all cases, the key is determining *who really sold the property*. Procuring cause disputes between brokers are usually settled through an arbitration hearing conducted by the local board or association. Disputes between a broker and a client may go to court, however.

Once a seller accepts an offer from a ready, willing and able buyer, the broker is entitled to a commission. A **ready, willing and able buyer** is one prepared to buy on the seller's terms and ready to take positive steps toward consummation of the transaction. Courts may prevent the broker from receiving a commission if the broker knew the buyer was unable to perform. If the transaction is not consummated, the broker may still be entitled to a commission if the seller:

- ♦ Had a change of mind and refused to sell;
- ♦ Has a spouse who refused to sign the deed;



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- ♦ Had a title with uncorrected defects;
- ♦ Committed fraud with respect to the transaction;
- ♦ Was unable to deliver possession within a reasonable time;
- ♦ Insisted on terms not in the listing (for example, the right to restrict the use of the property); or
- ♦ Had a mutual agreement with the buyer to cancel the transaction.

In general, then, a broker is due a commission if a sale is not consummated because of the principal's default.

It is illegal for a broker to pay a commission to anyone other than the salesperson licensed with the broker or to another broker. Fees, commissions or other compensation cannot be paid to unlicensed persons for services that require a real estate license.

Other compensation includes tangible gifts, such as a new television, or other premiums, such as a vacation. This is not to be confused with referral fees paid between brokers for leads. Referral fees are legal as long as both individuals are licensed.

SALESPERSON'S COMPENSATION

The amount of compensation a salesperson receives is set by mutual agreement between the broker and the salesperson. A broker may agree to pay a fixed salary or a share of the commissions from transactions originated by a salesperson. In some cases, a salesperson may draw from an account against earned shares of commissions. Some brokers require salespersons to pay all or part of the expenses of advertising listed properties.

Some firms have adopted a *100 percent commission plan*. Salespersons in these offices pay a monthly service charge to their brokers to cover the costs of office space, telephones and supervision in return for keeping 100 percent of the commissions from the sales they negotiate. The 100 percent commission salesperson pays all of his or her own expenses.

Other companies have *graduated commission splits* based on a salesperson's achieving specified production goals. For instance, a broker might agree to split commissions 50/50 up to a \$25,000 salesperson's share; 60/40 for shares from \$25,000 to \$30,000; and so on. Commission splits as generous as 80/20 or 90/10 are possible, however, particularly for high producers.

However the salesperson's compensation is structured, only the employing broker can pay it. In cooperating transactions, the commission must first be received by the employing broker and then paid to the salesperson, unless otherwise permitted by license laws and agreed to by the employing broker.

Sharing Commissions

A commission is usually shared by following people: the listing broker, the listing salesperson, the selling broker and the selling salesperson.

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ANTITRUST LAWS

The real estate industry is subject to federal and state antitrust laws. These laws prohibit monopolies as well as any contracts, combinations and conspiracies that unreasonably restrain trade—that is, acts that interfere with the free flow of goods and services in a competitive marketplace. The most common antitrust violations are price fixing, group boycotting, and allocation of customers or markets and tie-in agreements.

Price Fixing

Price fixing is the practice of setting prices for products or services rather than letting competition in the open market establish those prices. In real estate, price fixing occurs when competing brokers agree to set sales commissions, fees or management rates. Price fixing is *illegal*. Brokers must independently determine commission rates or fees for their own firms only. These decisions must be based on a broker's business judgment and revenue requirements without input from other brokers.

Multiple-listing organizations, Boards of REALTORS® and other professional organizations may not set fees or commission splits. Nor can they deny membership to brokers based on the fees the brokers charge. Either practice could lead the public to believe that the industry not only sanctions the unethical practice of withholding cooperation from certain brokers, but also encourages the illegal practice of restricting open-market competition.

The broker's challenge is to avoid even the impression of price fixing. Hinting to prospective clients that there is a “going rate” of commission or a “normal” fee implies that rates are, in fact, standardized. The broker must make it clear to clients that the rate stated is only what his or her firm charges.

Group Boycotting

Group boycotting occurs when two or more businesses conspire against another business or agree to withhold their patronage to reduce competition. Group boycotting is illegal under the antitrust laws.

☞ **Example: A and B, the only real estate brokers in Walnut, agree that there are too many apartment-finder services in town. They decide to refer all prospective tenants to the service operated by A's niece rather than handing out a list of all providers, as they have done in the past. As a result, A's niece runs the only apartment-finder service in Walnut by the end of the year.**

Tie-in Agreements

Finally, **tie-in agreements** are agreements to sell one product only if the buyer purchases another product as well. The sale of the first (desired) product is “tied” to the purchase of a second (less desirable) product.

☞ **Example: D, a real estate broker, owns a vacant lot in a popular area of town. B, a builder, wants to buy the lot and build three new homes on it. D refuses to sell the lot to the builder unless B agrees to list the improved lot with D so that D can sell the homes. This sort of list-back arrangement violates antitrust laws.**

Penalties



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The penalties for violating antitrust laws are severe. For instance, under the Federal Sherman Antitrust Act, people who fix prices or allocate markets may be subject to a maximum \$100,000 fine and three years in prison. For corporations the penalty may be as high as \$1 million. In a civil suit, a person who has suffered a loss because of the antitrust activities of a guilty party may recover triple the value of the actual damages plus attorney's fees and costs.

DISCLOSURE OBLIGATIONS

Since the real estate licensee is presumed to have superior knowledge, his/her statements are more likely to be construed as a statement of fact, the public would demand honesty and fair dealing from them. That demand resulted in a strong licensing law as well as laws of disclosure to assure everyone of a fair deal.

Both the real estate licensees and sellers are obligated to disclosure laws.

There is a seemingly unlimited number of duties to disclose particular facts to one or both of the parties to a real estate transaction scattered throughout the codes. Many of these duties are imposed on the seller, on the broker, or on both. It is not our intent with this course to discuss every single detail regarding disclosure in real estate but we will try to cover the most common and most important disclosure requirements encountered on a day to day basis.

The truth about disclosure is that it is common sense. If the question is, "should I tell the buyer this", the answer is almost always "yes."

Sellers must understand that the following disclosures, even though required by law, are also a matter of honesty and fairness. You, as a real estate agent must have the same understanding. Sellers must be made aware that failure to mention relevant facts about a property, however inconvenient the disclosure might be, is a violation of real estate law as well as ethical practices.

REAL ESTATE TRANSFER DISCLOSURE STATEMENT

California Civil Code Sections 1102–1102.14 requires a buyer of residential real property entitlement to a statement from the seller which provides information regarding the physical condition of the property. This information is captured in a form called the Real Estate Transfer Disclosure Statement (TDS) and is prescribed by statute.

This form specifically states that the disclosure statement does not constitute a warranty of the information provided but, it states that prospective buyers may rely on the information provided by the seller to decide whether, and on what terms, to purchase the property.

The seller's duty to disclose is specifically related to facts which are material, which affect the value or desirability of the property.

Required Disclosures

- Malfunctions and any defects of the structural components and/or plumbing, electrical, heating or other mechanical systems
- Neighborhood noise problems or nuisances
- Flooding, or drainage problems
- Zoning violations, such as nonconforming uses or insufficient setbacks

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- Easements, common driveways or fences shared in common with adjoining owners.
- Encroachments
- Additions, modifications, repairs, replacements or other changes, especially those made without required building permits
- Deed restrictions and or Homeowners' association obligations
- Citations against the property, or lawsuits against the owner or affecting the property
- Location of the property within a known earthquake zone
- Major damage to the property from fire, earthquake or landslide

The disclosure statement is required even if the property is being sold “as-is” or without covenant or warranty of the physical condition of the property.

Delivery Requirements

The seller of any real property subject to the statutory requirements for delivery of the TDS must deliver the written statement as follows:

- (a) In the case of a sale, as soon as practicable before transfer of title.
- (b) In the case of transfer by a real property sales contract, or by a lease together with an option to purchase, or on a ground lease coupled with improvements, before execution of the contract.

With respect to any transfer subject to items (a) and (b) above, the seller/transferor must indicate compliance with the statutory delivery requirements on the receipt for deposit, the real property sales contract, the lease, or any addendum attached thereto, or on a separate document. Item #11 of the standard CAR Real Estate Purchase Agreement and Receipt For Deposit (DLF-14) under Transfer Disclosure, a statement giving the opportunity for the parties to agree on when the disclosure statement will be delivered is provided.

If more than one licensed—real estate broker is acting as an agent in a transaction, the broker who has obtained the offer made by the transferee (buyer) is responsible to assure the delivery of the statement to the transferee (buyer), unless the seller has given other written instruction for delivery.

If the agent responsible for delivering the disclosure statement to the buyer cannot obtain the disclosure document required and does not have written assurance from the transferee that the disclosure has been received, the agent shall advise the transferee in writing of his or her right to the disclosure. The agent must maintain a record of what has been done to comply with the statutory requirements for the delivery of the statement.

Any disclosure made may be amended in writing by the transferor or his or her agent. If any disclosure, or any material amendment of any disclosure, is delivered after the execution of an offer to purchase, the buyer has:

- (a) Three days after delivery in person or;
- (b) Five days after delivery by deposit in the mail, to terminate his or her offer by delivery of a written notice of termination to the seller or the seller's agent.



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Rescission Rights

The Real Estate Transfer Disclosure Statement contains three separate parts to be completed by the seller, listing agent, and selling agent (if any), respectively. If one of these parties fails to complete his or her part of the statement, it gives the buyer the right to rescind. For example, if the selling agent failed to execute his or her part of the disclosure statement, even though the statement was executed and delivered promptly by the seller and the listing agent, the buyer would have the right to rescind the contract.

Exemptions

The statutory disclosure statement is not required when the transfer involves:

- 1.. Default and/or foreclosure.
2. Transfers required by a court order, including but not limited to, transfers ordered by a probate court in administration of an estate, transfers pursuant to a writ of execution, transfers by a trustee in bankruptcy, transfers by eminent domain, and transfers resulting from a decree for specific performance.

MELLO-ROOS DISCLOSURE

The Mello–Roos Community Facilities Act of 1982 authorizes the formation of community facilities districts; the issuance of bonds and the levying of special taxes, which will finance designated public facilities and services.

Effective July 1, 1993, the seller of a property consisting of one-to-four dwelling units subject to the lien of a Mello–Roos Community Facilities District must make a good faith effort to obtain from the district a disclosure notice concerning the special tax and give the notice to a prospective buyer. The buyer then can make an informed decision about the actual costs of the purchase.

CERTIFICATION REGARDING WATER HEATER'S SECURITY AGAINST EARTHQUAKE

To help reduce earthquake–caused damage to dwellings, as of January 1, 1996, California law requires that all water heaters be *braced, anchored or strapped* to resist falling or horizontal displacement. The seller of real property must certify to the buyer that the law has been complied. A household water heater should have at least a 40–gallon capacity.

EARTHQUAKE GUIDES

The Seismic Safety Commission has developed a "*Homeowner's Guide to Earthquake Safety*." The guide includes information on geologic and seismic hazards, explanations of related structural and nonstructural hazards, recommendations for mitigating earthquake damage, and a statement that safety cannot be guaranteed with respect to a major earthquake and that only precautions such as retrofitting can be undertaken to reduce the risk of various types of

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damage. The Seismic Safety Commission has also developed a *"Commercial Property Owner's Guide to Earthquake Safety."*

If a buyer receives a copy of the Homeowner's Guide (or, if applicable, the Commercial Property Owner's Guide), neither the seller nor the broker are required to provide additional information regarding geologic and seismic hazards, except that sellers and real estate brokers must disclose that a property is in an earthquake fault zone.

Delivery of a booklet is required in the following transactions:

1. Transfer of any real property improved with a residential dwelling built prior to January 1, 1960 and consisting of one-to-four units any of which are of conventional light-frame construction (Homeowner's Guide); and,

2. Transfer of any unreinforced masonry building with wood-frame floors or roofs built before January 1, 1975 (Commercial Property Owner's Guide).

The Seismic Safety Commission has developed a *"Homeowner's Guide to Earthquake Safety."* The guide includes information on geologic and seismic hazards, explanations of related structural and nonstructural hazards, recommendations for mitigating earthquake damage, and a statement that safety cannot be guaranteed with respect to a major earthquake and that only precautions such as retrofitting can be undertaken to reduce the risk of various types of damage. The Seismic Safety Commission has also developed a *"Commercial Property Owner's Guide to Earthquake Safety."*

If a buyer receives a copy of the Homeowner's Guide (or, if applicable, the Commercial Property Owner's Guide), neither the seller nor the broker are required to provide additional information regarding geologic and seismic hazards, except that sellers and real estate brokers must disclose that a property is in an earthquake fault zone.

Delivery of a booklet is required in the following transactions:

- ♦ Transfer of any real property improved with a residential dwelling built prior to January 1, 1960 and consisting of one-to-four units any of which are of conventional light-frame construction (Homeowner's Guide); and,
- ♦ Transfer of any unreinforced masonry building with wood-frame floors or roofs built before January 1, 1975 (Commercial Property Owner's Guide).
- ♦ In a transfer described in item 1 above, the following structural deficiencies and any corrective measures taken, which are within the seller's actual knowledge, are to be disclosed to prospective buyers:
 - ♦ absence of foundation anchor bolts;
 - ♦ unbraced or inappropriately braced perimeter cripple walls;
 - ♦ unbraced or inappropriately braced first-story wall or walls;
 - ♦ unreinforced masonry perimeter foundation;
 - ♦ unreinforced masonry dwelling walls;
 - ♦ habitable room or rooms above a garage;
 - ♦ water heater not anchored, strapped, or braced.



SMOKE DETECTOR STATEMENT OF COMPLIANCE

California law requires that any single-family house sold on or after January 1, 1986, have an operable smoke detector. A battery-operated unit is sufficient in most counties, but some require a smoke detector be wired to the home's electrical system to avoid the danger of a worn-down battery.


Whenever a sale (or exchange) of a single family dwelling occurs, the seller must provide the buyer with a written statement representing that the property is in compliance with California law regarding smoke detectors. The State Building Code mandates that all existing dwelling units have a smoke detector installed in a central location outside each sleeping area. In a two-story home with bedrooms on both floors, at least two smoke detectors would be required.

New construction, or any additions, alterations or repairs exceeding \$1,000 and for which a permit is required, must include a smoke detector installed in each bedroom and also at a point centrally located in a corridor or area outside of the bedroom(s). This standard applies for the addition of one or more bedrooms, no matter what the cost.

In new home construction, the smoke detector must be hard-wired, with a battery backup. In existing dwellings, the detector may be only battery operated.


DISCLOSURE REGARDING LEAD-BASED PAINT HAZARDS

The *Residential Lead Based Paint Hazard Reduction Act of 1992*, a federal law, requires disclosure of the possibility of presence of lead-based paint in homes built before 1978 (about 64 million homes contain lead-based paint.) The danger of lead exposure to adults includes high blood pressure, memory and concentration problems, and difficulty during pregnancy. The danger of children includes damage to the brain and nervous system, behavior and learning problems, slowed growth and hearing loss.

The seller or lessor must provide the buyer or lessee with a lead hazard information pamphlet (including disclosure form), and disclose the known presence of any lead-based paint. The enforcement body is the *Environmental Protection Agency (EPA)*. The EPA has a website:  www.epa.gov. To obtain the essential compliance information, a person may call the EPA at 1-800-424-LEAD.

The **Act** requires that a seller of target housing offer a prospective buyer ten days to inspect for lead-based paint and lead-based paint hazards. This 10-day inspection period can be increased, decreased, or waived by written agreement between buyer and seller. The Rule does not require a seller to pay for an inspection or to remove any lead-based paint/hazards, but merely gives a buyer the opportunity to have the property inspected. A list of State-certified lead inspectors and contractors is available by calling the California Department of Health Services at (800) 597-LEAD.

The federal Environmental Protection Agency (EPA) publishes a pamphlet titled "*Protect Your Family From Lead In Your Home.*" This pamphlet describes ways to recognize and reduce lead hazards. A seller (or lessor) of target housing must deliver this pamphlet to a prospective buyer (or tenant) before a contract is formed.

 **Information on legal requirements is available from the National Lead Information Center (NLIC). NLIC can be found at the website www.epa.gov/lead/nlic.htm.**

The CAR Residential Purchase Agreement and Deposit Receipt contains a Lead Warning Statement, to be signed by the buyer, that the buyer has read the warning statement. The

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retention period, for sellers (or lessors) and agents, of this document is three years from completion of the sale (or from commencement of the lease/rental).

SPECIAL FLOOD HAZARD AREA DISCLOSURE AND RESPONSIBILITIES OF THE FEDERAL EMERGENCY MANAGEMENT AGENCY (FEMA)

A seller of property located in a special flood hazard area, or the seller's agent and/or any agent cooperating in the transaction, must disclose that fact to the buyer and that federal law requires flood insurance as a condition of obtaining financing on most structures located in a special flood hazard area. Since the cost and extent of flood insurance coverage may vary, the buyer should contact an insurance carrier or the intended lender for further information.

➤ Information on National Flood Insurance Program (NFIP) is available from the Federal Emergency Management Agency (FEMA)'s website. NFIP can be found at the website www.fema.org/fima/nftp.shtm.

DISCLOSURE OF ORDNANCE LOCATION

Federal and state agencies have identified certain areas once used for military training and which may contain live ammunition. A seller of residential property (again, one-to-four dwelling units) located within one mile of such a potential hazard must give the buyer written notice as soon as practicable before transfer of title. This obligation depends upon the seller having actual knowledge of the hazard.

DISCLOSURE OF WINDOW SECURITY BARS

seller must disclose on the TDS or, if mandated, the Local Option TDS, the existence of window security bars and any safety release mechanism on the bars.

CALIFORNIA ENVIRONMENTAL HAZARDS PAMPHLET

California a seller (with a few exceptions) of residential real property comprising one-to-four dwelling units must give the buyer a Real Estate Transfer Disclosure Statement. The statement must specify environmental hazards (e.g., asbestos, radon gas, lead-based paint, formaldehyde, fuel or chemical storage tanks, contaminated soil or water, etc.) of which the seller is aware. The seller or the seller's agent can give the buyer (of any real property) a pamphlet titled *"Environmental Hazards: A Guide for Homeowners, Buyers, Landlords, and Tenants."* If the buyer receives the pamphlet, neither the seller nor any agent in the transaction is required to furnish more information concerning such hazards unless the seller or agent has actual knowledge of the existence of an environmental hazard on or affecting the property.

DELIVERY OF STRUCTURAL PEST CONTROL INSPECTION AND CERTIFICATION REPORTS

The law does not require that a structural pest control inspection be performed prior to transfer of any real property. However, if required by the contract or by the lender, the seller or the seller's agent must deliver to the buyer a copy of a report and written certification, prepared by a registered structural pest control company, regarding the presence or absence of wood-destroying organisms. Delivery must occur before transfer of title.



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If more than one real estate broker is acting as the seller's agent, the broker who obtained the offer is responsible for delivery, in person or by mail, of the report unless the seller directs otherwise in writing. The real estate broker responsible for delivery must retain for three years a record of the actions taken to effect delivery.

ENERGY CONSERVATION RETROFIT AND THERMAL INSULATION DISCLOSURES

State law prescribes minimum energy conservation standards for all new construction. Local governments also have ordinances that impose additional energy conservation measures on new and/or existing homes. Some local ordinances impose energy retrofitting as a condition of the sale of an existing home. The seller and or agent(s) should disclose to a prospective buyer the requirements of the various ordinances, as well as who is responsible for compliance.

Federal law requires that a "new home" seller (including a subdivider) disclose in every sales contract the type, thickness, and R-value of the insulation which has been or will be installed.

NATURAL HAZARDS DISCLOSURE

The seller or the seller's agent, as specified below, must make appropriate disclosures if the property is in one or more of the following zones or areas:

- An area of potential flooding
- A designated very high fire hazard severity zone
- A designated wildland area ("state responsibility area")
- A seismic hazard zone.

In **almost all** cases, disclosure of a geological **hazard** condition must be made. This is true of potential hazards from earthquakes, flooding, landslides, erosion and expansive soils.

FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT

Federal law requires that a buyer of real property must withhold and send to the Internal Revenue Service (IRS) 10% of the gross sales price if the seller of the real property is a "foreign person." The primary grounds for exemption from this requirement are: the seller's nonforeign affidavit and U.S. taxpayer I.D. number; a qualifying statement obtained through the IRS attesting to other arrangements resulting in collection of, or exemption from, the tax; or the sales price does not exceed \$300,000 and the buyer intends to reside in the property.

Because of the number of exemptions and other requirements relating to this law, principals and agents should consult the IRS or a qualified tax advisor for more information.

NOTICE AND DISCLOSURE TO BUYER OF STATE TAX WITHHOLDING ON DISPOSITION OF CALIFORNIA REAL PROPERTY

In certain California real estate sale transactions, the buyer must withhold 3 1/3% of the total sale price as state income tax and deliver the sum withheld to the State Franchise Tax Board. The escrow holder, in applicable transactions, is required by law to notify the buyer of this responsibility.

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A buyer's failure to withhold and deliver the required sum may result in the buyer being subject to penalties. If the escrow holder fails to notify the buyer, penalties may be levied against the escrow holder.

Transactions to which the law applies are those in which:

• the seller shows an out of state address, or sale proceeds are to be disbursed to a financial intermediary of the seller;

• the sales price exceeds \$100,000.00; and,

• the seller does not certify that he/she is a resident of California or that the property being conveyed is his/her personal residence, as defined in Section 1034 of the Internal Revenue Code. *Note: If the seller is a corporation, the certification would be that the corporation has a permanent place of business in California.*

For further information, contact the Franchise Tax Board.

NOTICE REGARDING THE ADVISABILITY OF TITLE INSURANCE

In an escrow for a sale (or exchange) of real property where no title insurance is to be issued, the buyer (or both parties to an exchange) must receive and sign/acknowledge the following notice as a separate document in the escrow:

"IMPORTANT: IN A PURCHASE OR EXCHANGE OF REAL PROPERTY, IT MAY BE ADVISABLE TO OBTAIN TITLE INSURANCE IN CONNECTION WITH THE CLOSE OF ESCROW SINCE THERE MAY BE PRIOR RECORDED LIENS AND ENCUMBRANCES WHICH AFFECT YOUR INTEREST IN THE PROPERTY BEING ACQUIRED. A NEW POLICY OF TITLE INSURANCE SHOULD BE OBTAINED IN ORDER TO ENSURE YOUR INTEREST IN THE PROPERTY THAT YOU ARE ACQUIRING."

Note: While the statute does not expressly assign the duty, it is reasonable to assume that delivery of the notice is an obligation of the escrow holder. A real estate broker conducting an escrow pursuant to the exemption set forth in Financial Code Section 17006(d) would, therefore, be responsible for delivery of the notice.

DATA BASE - LOCATIONS OF REGISTERED SEX OFFENDERS

Commencing July 1, 1999, written leases or rental agreements for residential real property and contracts (including real property sales contracts as defined in Civil Code Section 2985) for the sale of residential real property with one-to-four dwelling units must contain, in not less than eight-point type, the following notice:

The Department of Justice also maintains a Sex Offender Identification Line through which inquiries about individuals may be made. This is a "900" telephone service. Callers must have specific information about individuals they are checking. Information regarding neighborhoods is not available through the "900" telephone service.



SECTION II - DISCLOSURES REQUIRED OF REAL ESTATE AGENTS IN THE TRANSFER OF RESIDENTIAL REAL PROPERTY

Although this section relates to an agent's responsibility for certain disclosures, the seller is responsible for disclosures concerning the condition of the property to the same or greater extent than the seller's agent(s). The seller may also be responsible for those disclosures required by law that his/her agent(s) for that purpose fails to make.

NO DISCLOSURE REQUIRED FOR MANNER/OCCURRENCE OF DEATH; AFFLICTION OF OCCUPANT WITH AIDS

No cause of action arises against an owner or the owner's agent (or any cooperating agent) when selling, leasing, or renting real property and failing to disclose to the buyer, lessee, or renter the following:

- the manner or occurrence of an occupant's death upon the real property if the death occurred more than 3 years prior to the transferee's offer to purchase, lease, or rent the property; or
- that an occupant of the property was afflicted with, or died from, Acquired Immune Deficiency Syndrome (AIDS).

Note that the controlling statute does not change the law relating to disclosure of any other physical or mental condition or disease of an occupant or the physical condition of the property. Further, the statute will not protect the owner or agent(s) from misrepresentation if the buyer asks a direct question concerning deaths occurring on the real property.

Summary

Real estate brokerage is the act of bringing people together, for a fee or commission, who wish to buy, sell, exchange or lease real estate.

Real estate assistants and technologies are changing the way that brokerage offices are managed and operated.

The broker's compensation in a real estate sale may take the form of a commission, a flat fee or an hourly rate. The broker is considered to have earned a commission when he or she procures a ready, willing and able buyer for a seller.

A broker may hire salespersons to assist in this work. The salesperson works on the broker's behalf as either an employee or an independent contractor.

Federal and state antitrust laws prohibit brokers from conspiring to fix prices, engage in boycotts, allocate customers or markets or establish tie-in agreements.

🔗 INTERNET WEB LINKS

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www.imrmls.com	Board of Realtors – Southern California MLSS
www.living.com	About Fine Living
www.crb.com	California Real Estate Brokers
www.cre.org	California Residential Sales Council
ca.living.net	CAR business Services Realtors
www.ccim.com	Certified Commercial Investment Member
www.themls.com	Combined LA/Westside MLS
www.irem.org	Institute of Real Estate Management
www.century21.com	Realty Company – Century 21
www.fredsands.com	Realty Company – Fred Sands
www.sevilleprop.com	Realty Company – Independent Broker
www.lyonrealty.com	Realty Company – Lyon Realty
www.mm4re.com	Realty Company – Mason-Duffie
www.mcguirere.com	Realty Company – McGuirere
www.tarbellrealtors.com	Realty Company – Tarbell
www.realtors.com	Realtor's member's site
www.remax.com	Realty Company– Remax
www.sior.com	Society of Industrial and Office Realtors



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CHAPTER QUIZ

1. A licensee who is paid in a lump sum and who works for multiple firms at the same time is probably a(n):
 - A. Transactional broker.
 - B. Buyer's agent.
 - C. Independent contractor.
 - D. Employee.
2. Which of the following statements best explains the meaning of this sentence: "To recover a commission for brokerage services, a broker must be employed as the agent of the seller"?
 - A. The broker must work in a real estate office.
 - B. The seller must have made an express or implied agreement to pay a commission to the broker for selling the property.
 - C. The broker must have asked the seller the price of the property and then found a ready, willing and able buyer.
 - D. The broker must have a salesperson employed in the office.
3. M is a licensed real estate salesperson. M's written contract with broker G specifies that M is not an employee. In the last year, just less than half of M's income from real estate transactions came from sales commissions. The remainder was based on an hourly wage paid by G. Using these facts, it is likely that the IRS would classify M as which of the following for federal income tax purposes?
 - A. Self-employed
 - B. Employee
 - C. Independent contractor
 - D. Part-time real estate salesperson
4. While in the employ of a real estate broker, a salesperson has the authority to:
 - A. List properties in his or her own name.
 - B. Assume responsibilities assigned by the broker.
 - C. Accept a commission from another broker.
 - D. Advertise property on his or her own behalf.
5. A broker would have the right to dictate which of the following to an independent contractor?
 - A. Number of hours the person would have to work
 - B. Work schedule the person would have to follow
 - C. Minimum acceptable dress code for the office
 - D. Commission rate the person would earn
6. B and C were found guilty of conspiring with each other to allocate real estate brokerage markets. P suffered a \$90,000 loss because of B and C's activities. If P brings a civil suit against B and C, what can P expect to recover?
 - A. Nothing, a civil suit cannot be brought for damages resulting from antitrust activities
 - B. Only \$90,000-the amount of actual damages P suffered

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- C. Actual damages plus attorney's fees and costs
 - D. \$270,000 plus attorney's fees and costs
7. B and C are both salespersons who work for ABC Realty. One afternoon, they agree to divide their town into a northern region and a southern region. B will handle listings in the northern region, and C will handle listings in the southern region. Which of the following statements is true regarding this agreement?
- A. The agreement between B and C does not violate antitrust laws.
 - B. The agreement between B and C constitutes illegal price fixing.
 - C. B and C have violated the Sherman Antitrust Act, and are liable for triple damages.
 - D. B and C are guilty of group boycotting with regard to other salespersons in their office.
8. Which of the following statements best describes "Rules and Regulations" for the Real Estate Profession?
- A. The rules and regulations are state laws enacted by the legislature.
 - B. The rules and regulations are a set of administrative rules adopted by the state Real Estate Commission and do not have the same force and effect as the statutory license law.
 - C. The rules and regulations are a set of administrative rules adopted by the state Real Estate Commission that define the statutory license law and have the same force and effect as the license law itself.
 - D. The rules and regulations create a suggested level of competence and behavior, but are not enforceable against real estate licensees.
9. R is a real estate salesperson associated with broker B. After a particularly challenging transaction finally closes, the client gives R a check for \$500 "for all your extra work." which of the following statements is accurate?
- A. while such compensation is irregular, it is appropriate for R to accept the check.
 - B. R may receive compensation only from B.
 - C. R should accept the check and deposit it immediately in a special escrow account.
 - D. B is entitled to a share of the check.
10. A broker has established the following office policy: "All listings taken by any salesperson associated with this real estate brokerage must include compensation based on a 7 percent commission. No lower commission rate is acceptable." If the broker attempts to impose this uniform commission requirement, which of the following statements is true?
- A. A homeowner may sue the broker for violating the antitrust law's prohibition against price fixing.
 - B. The salespersons associated with the brokerage will not be bound by the requirement and may negotiate any commission rate they choose.
 - C. The broker must present the uniform commission policy to the local professional association for approval.
 - D. The broker may, as a matter of office policy, legally set the minimum commission rate acceptable for the firm.



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Answers: 1-C, 2-B, 3-B, 4-B, 5-D, 6-D, 7-A, 8-C, 9-B, 10-D

CHAPTER 9: BUSINESS OPPORTUNITIES



Preview

The sale of a business includes the sale of inventory, fixtures, trade name and goodwill and the assignment of a lease or license. A Real Estate License permits the licensee to sell business opportunities, including franchises. This is a different area of real estate, and requires knowledge and experience beyond that which is needed for real property transactions.

In this chapter you will learn the general subjects of Business Opportunities, Bulk Sales, Personal Property Loans, California Sales and Use Tax, Alcoholic Beverage and Control Act, Financial Statements and Franchise Investment Law.

BILL OF SALE (SALES OF PERSONAL PROPERTY)

A **bill of sale** is the written document used to transfer title to personal property from the vendor to the vendee in the same way that a deed passes title to real property. The condition of the title to the personal property cannot be determined by examining the public records. A valid bill of sale requires:

- ◆ Description of property being transferred.
- ◆ Name of buyer.
- ◆ Date.
- ◆ Signature of seller (vendor). No acknowledgment is needed since it is not usually recorded.

A bill of sale would not include:

- ◆ Assignment of leasehold.
- ◆ Names and addresses of creditors.

Other Definitions

Turnover - The number of times the average amount of inventory is sold over a given period of time.

Advance Fee for Advertising - Fee charged for advertising a business in a special publication (not a newspaper). Broker must furnish an accounting to the owner of the business.



UNIFORM COMMERCIAL CODE

Uniform Commercial Code (UCC) is a unified and comprehensive scheme for regulating transactions in personal property. It governs the sale or transfer of goods ordinarily held for sale in the course of business. It was created to make uniform the commercial statutes in various jurisdictions. Goods held for sale by a business probably were obtained on credit from a supplier or manufacturer.

BUSINESS OPPORTUNITY SALE

A **business opportunity** is the sale or lease of a business, including the goodwill of an existing business. It involves the sale of personal property and must also conform to the rules and laws that govern the transfer of chattels (personal property).

A business opportunity usually include three items:

1. Real Property
2. Personal Property (Trade Fixtures or Inventory)
3. Goodwill - The expectation of continued patronage.

Inventory - The complete list of stock being transferred that is not placed in the bill of sale.

Business Opportunity Listing

A business opportunity salesperson should have a working knowledge of business practice and a through understanding of accounting or bookkeeping principles. The seller of the business must give you all the pertinent information as part of the listing agreement. The accuracy of the information, however, should be validated by the listing broker.

The Business opportunity listing should include all the information necessary for a real property sale. But, in addition should include:

1. Name of business and owner
2. Nature and location of business
3. Price and terms of sale
4. Encumbrances and items that are to be assumed by the buyer.

In addition, if there is a lease, the terms should be stated. The important income information should detail the gross income, expenses and net income. If there is a competition in the area, it should be so stated. The usual business hours each day and the square footage of the building should also be stated. If the current employees are expected to stay, salary any existing fringe benefits should be explained in detail.

Buyers of business differ. They are usually motivated by the thought of becoming their own boss or the need for a steady income, and they usually fall into one of these categories:

1. The experienced individual with a background in the field or business he or she is buying.
2. The new buyer who is usually young and inexperienced.

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The experienced individual will usually only need the basic facts in order to decide whether to purchase or not. The inexperienced buyer needs more help but is sometimes hesitant to ask questions, so all pertinent facts should be explained, in detail, to the person. He or she should also be informed of applicable laws that govern the particular business.

BULK SALES (INVENTORY)

It applies to any person whose principal business is the sell of a substantial portion of their inventory not in the ordinary course of their business.

They are controlled by Division 6 of the Uniform Commercial Code. They are designed to protect creditors of the seller to give them a fair warning that a sale of all or a major part of the inventory is about to take place, so they may obtain payment of their claims or protect their rights.

Requirements of Buyer (Must comply with the UCC)

A transferee (buyer) must give public notice twelve business days before the transfer by:

- ◆ Recording the “Notice of Intention to Sell in Bulk.” (notice will not show names of creditors).
- ◆ Publishing notice once in the legal notice section of the newspaper in the county where the chief executive office of the business is located.
- ◆ Copy of notice sent to a county tax collector by certified mail.

The notice must include:

1. Notification that the transfer is going to take place;
2. The name and any business address used by the seller;
3. The location and a description of the property;
4. The place and date of the transfer.

Validity of sale

When parties do not comply with the sales law, the sale is still valid between the parties but is considered fraudulent and void against the creditors. Only creditors can void the transaction, not the seller or the buyer. Creditors could attach the inventory and sue within one year. The buyer would have primary responsibility for the debts of the business. Vendor, vendee and creditor are all protected by the law, but it primarily protects the creditors.

PERSONAL PROPERTY LOANS

Division 9 of the Uniform Commercial Code covers most transactions intended to create a security interest in personal property. Often, trade fixtures are used as the collateral for the loan.

Documents - When personal property is used to secure a loan, division 9 requires the use of following documents:



REAL ESTATE PRACTICE

1. Security Agreement: This is similar to a chattel mortgage and is used to secure the promissory note.
2. Promissory Note: Evidence of debt that is held by the lender.
3. Financing Statement - This document is used to give public notice of the transaction and to “perfect” the security interest. It lists every item used as security for the loan and is good for 5 years. This is filed or recorded with the Secretary of State except filings or recordings made with the County Recorder regarding:

Release, Termination or other changes:

Multiple purpose form is used to:

- ♦ Make amendments.
- ♦ Terminate agreement.
- ♦ Release a portion or remainder of the goods.
- ♦ Extend the agreement beyond the five years effective date.
- ♦ Assign the interest.

CALIFORNIA SALES & USE TAX

The **sales tax** is imposed upon all retailers for the privilege of selling tangible personal property at retail. The **use tax** is collected by the state when the seller of the property cannot collect a sales tax. Key provisions:

- ♦ The Rate of Sales Tax in Los Angeles County is back to 8.25% as of 2002 from 8.00% of 2001.
- ♦ A Seller's permit is required of every seller whether he is a wholesaler or retailer.
- ♦ Late Penalty: The penalties are 10% for remitting taxes late; plus a 25% if due to fraud or evasion for a maximum of 35%.
- ♦ Unlawful Advertising is illegal. A retailer cannot imply that tax is being absorbed to the sales price. Seller must state tax separately.
- ♦ State Board of Equalization administers these laws.
- ♦ When a business is sold, fixtures are subject to sales tax, but inventory is not.

Tax on sale of Business Opportunity

- ♦ Buyer must pay sales tax on fixtures to seller, who remits to the state.
- ♦ A Clearance Certificate from the State Board of Equalization indicating there are no sale or use taxes due from the seller must be secured. Buyer of a business should obtain one from the seller.
- ♦ Successor's Liability: If the seller has not remitted the taxes collected, the buyer (successor) is liable. The clearance certificate should be secured.

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ALCOHOLIC BEVERAGE CONTROL ACT

Administered by the **Department of Alcoholic Beverage Control (ABC)** under the Alcoholic Beverage Control Act, who issues all licenses.

A real estate broker should be familiar with the legal controls on the transfer of licenses for the sale of alcoholic beverages when negotiating such business opportunity.

License requirements

A license can be issued to qualified adult persons, partnerships, fiduciaries, and corporations for use at a particular premises, which also has to be approved by the ABC.

- ♦ Applicant must be of good moral character.
- ♦ Applicant must submit fingerprints.
- ♦ A social or private club must be in operation for at least one year and has at least 100 members.
- ♦ Licenses cannot be transferred from one county to another unless special permission is obtained.
- ♦ When a liquor license is issued to a person for a specific location, it must be placed into use within 30 days.

The ABC may refuse to issue a license to anyone who has a criminal record or has violated the ABC Act. The premises may be disapproved various reasons, including over concentration of alcoholic beverage licenses in the area, the creation of a police problem or the proximity to a school, residential neighborhood or church.

With the sale of a business opportunity involving a liquor license, you cannot automatically assume that ABE will permit the transfer. An escrow is legally required and no consideration may be paid out before the license and the sale of the business is approved. Each application and transfer is subject to protest by local officials and private parties within 30 days of the posted notice of intention to sell alcohol beverages.

Types of Licenses are based on the type of beverage sold and where it is consumed.

Types of Beverages

- A. **Liquor:** General license.
- B. **Beer:** Beer license.
- C. **Wine:** Wine license.

Where consumed

- A. On premises - On-sale license.
- B. Off premises - Off-sale license.

Fees

1. A \$6000 fee must accompany an application for an original on-sale or off-sale general (liquor) license.



REAL ESTATE PRACTICE

2. The fee is reduced to \$4500 for a Seasonal general license.

General (Liquor) license cannot be resold during first two years. General license cannot be resold for more than \$6000 during first 5 years.

New license for bars (*on-site*) and liquor stores (*off-sale*) are usually obtained through a lottery type system in each county. The maximum sales price for a new license is \$6,000.00, but after a period of five years from the date of the original issuance, this restriction is lifted and the purchase price is usually considerably more.

Financial Statements

When a business is sold, two instruments should be used in order to show the value of the business. A licensee engaged in the sale of a business opportunity must have some basic understanding of a financial statement in order to analyze an established concern. The two most important statements are the Balance Sheet and the Profit and Loss Statement.

A statement of the financial position at a given point in time, listing assets, liabilities, and net worth. It includes:

1. Assets

Those things owned by the business. The economic resources of a company or an individual. This includes:

- ♦ Cash on hand.
- ♦ Accounts receivable.
- ♦ Real and personal property.
- ♦ Prepaid expenses, insurance, rents or taxes.
- ♦ Depreciation reserve.
- ♦ Good will.

2. Liabilities

The creditor's claims or what is owed. This includes:

- ♦ Accounts or notes payable.
- ♦ Accrued wages, salaries, or commissions.
- ♦ Interest due of loans, unpaid taxes.

3. Net Worth

The owner's equity or the difference between assets and liabilities.

Net Worth = Assets - Liabilities.
Assets = Liabilities + Net Worth.
Liabilities = Assets - Net Worth.

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Liquidity is indicated by comparing the current assets to current liabilities.

Profit and Loss Statement

A statement, which shows the gain or loss (revenues, expenses and net income/loss) for a given period of time.

1. **Revenues/Gross Income.** Revenues from sale of goods or services. Best way to determine is to verify the sales tax receipts.
2. **Expenses.** Cost of goods, rents, taxes, advertising, wages, and commissions.
3. **Net Income.** (Loss) The difference between revenues and expenses. Net income analysis is used in appraisal of business opportunities.

The net income would be important when obtaining a loan. The cash on hand would be least important to the buyer of a business.

THE 1971 FRANCHISE INVESTMENT LAW

Controls the offering and sale of franchises in California.

Definitions

1. **Franchise.** It is an agreement between two parties whereby one party (franchisee) is permitted to operate a business under guidance and control of the other party (franchisor) under a common trademark, trade name, product, or trademark. The franchisor also usually provides large scale of advertising to promote the franchise's name and their trademark.
2. **Franchisor.** Seller, or the parent company. A party who owns a name, product or trademark.
3. **Franchisee.** Buyer. A party who pays a fee for the use of the franchisor's name, product, or trademark.

Exemptions

The franchisor (seller) is exempt from obtaining a permit if:

1. The Franchisor has a net worth of \$5,000,000 or has a net worth of \$1,000,000 and is 80% owned by a parent corporation that has a \$5,000,000 net worth, and
2. Has had 25 franchises operating continuously for five years preceding the offer or sale.

Licensees - Any one who sells a franchise covered under the law must be one of the following:

1. A licensed real estate salesperson or broker.
2. Broker-dealer or agent licensed by the Commissioner of Corporations.

Full Disclosure - It is the purpose of the law to provide the prospective franchisee with full and complete information regarding the contract and relationship. Disclosures must be made 10 business days before the contract is executed.



REAL ESTATE PRACTICE

INTERNET WEB LINKS

www.abc.ca.gov

Alcoholic Beverage Control

CHAPTER QUIZ

1. The sale or transfer of goods ordinarily held for sale in the course of business is governed in California by the:
 - A. Business Opportunity Code
 - B. Commercial Transfer Law
 - C. Uniform Commercial Code
 - D. Real Estate Law
2. A real estate business that is a partnership can have more than one office location, provided:
 - A. There is a designated broker-officer
 - B. All partners are real estate licensees
 - C. There is a broker partner licensed at each location
 - D. There is at least one partner at each location
3. All of the following items would appear on a balance sheet, **except**:
 - A. Accounts payable;
 - B. gross sales;
 - C. A company automobile;
 - D. Goodwill.
4. When a business is sold, the document that is used to indicate it is free of tax is:
 - A. Guaranteed certificate
 - B. clearance certificate
 - C. Tax deed
 - D. Tax-free certificate
5. The current rate of tax in Los Angeles County as of January 2002 is:
 - A. 6.5%
 - B. 7.25%
 - C. 7.5%
 - D. 8.25%
6. The sale of business is administered by the:
 - A. IRS
 - B. State Board of Equalization
 - C. City Office

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- D. Federal Government
7. Bulk Sales are controlled by:
- A. Division 3 of the Uniform Commercial Code
 - B. division 6 of the Uniform Commercial Code
 - C. Division 3 of Business Opportunity Code
 - D. Division 6 of the Business Opportunity Code
8. The document that is used to transfer title of personal property from vendor to vendee is called:
- A. Grant deed
 - B. Promissory note
 - C. Bill of sale
 - D. Bulk sale
9. An agreement between two parties whereby one party is permitted to operate a business under guidance and control of the other party is called:
- A. A limited partnership
 - B. A joint venture development
 - C. A franchise
 - D. A trademark
10. Alcoholic Beverage Control Act is administered by:
- A. Department of Real Estate
 - B. Department of Education
 - C. Department of Alcoholic Beverage Control
 - D. Department of Insurance

Answers: 1-C, 2-C, 3-B, 4-B, 5-D, 6-B, 7-B, 8-C, 9-C, 10-C

CHAPTER 10: CLOSING THE TRANSACTION



Preview

Closing is the point at which ownership of a property is transferred in exchange for the selling price.

BUYER'S ISSUES

Everything a licensee does in the course of a real estate transaction, from soliciting clients to presenting offers and coordinating inspections, leads to one final event - closing. **Closing** is the consummation of the real estate transaction. Closing actually involves two events: the promises made in the sales contract are fulfilled; and the mortgage loan funds (if any) are distributed to the buyer. It is the time when the title to the real estate is transferred in exchange for payment of the purchase price. Closing marks the end of any real estate transaction. Before the property changes hands, however, important issues must be resolved.

The buyer will want to be sure that the seller deliver title. The buyer should also ensure that the property is in the promised condition. This involves inspecting:

- ♦ The title evidence;
- ♦ The seller's deed;
- ♦ Any documents demonstrating the removal of undesired liens and encumbrances;
- ♦ The survey;
- ♦ The results of any required inspections, such as termite or structural inspections, or required repairs; and
- ♦ Any leases if tenants reside on the premises.

☞ ***One of the most frequent causes of lawsuits against licensees is inaccurate lot lines. Buyers want to be confident that the properties they purchase are in fact what they believe they are paying for. Relying on old surveys is not necessarily a good idea; the property should be resurveyed by a competent surveyor, whether or not the title company or lender requires it.***



FINAL PROPERTY INSPECTION

Shortly before the closing takes place, the buyer usually makes a *final inspection* of the property with the broker (often called the *walk-through*). Through this inspection, the buyer makes sure that necessary repairs have been made, that the property has been well maintained, that all fixtures are in place and that there has been no unauthorized removal or alteration of any part of the improvements.

Survey

A *survey* gives information about the exact location and size of the property. The sales contract specifies who will pay for the survey. It is usual for the survey to “spot” the location of all buildings, driveways, fences and other improvements located primarily on the premises being purchased. Any improvements located on adjoining property that may encroach on the premises being bought will also be noted. The survey should set out, in full, any existing easements and encroachments. Whether or not the sales contract calls for a survey, lenders frequently require one.

SELLER'S ISSUES

Obviously, the seller's main interest is in receiving payment for the property. He or she will want to be sure that the buyer has obtained the necessary financing and has sufficient funds to complete the sale. The seller will also want to be certain that he or she has complied with all the buyer's requirements so the transaction will be completed.

Both parties will want to inspect the closing statement to make sure that all monies involved in the transaction have been accounted for properly.

☞ Licensees often assist in preclosing arrangements as part of their service to clients. In California, licensees are required to advise the parties of the approximate expenses involved in closing when a sales contract is signed. In other states, it is the licensees' statutory duty to coordinate and supervise closing activities.

TYPES OF POLICIES

There are two types of title insurance policy, the Standard Policy and the Extended Policy.

STANDARD TITLE POLICY (CLTA)

The “**standard**” policy is the most widely used and generally:

- ◆ Insures the owner for the amount of the purchase price.
- ◆ Insures the lender for the amount of the loan.

Standard policy is frequently referred to as a CLTA (acronym for California Land Title Association) a state trade association for title insurance companies. This standard policy insures the lender only unless the owner requests and pays for owner coverage.

This policy protects against:

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1. Matters of public record. Acknowledged documents are recorded in the county where the property is located. Sources for searching for documents are city, county, state and federal, i.e.,:
 - ♦ Federal land offices
 - ♦ State of California Secretary of State
 - ♦ Taxing authorities
 - ♦ Special assessment districts
 - ♦ County Clerk's Office.
 - ♦ Any one having an interest in due property.
2. Forgery;
3. Impersonation or lack of capacity of a party to a transaction. For example, transaction with a minor.
4. Defective delivery of a recorded grant deed.

Under standard policy, the title company does not make a physical inspection of the property and therefore excludes the following:

- ♦ It does not protect against unrecorded easements and liens, encroachments, or rights of parties in possession.
- ♦ Changes in land use dictated by zoning ordinances.
- ♦ Mining claims and water rights.


EXTENDED POLICY (ALTA)

Other risks can be ascertained by an on-site inspection of the property and a survey. Extended coverage is established and normally required by lenders. If the owner wants additional perils covered, extended coverage or a special endorsement can be added to cover these risks.

The policy provides protection against many exclusions of the standard policy:

- ♦ Unrecorded liens and easements that are not shown by the public record.
- ♦ Rights of parties in possession.
- ♦ Claims which a correct survey would disclose.
- ♦ Mining claims, water rights and government actions such as zoning ordinances.
- ♦ Encroachments.

The extended coverage policy is commonly referred to as an ALTA (acronym for American Land Title Association) policy. The ALTA policy, which includes a competent survey or physical inspection is usually required by California and out-of-state lenders who are not able to make a personal, physical inspection of the property. The borrower pays for this policy.

 ***No policy will protect against defects known to the insured or against government regulations concerning occupancy and use (zoning).***



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ALTA-R

The ALTA-R policy is recommended by title companies, for one-to-four owner-occupied residential dwellings. It does not include a survey because the property lines are already established by a recorded subdivision map. Since the title companies do not have to do a survey, it gives the buyer more coverage for the same price. The CAR deposit receipt includes the ALTA-R as the preferred residential title policy choice.

TITLE INSURANCE FEES

Title insurance fee is a one time policy fee for title insurance benefiting the lender.

- ♦ In Northern California, the buyer usually pays the standard title insurance fee. In Southern California, the seller usually pays the standard title insurance fee.
- ♦ The additional cost of ALTA extended policy is usually charged to the party purchasing the property (the buyer).
- ♦ The selection of a title insurance company to use is another negotiable item between the buyer and seller.
- ♦ The usual custom is for the party paying for the title fee to select the Title Company. Real estate regulations prohibit a real estate agent from dictating which title insurance company to use. If the real estate agent should happen to have a financial interest in the Title Company selected, the agent must disclose this fact to both the buyer and the seller.

TITLE PROCEDURES

Both the buyer and the buyer's lender will want assurance that the seller's title compiles with the requirements of the sales contract. The seller is usually required to produce a current *abstract of title* or *title commitment* from the title insurance company. When an abstract of title is used, the purchaser's attorney examines it and issues an opinion of title. This opinion, like the title commitment, is a statement of the status of the seller's title. It discloses all liens, encumbrances, easements, conditions or restrictions that appear on the record and to which the seller's title is subject.

On the date when the sale is actually completed (the date of delivery of the deed). The buyer has a title commitment or an abstract that was issued several days or weeks before the closing. For this reason, there are usually two searches of the public records. The first shows the status of the seller's title on the date of the first search. Usually, the seller pays for this search. The second search, known as a *bring down*, is made after the closing and generally paid for by the purchaser. The abstract should be reviewed before closing to resolve any problems that might cause delays or threaten the transaction.

When the purchaser pays cash or obtains a new loan to purchase the property, the seller's existing loan is paid in full and satisfied on record. The exact amount required to pay the existing loan is provided in a current *payoff statement* from the lender effective the date of closing. This payoff statement notes the unpaid amount of principal, the interest due through the date of payment, the fee for issuing the certificate of satisfaction or release deed, credits (if any) for tax and insurance reserves and the amount of any prepayment penalties. The same procedure would be followed for any other liens that must be released before the buyer takes title.

10: CLOSING THE TRANSACTION

In a transaction in which the buyer assumes the seller's existing mortgage loan, the buyer will want to know the exact balance of the loan as of the closing date. In some areas, it is customary for the buyer to obtain a *mortgage reduction certificate* from the lender that certifies the amount owed on the mortgage loan, the interest rate and the last interest payment made.

As part of this later search, the seller may be required to execute an **affidavit of title**. This is a sworn statement in which the seller assures the title insurance company (and the buyer) that there have been no judgments, bankruptcies or divorces involving the seller since the date of the title examination. The affidavit promises that no unrecorded deeds or contracts have been made, no repairs or improvements have gone unpaid and no defects in the title have arisen that the seller knows of. The seller also affirms that he or she is in possession of the premises. In some areas, this form is required before the title insurance company will issue an owner's policy to the buyer. The affidavit gives the title insurance companies the right to sue the seller if his or her statements in the affidavit are incorrect.

In some areas, real estate sales transactions are customarily closed through an escrow (discussed below). In these areas, the escrow instructions usually provide for an extended coverage policy to be issued to the buyer as of the date of closing. The seller has no need to execute an affidavit of title.

CLOSING IN ESCROW

Closing is known by many names. For instance, in some areas closing is called *settlement and transfer*. In other parts of the country, the parties to the transaction sit around a single table and exchange copies of documents, a process known as *passing papers*. In still other regions, the buyer and seller may never meet at all; the paperwork is handled by an escrow agent. This process is known as **closing escrow**. Whether the closing occurs face to face or through escrow, the main concerns are that the buyer receives **marketable title**, the seller receives the purchase price and certain other items are adjusted properly between the two.

An **escrow** is a method of closing in which a disinterested third party is authorized to act as escrow agent and to coordinate the closing activities. The escrow agent may also be called the *escrow holder*; the escrow agent may be an attorney, a title company, a trust company, an escrow company or the escrow department of a lending institution. Many real estate firms offer escrow services. However, a broker cannot be a disinterested party in a transaction from which he or she expects to collect a commission. Because the escrow agent is placed in a position of great trust, many states have laws regulating escrow agents and limiting who may serve in this capacity.

☞ **Broker can only act as an escrow holder in a transaction in which he/she represents either party.**

REGULATION OF ESCROW HOLDERS

All escrow companies must be incorporated and can handle escrows only after obtaining a special license from the California Corporations Commissioner, *except*:

- ♦ Banks, trust companies, title companies, savings & loan associations, insurance companies, attorneys.
- ♦ Real Estate Brokers can escrow a transaction and charge a fee, but only when he or she is an agent in that transaction.



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- ♦ A license to act as an escrow agent must be held by a corporation. An individual cannot receive such a license. The licensed corporation must be solvent and furnish a \$10,000 surety bond.

ESSENTIALS OF A VALID ESCROW

To create a valid escrow for a real estate sale, two requirements must be met, as explained next:

- ♦ **Binding Contract**
There must be a binding contract between buyer and seller. This may be a deposit receipt, an agreement of sale, exchange agreement, or option, or other legally binding contract.
- ♦ **Conditional Delivery**
There must be a conditional delivery of transfer instruments to escrow holder. Instruments of transfer include money, the deed, loan documents and other required paperwork. The delivery of all instrument of transfer is conditioned on the successful fulfillment of the contract terms.

 ***Delivery is accompanied with instructions to deliver instruments upon performance of stipulated conditions.***

Escrow Procedure

When a transaction will close in escrow, the buyer and seller execute escrow instructions to the escrow agent after the sales contract is signed. One of the parties selects an escrow agent. Which party selects the agent is determined either by negotiation or by state law. Once the contract is signed, the broker turns over the earnest money to the escrow agent, who deposits it in a special trust, or escrow, account.

Buyer and seller deposit all pertinent documents and other items with the escrow agent before the specified date of closing. The seller usually deposits:

- ♦ The deed conveying the property to the buyer;
- ♦ Title evidence (certificate of title or title insurance);
- ♦ Existing hazard insurance policies;
- ♦ A letter or mortgage reduction certificate from the lender stating the exact principal remaining (if the buyer assumes the seller's loan);
- ♦ Affidavits of title (if required);
- ♦ A reduction certificate, or payoff statement (if the seller's loan is to be paid off); and
- ♦ Other instruments or documents necessary to clear the title or to complete the transaction.

The buyer deposits:

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- ♦ The balance of the cash needed to complete the purchase, usually in the form of a certified check;
- ♦ Loan documents (if the buyer secures a new loan);
- ♦ Proof of hazard insurance, including (where required) flood insurance; and
- ♦ Other necessary documents.

The escrow agent has the authority to examine the title evidence. When marketable title is shown in the name of the buyer and all other conditions of the escrow agreement have been met, the agent is authorized to disburse the purchase price to the seller, minus all charges and expenses. The agent then records the deed and mortgage or deed of trust (if a new loan has been obtained by the purchaser).

If the escrow agent's examination of the title discloses liens, a portion of the purchase price can be withheld from the seller. The withheld portion is used to pay the liens to clear the title.

If the seller cannot clear the title, or if for any reason the sale cannot be consummated, the escrow instructions usually provide that the parties be returned to their former statuses, as if no sale occurred. The escrow agent reconveys title to the seller and returns the purchase money to the buyer.

IRS REPORTING REQUIREMENTS

Every real estate transaction must be reported to the IRS by the closing agent on a Form 1099-S. Information includes the sales price, the amount of property tax reimbursement credited to the seller and the seller's Social Security number. If the closing agent does not notify the IRS, the responsibility for filing the form falls on the mortgage lender, although the brokers or the parties to the transaction ultimately could be held liable.

Broker's Role at Closing

Depending on local practice, the broker's role at closing can vary from simply collecting the commission to conducting the proceedings. Real estate brokers are not authorized to give legal advice or otherwise engage in the practice of law. This means that in some states, a broker's job is essentially finished as soon as the sales contract is signed. After the contract is signed, the attorneys take over. Even so, a broker's service generally continues all the way through closing. The broker makes sure all the details are taken care of so that the closing can proceed smoothly. This means making arrangements for title evidence, surveys, appraisals, inspections or repairs for structural conditions, water supplies, sewage facilities or toxic substances.

Though real estate licensees do not always conduct closing proceedings, they usually attend. Often, the parties look to their agents for guidance, assistance and information during what can be a stressful experience. Licensees need to be thoroughly familiar with the process and procedures involved in preparing a closing statement, which includes the expenses and prorations of costs to close the transaction. It is also in the brokers' best interests that the transactions they worked so hard to bring about move successfully and smoothly to a conclusion. Of course, a broker's (and a salesperson's) commission is generally paid out of the proceeds at closing.

 ***Licensees should avoid recommending sources for any inspection or testing services. If a buyer suffers any injury as a result of a provider's negligence, the***



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licensee may also be liable. The better practice is to give clients the names of several professionals who offer high-quality services.

Lender's Interest in Closing

Whether a buyer obtains new financing or assumes the seller's existing loan, the lender wants to protect its security interest in the property. The lender has an interest in making sure the buyer gets good, marketable title and that tax and insurance payments are maintained. Lenders want their mortgage lien to have priority over other liens. They also want to ensure that insurance is kept up to date in case property is damaged or destroyed. For this reason, a lender generally requires a title insurance policy and a fire and hazard insurance policy (along with a receipt for the premium). In addition, a lender may require other information: a survey, a termite or another inspection report, or a certificate of occupancy (for a newly constructed building). A lender may also request that a reserve account be established for tax and insurance payments. Lenders sometimes even require representation by their own attorneys at closings.

RESPA REQUIREMENTS

The federal **Real Estate Settlement Procedures Act** (RESPA) was enacted to protect consumers from abusive lending practices. RESPA also aids consumers during the mortgage loan settlement process. It ensures that consumers are provided with important, accurate and timely information about the actual costs of settling or closing a transaction. It also eliminates kickbacks and other referral fees that tend to inflate the costs of settlement unnecessarily. RESPA prohibits lenders from requiring excessive escrow account deposits.

RESPA requirements apply when a purchase is financed by a federally related mortgage loan. *Federally related loans* means loans made by banks, savings and loan associations or other lenders whose deposits are insured by federal agencies. It also includes loans insured by the FHA and guaranteed by the VA: loans administered by HUD; and loans intended to be sold by the lenders to Fannie Mae, Ginnie Mae or Freddie Mac. RESPA is administered by HUD.

RESPA regulations apply to first-lien residential mortgage loans made to finance the purchases of one-family to four-family homes, cooperatives and condominiums, for either investment or occupancy. RESPA also governs second or subordinate liens for home equity loans. A transaction financed solely by a purchase-money mortgage taken back by the seller, an installment contract (contract for deed) and a buyer's assumption of a seller's existing loan are not covered by RESPA. However, if the terms of the assumed loan are modified, or if the lender charges more than \$50 for the assumption, the transaction is subject to RESPA regulations.

☞ ***While RESPA's requirements are aimed primarily at lenders, some provisions of the act affect real estate brokers and agents as well. Real estate licensees fall under RESPA when they refer buyers to particular lenders, title companies, attorneys or other providers of settlement services. Licensees who offer computerized loan origination (CLO) services are also subject to regulation. Remember: Buyers have the right to select their own providers of settlement services.***

Controlled Business Arrangements

A service that is increasing in popularity is one-stop shopping for consumers of real estate services. A real estate firm, title insurance company, mortgage broker, home inspection

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company or even moving company may agree to offer a package of services to consumers. RESPA permits such a *controlled business arrangement* as long as a consumer is clearly *informed of the relationship among the service providers and that other providers are available*. Fees may not be exchanged among the affiliated companies simply for referring business to one another. This may be a particularly important issue for licensees who offer *computerized loan origination* services to their clients and customers. While a borrower's ability to comparison shop for a loan may be enhanced by a *computerized loan origination* system, his or her range of choices may not be limited. Consumers must be informed of the availability of other lenders.

Disclosure Requirements

Lenders and settlement agents have certain *disclosure* obligations at the time of loan application and loan closing:

Special information booklet

- ⇒ *Lenders must provide a copy of a special informational HUD booklet to every person from whom they receive or for whom they prepare a loan application (except for refinancing). The HUD booklet must be given at the time the application is received or within three days afterward. The booklet provides the borrower with general information about settlement (closing) costs. It also explains the various provisions of RESPA, including a line-by-line description of the Uniform Settlement Statement.*

Goodfaith estimate of settlement costs

- ⇒ *No later than three business days after receiving a loan application, the lender must provide to the borrower a good-faith estimate of the settlement costs the borrower is likely to incur. This estimate may be either a specific figure or a range of costs based on comparable past transactions in the area. In addition, if the lender requires use of a particular attorney or title company to conduct the closing, the lender must state whether it has any business relationship with that firm and must estimate the charges for this service.*

Uniform Settlement Statement (HUD Form 1).

- ⇒ *RESPA requires that a special HUD form be completed to itemize all charges to be paid by a borrower and seller in connection with settlement. The **Uniform Settlement Statement** includes all charges that will be collected at closing, whether required by the lender or a third party. Items paid by the borrower and seller outside closing, not required by the lender, are not included on HUD- 1. Charges required by the lender that are paid for before closing are indicated as "paid outside of closing" (POC). RESPA prohibits lenders from requiring borrowers to deposit amounts in escrow accounts for taxes and insurance that exceed certain limits, thus preventing the lenders from taking advantage of the borrowers. Sellers are also prohibited from requiring, as a condition of a sale, that the buyer purchase title insurance from a particular company.*

The settlement statement must be made available for inspection by the borrower at or *before* settlement. Borrowers have the right to inspect a completed HUD- 1, to the extent that the figures are available, **one business day before the closing**. (Sellers are not entitled to this privilege.)



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Lenders must retain these statements for two years after the dates of closing. In addition, state laws generally require licensees to retain all records of a transaction for a specific period. The Uniform Settlement Statement may be altered to allow for local custom, and certain lines may be deleted if they do not apply in an area.

Kickbacks and Referral fees

RESPA prohibits the payment of kickbacks, or unearned fees, in any real estate settlement service. ***It prohibits referral fees when no services are actually rendered.*** The *payment or receipt* of a fee, a kickback or anything of value for referrals for settlement services includes activities such as mortgage loans, title searches, title insurance, attorney services, surveys, credit reports and appraisals.

☞ ***RESPA prohibits of kickbacks and unearned fees***

CLOSING STATEMENT

Preparation of Closing Statements

A typical real estate transaction involves, in addition to the purchase price, expenses for both parties. These include items prepaid by the seller for which he or she must be reimbursed (such as taxes) and items of expense the seller has incurred, but for which the buyer will be billed (such as mortgage interest paid in arrears when a loan is assumed). The financial responsibility for these items must be prorated (or divided) between the buyer and the seller. All expenses and prorated items are accounted for on the settlement statement. This is how the exact amount of cash required from the buyer and the net proceeds to the seller are determined. (See Figure 10.1) Allocation of Expenses.

The completion of a **closing statement** involves an accounting of the parties' debits and credits. A **debit** is a charge. That is, it is an amount that a party owes and must pay at closing. A **credit** is an amount entered in a person's favor—an amount that has already been paid, an amount being reimbursed or an amount the buyer promises to pay in the form of a loan.

Figure 10-1 Allocation of Expenses

Item	Paid by Seller	Paid by Buyer
Broker's commission	<input checked="" type="checkbox"/> by agreement	<input checked="" type="checkbox"/> by agreement
Attorney's fees	<input checked="" type="checkbox"/> by agreement	<input checked="" type="checkbox"/> by agreement
Recording expenses	<input checked="" type="checkbox"/> to clear title	<input checked="" type="checkbox"/> transfer charges
Transfer tax		
Title expenses	<input checked="" type="checkbox"/> title search	
Loan fees	<input checked="" type="checkbox"/> prepayment penalty	<input checked="" type="checkbox"/> origination fee
Tax and insurance reserves (escrow or impound accounts)		<input checked="" type="checkbox"/>
Appraisal fees		<input checked="" type="checkbox"/> if required by lender

☞ ***A debit is an amount to be paid by the buyer or seller; A credit is an amount payable to the buyer or seller.***

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To determine the amount a buyer needs at closing, the buyer's debits are totaled. Any expenses and prorated amounts for items prepaid by the seller are added to the purchase price. Then the buyer's credits are totaled. These include the earnest money (already paid), the balance of the loan the buyer obtains or assumes and the seller's share of any prorated items the buyer will pay in the future. (See Figure 10.2 Credits vs. Debits.) Finally, the total of the buyer's credits is subtracted from the total debits to arrive at the actual amount of cash the buyer must bring to closing. Usually, the buyer brings a cashier's or certified check.

A similar procedure is followed to determine how much money the seller will actually receive. The seller's debits and credits are each totaled. The credits include the purchase price plus the buyer's share of any prorated items that the seller has prepaid. The seller's debits include expenses, the seller's share of prorated items to be paid later by the buyer and the balance of any mortgage loan or other lien that the seller pays off. Finally, the total of the seller's debits is subtracted from the total credits to arrive at the amount the seller will receive.

Broker's Commission.

The responsibility for paying the broker's commission will have been determined by previous agreement. If the broker is the agent for the seller, the seller is normally responsible for paying the commission. If an agency agreement exists between a broker and the buyer, or if two agents are involved, one for the seller and one for the buyer, the commission may be apportioned as an expense between both parties or according to some other arrangement.

Figure 10-2: Credits and Debits

Item	Credit To Buyer	Debit To Buyer	Credit To Seller	Debit To Seller	Prorated
Principal amount of new mortgage	<input checked="" type="checkbox"/>				
Payoff of existing mortgage				<input checked="" type="checkbox"/>	
Unpaid principal balance if assumed mortgage	<input checked="" type="checkbox"/>			<input checked="" type="checkbox"/>	
Accrued interest on existing assumed mortgage	<input checked="" type="checkbox"/>			<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Tenants' security deposit	<input checked="" type="checkbox"/>			<input checked="" type="checkbox"/>	
Purchase-money mortgage	<input checked="" type="checkbox"/>			<input checked="" type="checkbox"/>	
Unpaid water and other utility bills	<input checked="" type="checkbox"/>			<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Buyer's earnest money	<input checked="" type="checkbox"/>				
Selling price of property		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		
Fuel oil on hand (valued at current market price)		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>
Prepaid insurance and tax reserve for mortgage assumed by buyer		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>
Refund to seller of prepaid water charges and similar utility expenses		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>
Prepaid general real estate taxes		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>

Attorney's fees



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If either of the parties' attorneys will be paid from the closing proceeds, that party will be charged with the expense in the closing statement. This expense may include fees for the preparation or review of documents or for representing the parties at settlement.

Recording Expenses

The *seller* usually pays for recording charges (filing fees) necessary to clear all defects and furnish the purchaser with a marketable title. Items customarily charged to the seller include the recording of release deeds or satisfaction of mortgages, quitclaim deeds, affidavits and satisfaction of mechanics' liens. The *purchaser* pays for recording charges that arise from the actual transfer of title. Usually, such items include recording the deed that conveys title to the purchaser and a mortgage or deed of trust executed by the purchaser.

Transfer tax

Most states require some form of transfer tax, conveyance fee or tax stamps on real estate conveyances. This expense is most often borne by the seller, although customs vary. In addition, many cities and local municipalities charge transfer taxes. Responsibility for these charges varies according to local practice.

Title expenses

Responsibility for title expenses varies according to local custom. In most areas, the seller is required to furnish evidence of good title and pay for the title search. If the buyer's attorney inspects the evidence or if the buyer purchases title insurance policies, the buyer is charged for the expense.

Loan fees

When the buyer secures a new loan to finance the purchase, the lender ordinarily charges a loan origination fee of 1 to 2 percent of the loan. The fee is usually paid by the purchaser at the time the transaction closes. The lender may also charge discount points. If the buyer assumes the seller's existing financing, the buyer may pay an assumption fee. Also, under the terms of some mortgage loans, the seller may be required to pay a prepayment charge or penalty for paying off the mortgage loan before its due date.

Tax reserves and insurance reserves (escrow or impound accounts).

Most mortgage lenders require that borrowers provide reserve funds or escrow accounts to pay future real estate taxes and insurance premiums. A borrower starts the account at closing by depositing funds to cover at least the amount of unpaid real estate taxes from the date of lien to the end of the current month. (The buyer receives a credit from the seller at closing for any unpaid taxes.) Afterward, an amount equal to one month's portion of the estimated taxes is included in the borrower's monthly mortgage payment.

The borrower is responsible for maintaining adequate fire or hazard insurance as a condition of the mortgage loan. Generally, the first year's premium is paid in full at closing. An amount equal to one month's premium is paid after that. The borrower's monthly loan payment includes the principal and interest on the loan, plus one-twelfth of the estimated taxes and insurance (*PITI*). The taxes and insurance are held by the lender in the escrow or impound account until the bills are due.

Appraisal fees

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Either the seller or the purchaser pays the appraisal fees, depending on who orders the appraisal. When the buyer obtains a mortgage, it is customary for the lender to require an appraisal. In this case, the buyer bears the cost. If the fee is paid at the time of the loan application, it is reflected on the closing statement as having already been paid.

Survey fees

The purchaser who obtains new mortgage financing customarily pays the survey fees. The sales contract may require the seller to furnish a survey.

Additional fees

A FHA borrower owes a lump sum for payment of the mortgage insurance premium (MIP) if it is not financed as part of the loan. A VA mortgagor pays a funding fee directly to the VA at closing. If a conventional loan carries private mortgage insurance, the buyer prepays one year's insurance premium at closing.

Accounting for Expenses

Expenses paid out of the closing proceeds are debited only to the party making the payment. Occasionally, an expense item, such as an escrow fee, a settlement fee or a transfer tax, may be shared by the buyer and the seller. In this case, each party is debited for the share of the expense.

PRORATIONS

Most closings involve the division of financial responsibility between the buyer and seller for such items as loan interest, taxes, rents, fuel and utility bills. These allowances are called **prorations**. Prorations are necessary to ensure that expenses are divided fairly between the seller and the buyer. For example, the seller may owe current taxes that have not been billed; the buyer would want this settled at the closing, where taxes must be paid in advance, the seller is entitled to a rebate at the closing. If the buyer assumes the seller's existing mortgage or deed of trust, the seller usually owes the buyer an allowance for accrued interest through the date of closing.

Accrued items = buyer credits

Prepaid items = seller credits

Accrued items are expenses to be prorated (such as water bills and interest on an assumed mortgage) that are owed by the seller, but later will be paid by the buyer. The seller therefore pays for these items by giving the buyer credits for them at closing.

Prepaid items are expenses to be prorated, such as fuel oil in a tank, that have been prepaid by the seller, but not fully used up. They are therefore credits to the seller.

The Arithmetic of Prorating

Accurate prorating involves four considerations:

1. Nature of the item being prorated
2. Whether it is an accrued item that requires the determination of an earned amount



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3. Whether it is a prepaid item that requires the determination of an unearned amount (that is, a refund to the seller)
4. What arithmetic processes must be used.

The computation of a proration involves identifying a yearly charge for the item to be prorated, then dividing by 12 to determine a monthly charge for the item. Usually, it is also necessary to identify a daily charge for the item by dividing the monthly charge by the number of days in the month. These smaller portions are then multiplied by the number of months or days in the prorated time period to determine the accrued or unearned amount that will be figured in the settlement.

Using this general principle, there are two methods of calculating prorations:

1. The yearly charge is divided by a **360-day** year (commonly called a *banking year*), or 12 months of **30 days** each.
2. The yearly charge is divided by 365 (366 in a leap year) to determine the daily charge. Then the actual number of days in the proration period is determined, and this number is multiplied by the daily charge.

The final proration figure varies slightly, depending on which computation method is used. The final figure also varies according to the number of decimal places to which the division is carried. *All of the computations in this chapter are computed by carrying the division to three decimal places.* The third decimal place is rounded off to cents only after the final proration figure is determined.

Accrued Items

When the real estate tax is levied for the calendar year and is payable during that year or in the following year, the accrued portion is for the period from January 1 to the date of closing (or to the day before the closing in states where the sale date is excluded). If the current tax bill has not yet been issued, the parties must agree on an estimated amount based on the previous year's bill and any known changes in assessment or tax levy for the current year.

Example:

Assume a sale is to be closed on September 17. Current real estate taxes of \$1,200 are to be prorated. A 360-day year is used. The accrued period, then, is eight months and 17 days. First determine the prorated cost of the real estate tax per month and day:

$$\$1200/12 = \$100 \text{ per month.}$$

$$\$100/30 = \$3.333 \text{ per day.}$$

Next, multiply these figures by the accrued period, and add the totals to determine the prorated real estate tax:

$$\$100 \times 8 \text{ months} = \$800$$

$$\$3.333 \times 17 \text{ days} = \$56.66$$

$$\$800 + \$56.66 = \$856.66$$

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Thus, the accrued real estate tax for eight months and 17 days is \$856.66 (rounded off to two decimal places after the final computation). This amount represents the seller's accrued earned tax. It will be a credit to the buyer and a debit to the seller on the closing statement.

To compute this proration using the actual number of days in the accrued period, the following method is used: The accrued period from January 1 to September 17 runs 260 days (January's 31 days plus February's 28 days and so on, plus the 17 days of September).

$$\text{\$1,200 tax bill} / 365 \text{ days} = \text{\$3.288 per day}$$

$$\text{\$3.288} \times 260 \text{ days} = \text{\$854.88}$$

While these examples show proration as of the date of settlement, the agreement of sale may require otherwise. For instance, a buyer's possession date may not coincide with the settlement date. In this case, the parties could prorate according to the date of possession.

Prepaid Items

A tax proration could be a prepaid item. Because real estate tax may be paid in the early part of the year, a tax proration calculated for a closing taking place later in the year must reflect the fact that the seller has already paid the tax. For example, in the preceding problem, suppose that all taxes had been paid. The buyer, then, would have to reimburse the seller; the proration would be *credited to the settler and debited to the buyer*.

Sample prepaid item calculation. One example of a prepaid item is a water bill. Assume that the water is billed in advance by the city without using a meter. The six months' billing is \$60 for the period ending October 31. The sale is to be closed on August 3. Because the water bill is paid to October 31, the prepaid time must be computed. Using a 30-day basis, the time period is the 27 days left in August plus two full months: $\text{\$60} \div 6 = \text{\$10 per month}$. For one day, divide \$10 by 30, which equals \$0.333 per day. The prepaid period is two months and 27 days, so:

$$\begin{aligned} 27 \text{ days} \times \$0.333 \text{ per day} &= \$8.991 \\ 2 \text{ months} \times \$10 &= \$20 \\ \$8.991, \text{ or } \$28.99 \end{aligned}$$

This is a prepaid item; it is credited to the seller and debited to the buyer on the closing statement.

General Rules for Prorating

The rules or customs governing the computation of prorations for the closing of a real estate sale vary widely from state to state. The following are some general guidelines for preparing the closing statement:

- ⇒ *In most states, the seller owns the property on the day of closing, and prorations or apportionments are usually made to and including the day of closing. In a few states, however, it is provided specifically that the buyer owns the property on the closing date. In that case, adjustments are made as of the day preceding the day on which title is closed.*
- ⇒ *Mortgage interest, general real estate taxes, water taxes, insurance premiums and similar expenses are usually computed by using 360 days in a year and 30 days in a*



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month. However, the rules in some areas provide for computing prorations on the basis of the actual number of days in the calendar month of closing. The agreement of sale should specify which method would be used.

- ⇒ *Accrued or prepaid general real estate taxes are usually prorated at the closing. When the amount of the current real estate tax cannot be determined definitely, the proration is usually based on the last obtain-able tax bill.*
- ⇒ *Special assessments for municipal improvements such as sewers, water mains or streets are usually paid in annual installments over several years, with annual interest charged on the outstanding balance of future installments. The seller normally pays the current installment, and the buyer assumes all future installments. The special assessment installment generally is not prorated at the closing. A buyer may insist that the seller allow the buyer a credit for the seller's share of the interest to the closing date. The agreement of sale may address the manner in which special assessments will be handled at settlement.*
- ⇒ *Rents are usually adjusted on the basis of the actual number of days in the month of closing. It is customary for the seller to receive the rents for the day of closing and to pay all expenses for that day. If any rents for the current month are uncollected when the sale is closed, the buyer often agrees by a separate letter to collect the rents if possible and remit the pro rata share to the seller.*
- ⇒ *Security deposits made by tenants to cover the last month's rent of the lease or to cover the cost of repairing damage caused by the tenant are generally transferred by the seller to the buyer.*

Real estate taxes

Proration of real estate taxes varies widely depending on how the taxes are paid in the area where the real estate is located. In California, real estate taxes are paid *in advance*; that is, the tax year runs from July 1 to June 30, taxes for the coming year are due on November 1 and February 1. In this case, the seller, who has prepaid a year's taxes, should be reimbursed for the portion of the year remaining after the buyer takes ownership of the property. The licensee should understand how the taxes will be prorated.

Mortgage loan interest.

On almost every mortgage loan the interest is paid *in arrears*, so buyer and seller must understand that the mortgage payment due on June 1, for example, includes interest due for the month of May. Thus, the buyer who assumes a mortgage on May 31 and makes the June payment pays for the time the seller occupied the property and should be credited with a month's interest. On the other hand, the buyer who places a new mortgage loan on May 31 may be pleasantly surprised to hear that he or she will not need to make a mortgage payment until a month later.

CHAPTER QUIZ

1. Legal title always passes from seller to buyer:

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- A. On the date of execution of the deed.
 - B. When the closing statement has been signed.
 - C. When the deed is placed in escrow.
 - D. When the deed is delivered.
2. All encumbrances and liens shown on the report of title other than those waived or agreed to by the purchaser and listed in the contract must be removed so that the title can be delivered free and clear. The removal of such encumbrances is the duty of the:
 - A. Buyer.
 - B. Seller.
 - C. Broker
 - D. Title company.
3. Which of the following would a lender generally require at the closing?
 - A. Title insurance binder
 - B. Market value appraisal
 - C. Application
 - D. Credit report
4. The document that provides borrowers with general information about settlement costs, RESPA provisions and the Uniform Settlement Statement is the:
 - A. HUD Form 1.
 - B. Special information booklet.
 - C. Good-faith estimate of settlement costs.
 - D. Closing statement.
5. The RESPA Uniform Settlement Statement must be used to illustrate all settlement charges for:
 - A. Every real estate transaction.
 - B. Transactions financed by VA and FHA loans only.
 - C. Residential transactions financed by federally related mortgage loans.
 - D. All transactions involving commercial property.
6. The earnest money left on deposit with the broker is a:
 - A. Credit to the seller.
 - B. Credit to the buyer.
 - C. Balancing factor.
 - D. Debit to the buyer.
7. Security deposits should be listed on a closing statement as a credit to the:
 - A. Buyer
 - B. Seller
 - C. Lender.
 - D. Broker.
8. At closing, the listing broker's commission usually is shown as a:



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- A. Credit to the seller.
 - B. Credit to the buyer.
 - C. Debit to the seller.
 - D. Debit to the buyer.
9. The Real Estate Settlement Procedures Act applies to the activities of:
- A. Brokers selling commercial and office buildings.
 - B. Security salespersons selling limited partnerships.
 - C. Ginnie Mae or Fannie Mae when purchasing mortgages.
 - D. Lenders financing the purchases of borrowers' residences.
10. The purpose of RESPA (Real Estate Settlement Procedures Act) is to:
- A. Make sure buyers do not borrow more than they can repay.
 - B. Make real estate brokers more responsive to buyers' needs.
 - C. Help buyers know how much money is required.
 - D. See that buyers know all settlement costs.

Answers: 1-D, 2-B, 3-A, 4-B, 5-C, 6-D, 7-A, 8-C, 9-D, 10-D

CHAPTER 11: REAL ESTATE FINANCING

Preview



Almost all real estate transactions require some sort of financing. Few people have the cash in hand necessary to buy a house or another large property. Also, as economic conditions change, the forces of supply and demand reshape the real estate market (see Chapter 1). Both of these factors have combined to create a complex and rapidly evolving mortgage market. One of the greatest challenges today's real estate licensees face is how to maintain a working knowledge of all the financing techniques available.

Although it has never been easier to buy a house, it has never been more challenging to keep up with the financing alternatives. By altering the terms of the basic mortgage or deed of trust and note, a borrower and a lender can tailor financing instruments to suit the type of transaction and the financial needs of both parties. Having an overview of current financing techniques and sources of financing can help salesperson direct buyers to the mortgage loans that will help the buyers reach their real estate goals.

THE FEDERAL RESERVE SYSTEM

The role of the **Federal Reserve System** (also known as the *Fed*) is to maintain sound credit conditions, help counteract inflationary and deflationary trends and create a favorable economic climate. The Federal Reserve System divides the country into 12 federal reserve districts, each served by a federal reserve bank. All nationally chartered banks must join the Fed and purchase stock in its district reserve banks.

The Federal Reserve regulates the flow of money and interest rates in the marketplace indirectly through its member banks by controlling their *reserve requirements* and *discount rates*.

RESERVE REQUIREMENTS

The Federal Reserve requires that each member bank keep a certain amount of assets on hand as reserve funds. These reserves are unavailable for loans or any other use. This requirement not only protects customer deposits, but also provides a means of manipulating the flow of cash in the money market.

By increasing its reserve requirements, the Federal Reserve in effect limits the amount of money that member banks can use to make loans. When the amount of money available for lending decreases, interest rates (the amount lenders charge for the use of their money) rise. By causing interest rates to rise, the government can slow down an overactive economy by limiting



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the number of loans that would have been directed toward major purchases of goods and services. The opposite is also true: by decreasing the reserve requirements, the Fed can encourage more lending. Increased lending causes the amount of money circulated in the marketplace to rise, while simultaneously causing interest rates to drop.

DISCOUNT RATES

Federal Reserve member banks are permitted to borrow money from the district reserve banks to expand their lending operations. The interest rate that the district banks charge for the use of this money is called the **discount rate**. This rate is the basis on which the banks determine the percentage rate of interest they will charge their loan customers. The prime rate (the short-term interest rate charged to a bank's largest, most creditworthy customers) is strongly influenced by the Fed's discount rate. In turn, the prime rate is often the basis for determining a bank's interest rate on other loans, including mortgages. In theory, when the Federal Reserve discount rate is high, bank interest rates are high. When bank interest rates are high, fewer loans are made and less money circulates in the marketplace. On the other hand, a lower discount rate results in lower interest rates, more bank loans and more money in circulation.

PRIMARY MORTGAGE MARKET

The primary mortgage market is made up of the lenders that originate mortgage loans. These lenders make money available directly to borrowers. From a borrower's point of view, a loan is a means of financing an expenditure; from a lender's point of view, a loan is an investment. All investors look for profitable returns on their investments. For a lender, a loan must generate enough income to be attractive as an investment. Income on the loan is realized from two sources:

1. *Finance charges* collected at closing, such as loan origination fees and discount points
2. *Recurring income* - that is, the interest collected during the term of the loan

An increasing number of lenders look at the income generated from the fees charged in originating loans as their primary investment objective. Once the loans are made, they are sold to investors. By selling loans to investors in the secondary mortgage market, lenders generate funds with which to originate additional loans.

In addition to the income directly related to loans, some lenders derive income from *servicing loans* for other mortgage lenders or the investors who have purchased the loans. Servicing involves such activities as

- ♦ Collecting payments (including insurance and taxes);
- ♦ Accounting;
- ♦ Bookkeeping;
- ♦ Preparing insurance and tax records;
- ♦ Processing payments of taxes and insurance; and
- ♦ Following up on loan payment and delinquency.

The terms of the servicing agreement stipulate the responsibilities and fees for the service.

Some of the major lenders in the primary market include:

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- ♦ Trusts
- ♦ Savings associations
- ♦ Commercial banks
- ♦ Insurance companies
- ♦ Credit unions
- ♦ Pension funds
- ♦ Endowment funds
- ♦ Investment group financing
- ♦ Mortgage banking companies
- ♦ Mortgage brokers

Thrifts savings associations and commercial banks

These institutions are known as *fiduciary lenders* because of their fiduciary obligations to protect and preserve their depositors' funds. Mortgage loans are perceived as secure investments for generating income and enable these institutions to pay interest to their depositors. Fiduciary lenders are subject to standards and regulations established by government agencies, such as the [Federal Deposit Insurance Corporation \(FDIC\)](#). The [Financial Institutions Reform, Recovery, and Enforcement Act of 1989 \(FIRREA\)](#) created the [Office of Thrift Supervision \(OTS\)](#) specifically to govern the practices of fiduciary lenders. The various government regulations (which include reserve fund, reporting and insurance requirements) are intended to protect depositors against the reckless lending that characterized the savings and loan industry in the 1980s.

Insurance companies

Insurance companies accumulate large sums of money from the premiums paid by their policyholders. While part of this money is held in reserve to satisfy claims and cover operating expenses, much of it is free to be invested in profit-earning enterprises, such as long-term real estate loans. Although insurance companies are considered primary lenders, they tend to invest their money in large, long-term loans that finance commercial and industrial properties rather than single-family home mortgages.

Credit Unions

Credit unions are cooperative organizations whose members place money in savings accounts. In the past, credit unions made only short-term consumer and home improvement loans. Recently, however, they have branched out to originating longer-term first and second mortgage and deed of trust loans.

Pension Funds

Pension funds usually have large amounts of money available for investment. Because of the comparatively high yields and low risks offered by mortgages, pension funds have begun to participate actively in financing real estate projects. Most real estate activity for pension funds is handled through mortgage bankers and mortgage brokers.

Endowment Funds



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Many commercial banks and mortgage bankers handle investments for endowment funds. The endowments of hospitals, universities, colleges, charitable foundations and other institutions provide a good source of financing for low-risk commercial and industrial properties.

Investment Group Financing

Large real estate projects, such as highrise apartment buildings, office complexes and shopping centers, are often financed as joint ventures through group financing arrangements like syndicates, limited partnerships and real estate investment trusts. These complex investment agreements are discussed in Chapter 10.

Mortgage Companies

Mortgage companies originate mortgage loans with money belonging to insurance companies, pension funds and individuals and with funds of their own. They make real estate loans with the intention of selling them to investors and receiving a fee for servicing the loans. Mortgage banking companies are generally organized as stock companies. As a source of real estate financing, they are subject to fewer lending restrictions than are commercial banks or savings associations. Mortgage banking companies often are involved in all types of real estate loan activities and often serve as intermediaries between investors and borrowers. They are *not* mortgage brokers.

Mortgage Brokers

Mortgage brokers are not lenders. They are intermediaries who bring borrowers and lenders together. Mortgage brokers locate potential borrowers, process preliminary loan applications and submit the applications to lenders for final approval. Frequently, they work with or for mortgage banking companies. They do not service loans once they are made. Mortgage brokers may also be real estate brokers who offer these financing services in addition to their regular brokerage activities. Many state governments are establishing separate licensure requirements for mortgage brokers to regulate their activities.

SECONDARY MORTGAGE MARKET

In addition to the primary mortgage market, where loans are originated, there is a **secondary mortgage market**. Here, loans are bought and sold only after they have been funded. Lenders routinely sell loans to avoid interest rate risks and to realize profits on the sales. This secondary market activity helps lenders raise capital to continue making mortgage loans. Secondary market activity is especially desirable when money is in short supply, it stimulates both the housing construction market and the mortgage market by expanding the types of loans available.

When a loan is sold, the original lender may continue to collect the payments from the borrower. The lender then passes the payments along to the investor who purchased the loan. The investor is charged a fee for servicing of the loan.

Warehousing agencies purchase a number of mortgage loans and assemble them into packages (called *pools*). Securities that represent shares in these pooled mortgages are then sold to investors. Loans are eligible for sale to the secondary market only when the collateral, borrower and documentation meet certain requirements to provide a degree of safety for the investors. The major warehousing agencies are discussed in the following paragraphs.

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FANNIE MAE (FORMERLY FEDERAL NATIONAL MORTGAGE ASSOCIATION)

The **Fannie Mae** is a quasi-governmental agency. It is organized as a privately owned corporation that issues its own common stock and provides a secondary market for mortgage loans. FNMA deals in conventional, and FHA and VA loans. FNMA buys a *block* or *pool* of mortgages from a lender in exchange for *mortgage-backed securities*, which the lender may keep or sell. FNMA guarantees payment of all interest and principal to the holder of the securities.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

Unlike FNMA, the Government National Mortgage Association (**GNMA**, or **Ginnie Mae**) is entirely a governmental agency. GNMA is a division of the Department of Housing and Urban Development (HUD), organized as a corporation without capital stock. GNMA administers special-assistance programs and works with FNMA in secondary market activities.

In times of tight money and high interest rates, Fannie Mae and Ginnie Mae can join forces through their tandem plan. The *tandem plan* provides that FNMA can purchase high-risk, low-yield (usually FHA) loans at full market rates, with GNMA guaranteeing payment and absorbing the difference between the low yield and current market prices.

Ginnie Mae also guarantees investment securities issued by private offerors (such as banks, mortgage companies and savings and loan associations) and backed by pools of FHA and VA mortgage loans. The *Ginnie Mae pass-through certificate* is a security interest in a pool of mortgages that provides for a monthly pass-through of principal and interest payments directly to the certificate holder. Such certificates are guaranteed by Ginnie Mae.

FEDERAL HOME LOAN MORTGAGE CORPORATION

The **Federal Home Loan Mortgage Corporation** (FHLMC, or Freddie Mac) provides a secondary market for mortgage loans, primarily conventional loans. Freddie Mac has the authority to purchase mortgages, pool them and sell bonds in the open market with the mortgages as security. However, FHLMC does not guarantee payment of Freddie Mac mortgages.

Many lenders use the standardized forms and follow the guidelines issued by Fannie Mae and Freddie Mac. In fact, the use of such forms is mandatory for lenders that wish to sell mortgages in the agencies' secondary mortgage market. The standardized documents include loan applications, credit reports and appraisal forms.

☞ ***Because FNMA's and FHLMC's involvement in the secondary market is so pervasive, many underwriting guidelines are written to comply with their regulations. Bank statements, tax returns, verifications of employment and child support-most of the paperwork a potential borrower must deal with-may be tied to FNMA and FHLMC requirements.***

FINANCING TECHNIQUES

As mentioned at the beginning of this chapter, real estate financing comes in a wide variety of forms. While the payment plans described in the following sections are commonly referred to as *mortgages*, they are really *loans* secured by either a mortgage or a deed of trust.



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STRAIGHT LOANS (TERM LOANS)

A **straight loan** (also known as a **term loan**) essentially divides the loan into two amounts, to be paid off separately. The borrower makes periodic interest payments, followed by the payment of the principal *in full at the end of the term*. Straight loans were once the only form of mortgage available. Today, they are generally used for home improvements and second mortgages rather than for residential first mortgage loans.

AMORTIZED LOANS

The word **amortize** literally means “to kill off slowly, over time.” Most mortgage and deed of trust loans are amortized loans. That is, they are paid off slowly, over time. Regular periodic payments are made over a term of years. The most common periods are 15 or 30 years, although 20-year and 40-year mortgages are also available. Unlike a straight loan payment, an amortized loan payment partially pays off both principal and interest. Each payment is applied first to the interest owed; the balance is applied to the principal amount.

Calculating Simple Interest

To compute simple interest, use the formula $I = P \times R \times T$, where

I = Interest; P = Principal; R = Rate; T = Time

Apply this formula to a \$30,000 loan (*P*) at 8 percent interest (*I*) to be repaid over 15 years (*T*):

$$\begin{aligned} I &= \$30,000 \times .08 \times 15 \\ I &= \$36,000 \end{aligned}$$

The total interest to be paid by the borrower is \$36,000. Therefore

$$\begin{aligned} \$36,000 \text{ total interest} / 15 \text{ years} &= \$2,400 \text{ yearly interest payment} \\ \$2,400 / 12 \text{ months} &= \$200 \text{ monthly interest payment} \end{aligned}$$

At the end of the term, the full amount of the principal and all interest due is reduced to zero. Such loans are also called **direct reduction loans**. Most amortized mortgage and deed of trust loans are paid in monthly installments. However, some are payable quarterly (four times a year) or semiannually (twice a year).

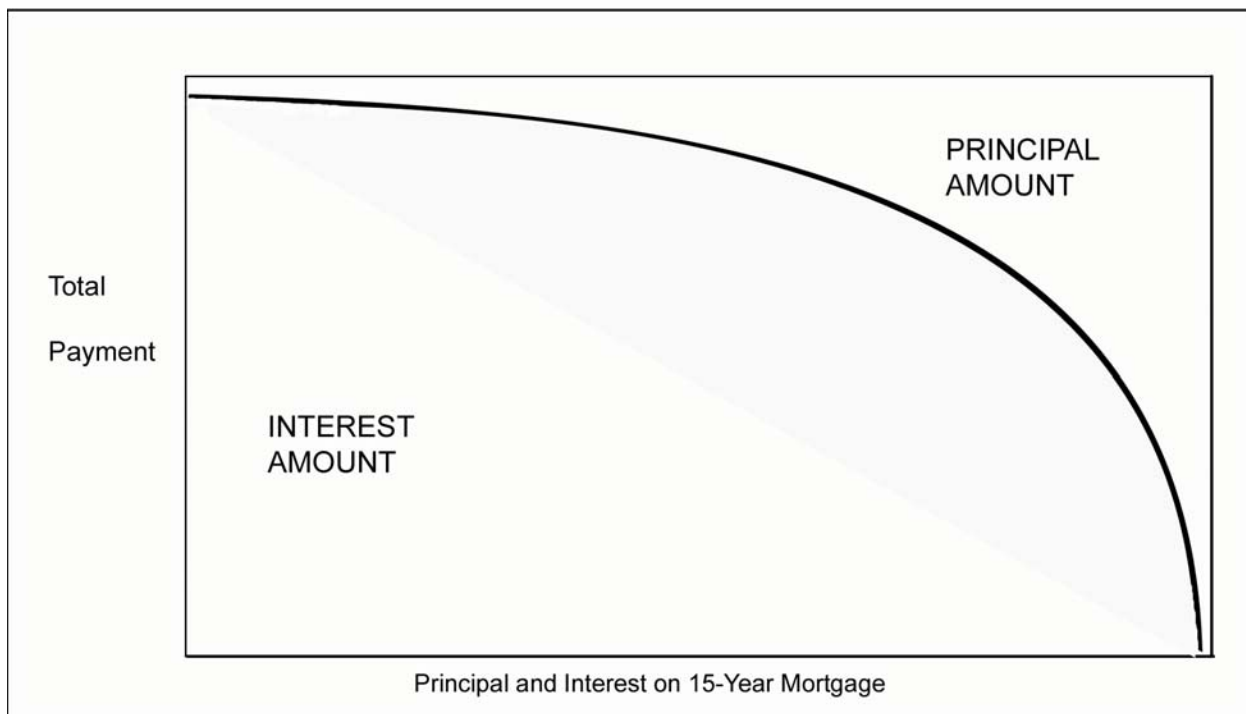
Different payment plans tend alternately to gain and lose favor with lenders and borrowers as the cost and availability of mortgage money fluctuate. The most frequently used plan is the fully amortized loan, or level-payment loan. The mortgagor pays a constant amount, usually monthly. The lender credits each payment first to the interest due, then to the principal amount of the loan. As a result, while each payment remains the same, the portion applied to repayment of the principal grows and the interest due declines as the unpaid balance of the loan is reduced. (See Figure 10.1 Amortized Loan) If the borrower pays additional amounts that are applied directly to the principal, the loan will amortize more quickly. This benefits the borrower because he or she will pay less interest if the loan is paid off before the end of its term. Of course, lenders are aware of this, too, and may guard against unprofitable loans by including penalties for early payment.

The amount of the constant payment is determined from a prepared mortgage payment book or a mortgage factor chart. (See Figure 11-2) The mortgage factor chart indicates the amount of

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monthly payment per \$1,000 of loan, depending on the term and interest rate. The factor is multiplied by the number of thousands (and fractions of thousands) of the amount borrowed.

Figure 11-1: Amortized Loan (Principal vs. Interest payment)



ADJUSTABLE-RATE MORTGAGES (ARMS)

An **adjustable-rate mortgage** (ARM) is generally originated at one rate of interest. That rate then fluctuates up or down during the loan term based on some objective economic indicator. Because the interest rate may change, the mortgagor's loan repayments may also change. Details of how and when the interest rate will change are included in the note. Common components of an ARM include the following:

The interest rate is tied to the movement of an objective economic indicator called an index. Most indexes are tied to U.S. Treasury securities.

How to Use Mortgage Loan Table

To use this chart, start by finding the appropriate interest rate. Then follow that row over to the column for the appropriate loan term. This number is the *interest rate factor* required each month to amortize a \$1,000 loan. To calculate the principal and interest (PI) payment, multiply the interest rate factor by the number of 1,000s in the total loan.

For example, if the interest rate is 10 percent for a term of 30 years, the interest rate factor is 8.78. If the total loan is \$100,000, the loan contains 100 1,000s. Therefore

$$100 \times 8.78 = \$878 \text{ PI only}$$



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To estimate a mortgage loan amount using the amortization chart, divide the PI payment by the appropriate interest rate factor. Using the same facts as in the first example:

$$\begin{aligned} \$878 / 8.78 &= \$100 \\ 1,000\text{'s, or } \$100,000 \end{aligned}$$

Figure 11-2: Mortgage Loan Table

Term Rate	10 Years	15 Years	20 Years	25 Years	30 Years
4	10.13	7.40	6.06	5.28	4.78
4 1/8	10.19	7.46	6.13	5.35	4.85
4 1/4	10.25	7.53	6.20	5.42	4.92
4 3/8	10.31	7.59	6.26	5.49	5.00
4 1/2	10.37	7.65	6.33	5.56	5.07
4 5/8	10.43	7.72	6.40	5.63	5.15
4 3/4	10.49	7.78	6.47	5.71	5.22
4 7/8	10.55	7.85	6.54	5.78	5.30
5	10.61	7.91	6.60	5.85	5.37
5 1/8	10.67	7.98	6.67	5.92	5.45
5 1/4	10.73	8.04	6.74	6.00	5.53
5 3/8	10.80	8.11	6.81	6.07	5.60
5 1/2	10.86	8.18	6.88	6.15	5.68
5 5/8	10.92	8.24	6.95	6.22	5.76
5 3/4	10.98	8.31	7.03	6.30	5.84
5 7/8	11.04	8.38	7.10	6.37	5.92
6	11.10	8.44	7.16	6.44	6.00
6 1/8	11.16	8.51	7.24	6.52	6.08
6 1/4	11.23	8.57	7.31	6.60	6.16
6 3/8	11.29	8.64	7.38	6.67	6.24
6 1/2	11.35	8.71	7.46	6.75	6.32
6 5/8	11.42	8.78	7.53	6.83	6.40
6 3/4	11.48	8.85	7.60	6.91	6.49
6 7/8	11.55	8.92	7.68	6.99	6.57
7	11.61	8.98	7.75	7.06	6.65
7 1/8	11.68	9.06	7.83	7.15	6.74
7 1/4	11.74	9.12	7.90	7.22	6.82
7 3/8	11.81	9.20	7.98	7.31	6.91
7 1/2	11.87	9.27	8.05	7.38	6.99
7 5/8	11.94	9.34	8.13	7.47	7.08
7 3/4	12.00	9.41	8.20	7.55	7.16
7 7/8	12.07	9.48	8.29	7.64	7.25
8	12.14	9.56	8.37	7.72	7.34
8 1/8	12.20	9.63	8.45	7.81	7.43
8 1/4	12.27	9.71	8.53	7.89	7.52
8 3/8	12.34	9.78	8.60	7.97	7.61
8 1/2	12.40	9.85	8.68	8.06	7.69
8 5/8	12.47	9.93	8.76	8.14	7.78
8 3/4	12.54	10.00	8.84	8.23	7.87
8 7/8	12.61	10.07	8.92	8.31	7.96
9	12.67	10.15	9.00	8.40	8.05
9 1/8	12.74	10.22	9.08	8.48	8.14

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9 1/4	12.81	10.30	9.16	8.57	8.23
9 3/8	12.88	10.37	9.24	8.66	8.32
9 1/2	12.94	10.45	9.33	8.74	8.41
9 5/8	13.01	10.52	9.41	8.83	8.50
9 3/4	13.08	10.60	9.49	8.92	8.60
9 7/8	13.15	10.67	9.57	9.00	8.69
10	13.22	10.75	9.66	9.09	8.78
10 1/8	13.29	10.83	9.74	9.18	8.87
10 1/4	13.36	10.90	9.82	9.27	8.97
10 3/8	13.43	10.98	9.90	9.36	9.06
10 1/2	13.50	11.06	9.99	9.45	9.15
10 5/8	13.57	11.14	10.07	9.54	9.25
10 3/4	13.64	11.21	10.16	9.63	9.34

Interest and Principal Credited from Amortized Payments

Lenders charge borrowers a certain percentage of the principal as interest for each year a debt is outstanding. The amount of interest due on any one payment date is calculated by computing the total yearly interest (based on unpaid balance) and dividing that figure by the number of payments made each year.

For example, assume the current outstanding balance of a loan is \$70,000. The interest rate is 7½ percent per year, and the monthly payment is \$489.30. Based on these facts, the interest and principal due on the next payment would be computed as shown:

$\$70,000 \text{ loan balance} \times .075 \text{ annual interest rate} = \$5,250 \text{ annual interest}$

$\$5,250 \text{ annual interest} / 12 \text{ months} = \$437.50 \text{ monthly interest}$

$\$489.30 \text{ monthly payment} - 437.50 \text{ monthly interest} = \$51.80 \text{ monthly principal}$

$\$70,000 \text{ loan balance} - \$51.80 \text{ monthly principal} = \$69,948.20$

This process is followed with each payment over the term of the loan. The same calculations are made each month, starting with the declining new balance figure from the previous month.

- ⇒ *Usually, the interest rate is the index rate plus a premium, called the **margin**. The margin represents the lender's cost of doing business. For example, the loan rate may be 2 percent over the U.S. Treasury bill rate.*
- ⇒ ***Rate caps** limit the amount the interest rate may change. Most ARMs have two types of rate caps - periodic and aggregate. A periodic rate cap limits the amount the rate may increase at any one time. An aggregate rate cap limits the amount the rate may increase over the entire life of the loan.*
- ⇒ *The mortgagor is protected from unaffordable individual payments by the payment cap. The payment cap sets a maximum amount for payments. With a cap, a rate increase could result in negative amortization-that is, an increase in the loan balance.*
- ⇒ *The adjustment period establishes how often the rate may be changed. For instance, the adjustment period may be monthly, quarterly or annually.*

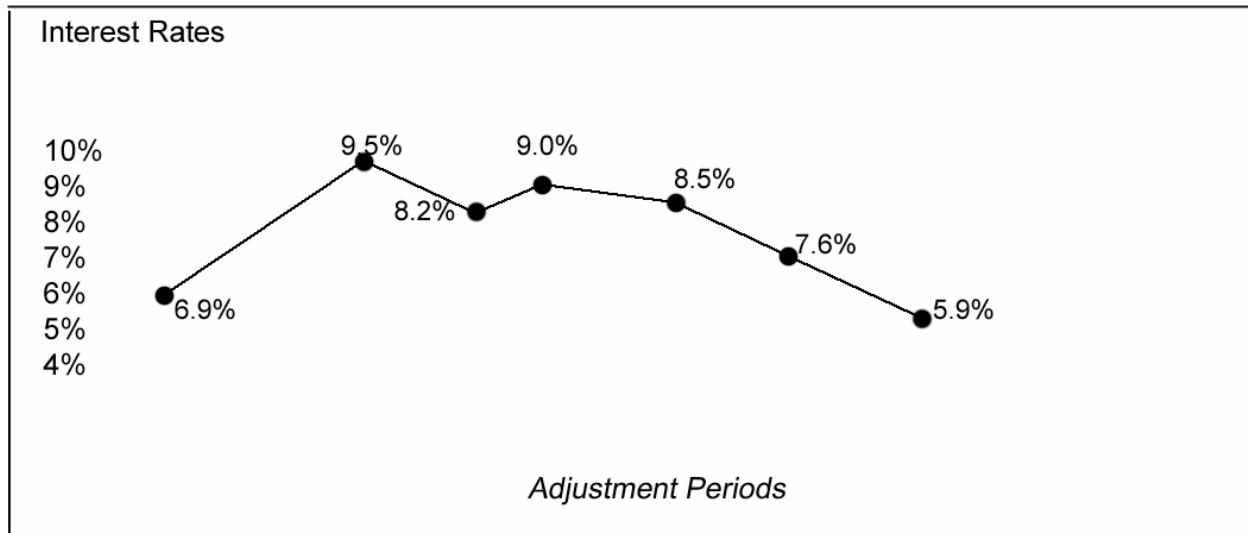


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⇒ Lenders may offer a conversion option, which permits the mortgagor to convert from an adjustable-rate to a fixed-rate loan at certain intervals during the life of the mortgage. The option is subject to certain terms and conditions for the conversion.

Figure 11.3 illustrates the effect interest rate fluctuations and periodic caps have on an adjustable-rate mortgage. Obviously, without rate caps and payment caps, a single mortgage's interest rate could fluctuate wildly over several adjustment periods, depending on the behavior of the index to which it is tied. In Figure 11.3, the borrower's rate changes from a low of 5.9 percent to a high of 9.5 percent. Such unpredictability makes personal financial planning difficult. On the other hand, if the loan had a periodic rate cap of 7.5 percent, the borrower's rate would never go above that level, regardless of the index's behavior. Similarly, a lender would want a floor to keep the rate from falling below a certain rate (here, 6.5 percent). The shaded area in the figure shows how caps and floors protect against dramatic changes in interest rates.

Figure 11-3: Adjustment Rate Mortgage



Balloon Payment Loan

When the periodic payments are not enough to fully amortize the loan by the time the final payment is due, the final payment is larger than the others. This is called a balloon payment. It is a **partially amortized loan** because principal is still owed at the end of the term. It is frequently assumed that if payments are made promptly, the lender will extend the balloon payment for another limited term. The lender, however, is not legally obligated to grant this extension and can require payment in full when the note is due.

Growing-Equity Mortgage (GEM)

A **growing-equity mortgage** (GEM) is also known as a *rapid-payoff mortgage*. The GEM uses a fixed interest rate, but payments of principal are increased according to an index or a schedule. Thus, the total payment increases, and the loan is paid off more quickly. A GEM is

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most frequently used when the borrower's income is expected to keep pace with the increasing loan payments.

Reverse-Annuity Mortgage (RAM)

A **reverse-annuity mortgage (RAM)** is one in which regular monthly payments are made by the lender to the *borrower*. The payments are based on the equity the homeowner has invested in the property given as security for the loan. This loan allows senior citizens on fixed incomes to realize the equity they have built up in their homes without having to sell. The borrower is charged a fixed rate of interest, and the loan is eventually repaid from the sale of the property or from the borrower's estate upon his or her death.

LOAN PROGRAMS

Mortgage loans are generally classified based on their **loan-to-value ratios**, or *LTVs*. The LTV is the ratio of debt to value of the property. Value is the sale price or the appraisal value, whichever is less. The *lower* the ratio of debt to value, the *higher* the down payment by the borrower. For the lender, the higher down payment means a more secure loan, which minimizes the lender's risk.

CONVENTIONAL LOANS

☞ **Low LTV = High down payment High down payment = Low lender risk**

Conventional loans are viewed as the most secure loans because their loan-to-value ratios are lowest. Usually, the ratio is 80 percent of the value of the property or less, because the borrower makes a down payment of at least 20 percent. The security for the loan is provided solely by the mortgage; the payment of the debt rests on the ability of the borrower to pay. In making such a loan, the lender relies primarily on its appraisal of the security (the real estate). Information from credit reports that indicate the reliability of the prospective borrower is also important. No additional insurance or guarantee on the loan is necessary to protect the lender's interest.

Lenders can set criteria by which a borrower and the collateral are evaluated to qualify for a loan. However, in recent years the secondary mortgage market has had a significant impact on the borrower qualifications, standards for the collateral and documentation procedures followed by lenders. Loans must meet strict criteria to be sold to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Lenders can still be flexible in their lending decisions, but they may not be able to sell unusual loans in the secondary market.

PRIVATE MORTGAGE INSURANCE

One way a borrower can obtain a mortgage loan with a lower down payment is under a **private mortgage insurance (PMI)** program. Because the loan-to-value ratio is higher than for other conventional loans, the lender requires additional security to minimize its risk. The borrower purchases insurance from a private mortgage insurance company as additional security to insure the lender against borrower default. LTVs of up to 95 percent of the appraised value of the property are possible with mortgage insurance.

PMI protects a certain percentage of a loan, usually 25 to 30 percent, against borrower default. Normally, the borrower is charged a fee for the first year's premium at closing. The borrower also pays a monthly fee while the insurance is in force. Other methods of payment are available, however: the premium may be financed, or the fee at closing may be waived in exchange for slightly higher monthly payments. When a borrower has limited funds for investment, these



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alternative methods of reducing closing costs are very important. Because only a portion of the loan is insured, once the loan is repaid to a certain level, the lender may agree to allow the borrower to terminate the coverage. Practices for termination vary from lender to lender.

Balloon Payment Loan

Consider a loan with the following terms: \$80,000 at 8 percent interest, with only interest payable monthly and the loan fully repayable in 15 years. This is how to calculate the amount of the final balloon payment:

$\$80,000 \times .08 = \$6,400$ annual interest

$\$6,400 \text{ annual interest} / 12 \text{ months} = \533.33 monthly interest payment

$\$80,000 \text{ principal payment} + \$533.33 \text{ final month's interest} = \$80,533.33$ final balloon payment

FHA-INSURED LOANS

The Federal Housing Administration (FHA), which operates under HUD, neither builds homes nor lends money itself. The common term FHA Loan refers to a loan that is *insured* by the agency. **These loans must be made by FHA-approved lending institutions.** The FHA insurance provides security to the lender in addition to the real estate. As with private mortgage insurance, the FHA insures lenders against loss from borrower default.

The most popular FHA program is Title II, Section 203(b), fixed-interest rate loans for 10 to 30 years on one- to four-family residences. Rates are competitive with other types of loans, even though they are high-LTV loans. Certain technical requirements must be met before the FHA will insure the loans. These requirements include the following:


- ♦ The borrower is charged a percentage of the loan as a premium for the FHA insurance. The *upfront premium* is paid at closing by the borrower or some other party. It may also be financed along with the total loan amount. A monthly premium may also be charged. Insurance premiums vary for new loans, refinancing and condominiums.
- ♦ FHA regulations set standards for type and construction of buildings, quality of neighborhood and credit requirements for borrowers.
- ♦ The mortgaged real estate must be appraised by an *approved FHA appraiser*. The loan amount generally cannot exceed either of the following:
 - (1) 97 percent on the first \$25,000 of appraised value or purchase price, whichever is less; 95 percent up to \$125,000; and 90 percent of any amount exceeding \$125,000 (including the allowable amount for closing costs); or
 - (2) 97.75 percent of the sales price or appraised value, whichever is less. If the purchase price exceeds the FHA-appraised value, the buyer may pay the difference in cash as part of the down payment. In addition, the FHA has set maximum loan amounts for various regions of the country.

Other types of FHA loans are available, including one-year adjustable-rate mortgages; home improvement and rehabilitation loans; and loans for the purchase of condominiums. Specific standards for condominium complexes and the ratio of owner-occupants to renters must be met for a loan on a condominium unit to be financed through the FHA insurance programs.

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Determining LTV

If a property has an appraised value of \$100,000, secured by a \$90,000 loan, the LTV is 90 percent. ($\$90,000 / 100,000 = 90\%$)

 ***The FHA sets lending limits for single-unit and multiple-unit properties. The limits vary significantly depending on the average cost of housing in different regions of the country. In addition, the FHA changes its regulations for various programs from time to time. Contact your local FHA office or mortgage lender for loan amounts in your area and for specific loan requirements.***

Prepayment Privileges

A borrower may repay a FHA-insured loan on a one- to four-family residence without penalty.

For loans initiated *after* August 2, 1985, no written notice of prepayment is required.

Assumption Rules

The assumption rules for FHA-insured loans vary, depending on the dates the loans were originated:

- ♦ FHA loans originated before December 1986 generally have no restrictions on their assumptions.
- ♦ For a FHA loan originated between December 1, 1986, and December 15, 1989, a creditworthiness review of the prospective assumer is required. If the original loan was for the purchase of a principal residence, this review is required during the first 12 months of the loan's existence. If the original loan was for the purchase of an investment property, the review is required during the first 24 months of the loan.
- ♦ For FHA loans originated on December 15, 1989, and later, no assumptions are permitted without complete buyer qualification.

Discount Points

The lender of a FHA-insured loan may charge discount points in addition to a loan origination fee. The payment of points is a matter of negotiation between the seller and the buyer. However, if the seller pays more than 6 percent of the costs normally paid by the buyer (such as discount points, the loan origination fee, the mortgage insurance premium, buydown fees, prepaid items and impound or escrow amounts), the lender will treat the payments as a reduction in sales price and recalculate the mortgage amount accordingly. Points are tax deductible to the buyer regardless of which party pays them.

VA-GUARANTEED LOANS

The Department of Veterans Affairs (VA) is authorized to guarantee loans to purchase or construct homes for eligible veterans and their spouses (including unremarried spouses of veterans whose deaths were service-related). The VA also guarantees loans to purchase mobile homes and plots on which to place them. A veteran who meets any of the following time-in-service criteria is eligible for a VA loan:

- ♦ 90 days of active service for veterans of World War II, the Korean War, the Viet Nam conflict and the Persian Gulf War



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- ♦ A minimum of 181 days of active service during interconflict periods between July 26, 1947, and September 6, 1980.
- ♦ Two full years of service during any peacetime period after September 7, 1980
- ♦ Six or more years of continuous duty as a reservist in the Army, Navy, Air Force, Marine Corps or Coast Guard or as a member of the Army or Air National Guard (eligibility expires on October 28, 1999).

The VA assists veterans in financing the purchase of homes with little or no down payments, at comparatively low interest rates. The VA issues rules and regulations that set forth the qualifications, limitations and conditions under which a loan may be guaranteed.

Like the term *FHA loan*, *VA loan* is something of a misnomer. The VA does not normally lend money; it guarantees loans made by lending institutions approved by the agency. The term **VA loan** refers to a loan that is not made by the agency, but guaranteed by it.

There is no VA limit on the amount of the loan a veteran can obtain; this is determined by the lender. The VA limits the amount of the loan it will guarantee. (See Figure 11.4.)

To determine what portion of a mortgage loan the VA will guarantee, the veteran must apply for a certificate of eligibility. This certificate does not mean that the veteran automatically receives a mortgage. It merely sets forth the maximum guarantee to which the veteran is entitled. For individuals with full eligibility, no down payment is required for a loan up to the maximum guarantee limit.

The VA also issues a **certificate of reasonable value (CRV)** for the property being purchased. The CRV states the property's current market value based on a VA-approved appraisal. The CRV places a ceiling on the amount of a VA loan allowed for the property. If the purchase price is greater than the amount cited in the CRV, the veteran may pay the difference in cash.

The VA purchaser pays a loan origination fee to the lender, as well as a funding fee (1.25 to 2 percent, depending on the down payment amount) to the Department of Veterans Affairs. Reasonable discount points may be charged on a VA-guaranteed loan, and either the veteran or the seller may pay them.

Prepayment Privileges

As with a FHA loan, the borrower under a VA loan can prepay the debt at any time without penalty.

Assumption Rules

VA loans made before March 1, 1988, are freely assumable, although an assumption processing fee will be charged. The fee is ½ percent of the loan balance. For loans made on or after March 1, 1988, the VA must approve the buyer and assumption agreement. The original veteran borrower remains personally liable for the repayment of the loan unless the VA approves a *release of liability*. The release of liability will be issued by the VA only if

Figure 11-4: VA Schedule of Guarantees

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<i>Loan Amount</i>	<i>Maximum Guarantee Amount</i>
Upto\$45,000	50%
\$45,001 to \$144,000	(\$22,500 minimum)
More than \$144,000 to \$203,000	The lesser of \$36,000 or 40% of loan
	The lesser of \$50,750 or 25% of loan

The buyer assumes all of the veteran's liabilities on the loan and

The VA or the lender approves both the buyer and the assumption agreement.

A release would also be possible if another veteran used his or her own entitlement in assuming the loan.

☞ ***A release of liability issued by the VA does not release the veteran's liability to the lender. This must be obtained separately from the lender. Real estate licensees should contact their local VA offices or mortgage lenders for specific requirements for obtaining or assuming VA-insured loans. The programs change from time to time.***

CREATIVE FINANCING TECHNIQUES

Because borrowers often have different needs, a variety of other financing techniques have been created. Other techniques apply to various types of collateral. The following pages consider some of the loans that do not fit into the categories previously discussed.

PURCHASE-MONEY MORTGAGES

A **purchase-money mortgage** is a note and mortgage *created at the time of purchase*. Its purpose is to make the sale possible. The term is used in two ways. First, it may refer to any security instrument that originates at the time of sale. More often, it refers to the instrument given by the purchaser to a seller who takes back a note for part or all of the purchase price. The mortgage may be a first or a junior lien, depending on whether prior mortgage liens exist.

☞ ***Example: B wants to buy Brownacre for \$200,000. B has a \$40,000 down payment and agrees to assume an existing mortgage of \$80,000. Because B might not qualify for a new mortgage under the circumstances, the owner agrees to take back a purchase-money second mortgage in the amount of \$80,000. At the closing, B will execute a mortgage and note in favor of the owner, who will convey title to B.***

PACKAGE LOANS

A **package loan** includes not only the real estate, but also all *personal property and appliances installed on the premises*. In recent years, this kind of loan has been used extensively to finance furnished condominium units. Package loans usually include furniture, drapes, carpets and the kitchen range, refrigerator, dishwasher, garbage disposal, washer, dryer, food freezer and other appliances as part of the sales price of the home.

BLANKET LOANS

A **blanket loan** covers *more than one parcel or lot*. It is usually used to finance subdivision developments. However, it can finance the purchase of improved properties or consolidate loans as well. A blanket loan usually includes a provision known as a **partial release clause**.



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This clause permits the borrower to obtain the release of any one lot or parcel from the lien by repaying a certain amount of the loan. The lender issues a partial release for each parcel released from the mortgage lien. The release form includes a provision that the lien will continue to cover all other unreleased lots.

WRAPAROUND LOANS

A **wraparound loan** enables a borrower with an existing mortgage or deed of trust loan to obtain additional financing from a second lender *without paying off the first loan*. The second lender gives the borrower a new, increased loan at a higher interest rate and assumes payment of the existing loan. The total amount of the new loan includes the existing loan as well as the additional funds needed by the borrower. The borrower makes payments to the new lender on the larger loan. The new lender makes payments on the original loan out of the borrower's payments.

A wraparound mortgage can be used to refinance real property or to finance the purchase of real property when an existing mortgage cannot be prepaid. The buyer executes a wraparound mortgage to the seller, who collects payments on the new loan and continues to make payments on the old loan. It also can finance the sale of real estate when the buyer wishes to invest a minimum amount of initial cash. A wraparound loan is possible only if the original loan permits it. For instance, an acceleration and alienation or a due-on-sale clause in the original loan documents may prevent a sale under a wraparound loan.

☞ ***To protect themselves against a seller's default on a previous loan, buyers should require protective clauses to be included in any wraparound document to grant buyers the right to make payments directly to the original lender.***

OPEN-END LOANS

An **open-end loan** secures a note executed by the borrower to the lender. It also secures any future *advances* of funds made by the lender to the borrower. The interest rate on the initial amount borrowed is fixed, but interest on future advances may be charged at the market rate in effect. An open-end loan is often a less costly alternative to a home improvement loan. It allows the borrower to "open" the mortgage or deed of trust to increase the debt to its original amount, or the amount stated in the note, after the debt has been reduced by payments over a period of time. The mortgage usually states the maximum amount that can be secured, the terms and conditions under which the loan can be opened and the provisions for repayment.

CONSTRUCTION LOANS

A **construction loan** is made to finance the construction of Improvements on real estate such as homes, apartments and office buildings. The lender commits to the full amount of the loan, but disburses the funds in payments during construction. These payments are also known as *draws*. Draws are made to the general contractor or the owner for that part of the construction work that has been completed since the previous payment. Before each payment, the lender inspects the work. The general contractor must provide the lender with adequate waivers that release all mechanic's lien rights for the work covered by the payment.

This kind of loans generally bears a higher-than-market interest rate because of the risks assumed by the lender. These risks include the inadequate releasing of mechanics' liens, possible delays in completing the construction or the financial failure of the contractor or subcontractors. Construction loans are generally **short-term** or **interim-financing**. The

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borrower pays interest only on the monies that have actually been disbursed. The borrower is expected to arrange for a permanent loan, also known as an *end loan* or *take-out loan*, that will repay or “take out” the construction financing lender when the work is completed. Some lenders now offer construction-to-permanent loans that become fixed mortgages upon completion. **Participation financing** is when a lender demands an equity position in the project as a requirement for the loan.

SALE-AND-LEASEBACK

Sale-and-leaseback arrangements are used to finance large commercial or industrial properties. The land and building, usually used by the seller for business purposes, are sold to an investor. The real estate is then leased back by the investor to the seller, who continues to conduct business on the property as a tenant. The buyer becomes the lessor, and the original owner becomes the lessee. This enables a business to free money tied up in real estate to be used as working capital.

Sale-and-leaseback arrangements involve complicated legal procedures, and their success is usually related to the effects the transaction has on the firm’s tax situation. Legal and tax experts should be involved in this type of transaction.

BUYDOWNS

A buydown is a way to temporarily lower the initial interest rate on a mortgage or deed of trust loan. Perhaps a homebuilder wishes to stimulate sales by offering a lower-than-market rate. Or a first-time residential buyer may have trouble qualifying for a loan at the prevailing rates; relatives or the sellers might want to help the buyer qualify. In any case, a lump sum is paid in cash to the lender at the closing. The payment offsets (and so reduces) the interest rate and monthly payments during the mortgage’s first few years. Typical buydown arrangements reduce the interest rate by 1 to 3 percent over the first one to three years of the loan term. After that, the rate rises. The assumption is that the borrower’s income will also increase and that the borrower will be more able to absorb the increased monthly payments.

HOME EQUITY LOANS

Using the equity buildup in a home to finance purchases is an alternative to refinancing. **Home equity loans** are a source of funds for homeowners to use for a variety of financial needs:

- To finance the purchase of expensive items
- To consolidate existing installment loans on credit card debt
- To pay medical, education, home improvement or other expenses

The original mortgage loan remains in place; the home equity loan is junior to the original lien. If the homeowner refinances, the original mortgage loan is paid off and replaced by a new loan. (This is an alternative way to borrow the equity; it’s not really a home equity loan.)

A home equity loan can be taken out as a fixed loan amount or as an equity line of credit. With the home equity line of credit, the lender extends a line of credit that the borrower can use whenever he or she wants. The borrower receives his or her money by a check sent to them, deposits made in a checking or savings account, or a book of drafts the borrower can use up to his or her credit limit.



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Use of this type of financing has increased in recent years, partly because interest on consumer loans is no longer deductible under IRS rules. Home equity loans are secured by a borrower's residence, and the interest charged is deductible up to a loan limit of \$100,000.

☞ ***The homeowner must consider a number of factors before deciding on a home equity loan. The costs involved in obtaining a new mortgage loan or a home equity loan; current interest rates; total monthly payments; and income tax consequences are all important issues to be examined.***

FINANCING LEGISLATION

The federal government regulates the lending practices of mortgage lenders through the Truth-in-Lending Act, the Equal Credit Opportunity Act, the Community Reinvestment Act of 1977 and the Real Estate Settlement Procedures Act.

TRUTH-IN-LENDING ACT AND REGULATION Z

Regulation Z, which was promulgated pursuant to the **Truth-in-Lending Act**, requires credit institutions to inform borrowers of the true cost of obtaining credit. Its purpose is to permit borrowers to compare the costs of various lenders and avoid the uninformed use of credit. Regulation Z applies when credit is extended to individuals for personal, family or household uses. The amount of credit sought must be \$25,000 or less. Regardless of the amount, however, *Regulation Z always applies when a credit transaction is secured by a residence*. The regulation does not apply to business or commercial loans or to agricultural loans of more than \$25,000.

Under Regulation Z, a consumer must be fully informed of all finance charges and the true interest rate before a transaction is completed. The finance charge disclosure must include any loan fees, finder's fees, service charges and points, as well as interest. In the case of a mortgage loan made to finance the purchase of a dwelling, the lender must compute and disclose the **annual percentage rate (APR)**. However, the lender does not have to indicate the total interest payable during the term of the loan. Also, the lender does not have to include actual costs such as title fees, legal fees, appraisal fees, credit reports, survey fees and closing expenses as part of the finance charge.

Creditor

A **creditor** for purposes of Regulation Z, is any person who extends consumer credit more than 25 times each year or more than 5 times each year if the transactions involve dwellings as security. The credit must be subject to a finance charge or payable in more than four installments by written agreement.

Three-day right of rescission

In the case of most consumer credit transactions covered by Regulation Z, the borrower has three days in which to rescind the transaction by merely notifying the lender. This *right of rescission does not apply to residential purchase-money or first mortgage or deed of trust loans*. In an emergency, the right to rescind may be waived in writing to prevent a delay in funding.

Advertising

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Regulation Z provides strict regulation of real estate advertisements that include mortgage financing terms. General phrases like “liberal terms available” may be used, but if details are given, they must comply with the act. The annual percentage rate (APR)-which is calculated based on all charges rather than the interest rate alone-must be stated.

Advertisements for buydowns or reduced-interest rate mortgages must show both the limited term to which the interest rate applies and the annual percentage rate. If a variable-rate mortgage is advertised, the advertisement must include

The number and timing of payments;

The amount of the largest and smallest payments; and

A statement of the fact that the actual payments will vary between these two extremes.

Specific credit terms, such as down payment, monthly payment, dollar amount of the finance charge or term of the loan, may not be advertised unless the advertisement includes the following information:

Cash price

Required down payment

Number, amounts and due dates of all payments

Annual percentage rate

Total of all payments to be made over the term of the mortgage (unless the advertised credit refers to a first mortgage or deed of trust to finance the acquisition of a dwelling)

Penalties

Regulation Z provides penalties for noncompliance. The penalty for violation of an administrative order enforcing Regulation Z is \$10,000 for each day the violation continues. A fine of up to \$10,000 maybe imposed for engaging in an unfair or a deceptive practice. In addition, a creditor may be liable to a consumer for twice the amount of the finance charge, for a minimum of \$100 and a maximum of \$1,000, plus court costs, attorney’s fees and any actual damages - Willful violation is a misdemeanor punishable by a fine of up to \$5,000, one year’s imprisonment or both.

EQUAL CREDIT OPPORTUNITY ACT

The federal **Equal Credit Opportunity Act** (ECOA) prohibits lenders and others who grant or arrange credit to consumers from discriminating against credit applicants on the basis of

Race; Color; Religion; National origin; Sex; Marital status; Age (provided the applicant is of legal age); or Dependence on public assistance.

In addition, lenders and other creditors must inform all rejected credit applicants of the principal reasons for the denial or termination of credit. The notice must be provided in writing, within 30 days. The federal Equal Credit Opportunity *Act* also provides that a borrower is entitled to a copy of the appraisal report if the borrower paid for the appraisal.



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REAL ESTATE SETTLEMENT PROCEDURES ACT

The federal **Real Estate Settlement Procedures Act** (RESPA) applies to any residential real estate transaction involving a new first mortgage loan. RESPA is designed to ensure that buyer and seller are both fully informed of all settlement costs. RESPA will be discussed in detail later.

Computerized Loan Origination and Automated Underwriting

A *computerized loan origination (CLO) system* is an electronic network for handling loan applications through remote computer terminals linked to several lenders' computers. With a CLO system, a real estate broker or salesperson can call up a menu of mortgage lenders, interest rates and loan terms, then help a buyer select a lender and apply for a loan right from the brokerage office.

The licensee may assist the applicant in answering the on-screen questions and in understanding the services offered. The broker in whose office the terminal is located may earn fees of up to one half point of the loan amount. The *borrower*, not the mortgage broker or lender, *must pay the fee*. The fee amount may be financed, however, while multiple lenders may be represented on an office's CLO computer, consumers must be informed that other lenders are available. An applicant's ability to comparison shop for a loan may be enhanced by a CLO system; the range of options may not be limited. One-stop shopping real estate services and federal regulation pertaining to CLOs are discussed earlier in Chapter 9.

On the lenders' side, new automated underwriting procedures can shorten loan approvals from weeks to minutes. Automated underwriting also tends to lower the cost of loan application and approval by reducing lenders' time spent on the approval process by as much as 60 percent. The Federal Home Loan Mortgage Corporation uses a system called *Loan Prospector*. The Federal National Mortgage Association has a system called *Desktop Underwriter* that reduces approval time to minutes, based on the borrower's credit report, a paycheck stub and a drive-by appraisal of the property. Complex or difficult mortgages can be processed in less than 72 hours. Through automated underwriting, one of a borrower's biggest headaches in buying a home -waiting for loan approval is eliminated. In addition, a prospective buyer can strengthen his or her purchase offer by including proof of loan approval.

Summary

The federal government affects real estate financing money and interest rates through the Federal Reserve Board's discount rate and reserve requirements; it also participates in the secondary mortgage market. The secondary market is generally composed of the investors who ultimately purchase and hold the loans as investments. These include insurance companies, investment funds and pension plans.

Types of loans include fully amortized and straight loans as well as adjustable-rate mortgages, growing-equity mortgages, balloon payment mortgages and reverse-annuity mortgages.

Many mortgage and deed of trust loan programs exist, including conventional loans and those insured by the FHA or private mortgage insurance companies or guaranteed by the VA. FRA and VA loans must meet certain requirements for the borrower to obtain the benefits of government backing, which induces the lender to lend its funds. The interest rates for these loans may be lower than those charged for conventional loans. Lenders may also charge points.

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Other types of real estate financing include seller-financed purchase-money mortgages or deeds of trust, blanket mortgages, package mortgages, wraparound mortgages, open-end mortgages, construction loans, sale-and-leaseback agreements and home equity loans.

Regulation Z, implementing the federal Truth-in-Lending Act, requires lenders to inform prospective borrowers who use their homes as security for credit of all finance charges involved in such loans. Severe penalties are provided for noncompliance. The federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age or dependence on public assistance. The Real Estate Settlement Procedures Act requires lenders to inform both buyers and sellers in advance of all fees and charges required for the settlement or closing of residential real estate transactions.

INTERNET WEB LINKS

www.ns.net/cadva/calvet.html	Cal-Vet loans
www.bankrate.com	Current interest rates
www.fanniemae.com	Fannie Mae Home Site
www.fdic.gov	Federal Deposit Insurance Corp.
www.frbsf.org	Federal Reserve Bank of San Francisco – 12 th District
www.federreserve.gov	Federal Reserve System
www.bog.frb.fed.us	Federal Reserve Board
www.freddiemac.com	Freddie Mac Home Site
www.hud.gov/funcgnma.html	Ginnie Mae Home Site
www.comerica.com/mortgage/fha.html	Independent FHA lender
www.fix.net/~chase/fha.html	Independent FHA lender
www.loanpage.com	Independent loan information
www.loanshop.com	Independent loan information
www.relist.com/mortcalc.html	Mortgage Calculator
www.countrywide.com	Mortgage Lender
www.ncua.gov	National Credit Union Administration
www.norwest.com	Norwest Corporation
www.occ.treas.gov	Office of the Comptroller of the Currency
www.ustreas.gov	U. S. Treasury
www.va.gov	VA loans

CHAPTER QUIZ

- Which of the following best defines the secondary' market?
 - Lenders who deal exclusively in second mortgages
 - Where loans are bought and sold after they have been originated
 - The major lender of residential mortgages and deeds of trust
 - The major lender of FHA and VA loans
- Under the provisions of the Truth-in-Lending Act (Regulation Z, the annual percentage rate (APR) of a finance charge includes all of the following components **except**:



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- A. Discount points.
 - B. A broker's commission.
 - C. A loan origination fee.
 - D. A loan interest rate.
3. A purchaser obtains a fixed-rate loan to finance a home. Which of the following characteristics is true of this type of loan?
- A. The amount of interest to be paid is predetermined.
 - B. The loan cannot be sold in the secondary' market.
 - C. The monthly payment amount will fluctuate each month.
 - D. The interest rate change may be based on an index.
4. With a fully amortized mortgage or deed of trust loan:
- A. Interest may be charged in arrears-that is, at the end of each period for which interest is due.
 - B. The interest portion of each payment increases throughout the term of the loan.
 - C. Interest only is paid each period.
 - D. A portion of the principal will be owed after the last payment is made.
5. Which of the following is **not** a participant in the secondary market?
- A. FNMA
 - B. GNMA
 - C. RESPA
 - D. FHLMC
6. Funds for Federal Housing Administration loans are usually provided by:
- A. The Federal Housing Administration.
 - B. The Federal Reserve.
 - C. Qualified lenders.
 - D. The seller.
7. If buyers seek a mortgage on a single-family house, they would be likely to obtain the mortgage from all of the following, **except**:
- A. Mutual savings bank.
 - B. Life insurance company.
 - C. Credit union.
 - D. Commercial bank.
8. The federal Equal Credit Opportunity Act prohibits lenders from discriminating against potential borrowers on the basis of all of the following **except**:
- A. Race.
 - B. Sex.
 - C. Source of income.
 - D. Amount of income.

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9. When the Federal Reserve Board raises its discount rate, all of the following are likely to happen **except**:
- A. Buyer's points will increase.
 - B. Interest rates will fall.
 - C. Mortgage money will become scarce.
 - D. The percentage of ARM's will increase.
10. In a loan that requires periodic payments that do not fully amortize the loan balance by the final payment, what term best describes the final payment?
- A. Adjustment
 - B. Acceleration
 - C. Balloon
 - D. Variable

Answers: 1-B, 2-B, 3-A, 4-A, 5-C, 6-C, 7-B, 8-D, 9-B, 10-C

CHAPTER 12: REAL ESTATE INVESTMENT

Preview



Real estate is a popular investment. Even though changes in the economy have increased risk or lowered returns, the investment market continues to devise innovative and attractive investment strategies. These developments make it important for real estate licensees to have an elementary and up-to-date knowledge of real estate investment. Even the average homebuyer will want assurance that a residential purchase is a good investment. Of course, this does not mean that licensees should act as investment counselors. They should always refer investors to competent tax accountants, attorneys or investment specialists. These are the professionals who can give expert advice on an investor's specific needs.

ADVANTAGES OF REAL ESTATE INVESTMENT

In recent years, real estate values have fluctuated widely in various regions of the country. This results in some investments failing to produce returns greater than the rate of inflation (that is, serving as inflation hedges). Yet many real estate investments have shown above-average *rates of return*, generally greater than the prevailing interest rates charged by mortgage lenders. In theory, this means an investor can use the *leverage* of borrowed money to finance a real estate purchase and feel relatively sure that, if held long enough, the asset will yield more money than it cost to finance the purchase.

Real estate offers investors greater control over their investments than do other options, such as stocks, bonds or other securities. Real estate investors also receive certain tax benefits, such as leverage and taxes are discussed in full later in this chapter.

DISADVANTAGES OF REAL ESTATE INVESTMENT

Unlike stocks and bonds, real estate is not highly liquid over a short period of time. *Liquidity* refers to how quickly an asset may be converted into cash. For instance, an investor in listed stocks has only to call a stockbroker when funds are needed. The stockbroker sells the stock, and the investor receives the cash. In contrast, a real estate investor may have to sell the property at a substantially lower price than desired to ensure a quick sale. Of course, a real estate investor may be able to raise a limited amount of cash by refinancing the property.

Real estate investment is expensive. Large amounts of capital are usually required.

It is difficult to invest in real estate without expert advice. Investment decisions must be based on careful studies of all the facts, reinforced by a thorough knowledge of real estate and the manner in which it is affected by the marketplace.



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Real estate requires active management. A real estate investor can rarely sit idly by and watch his or her money grow. Management decisions must be made. How much rent should be charged? How should repairs and tenant grievances be handled? The investor may want to manage the property personally. On the other hand, it may be preferable to hire a professional property manager. *Sweat equity* (physical improvements accomplished by the investor personally) may be required to make the asset profitable. Many good investments fail because of poor management.

Finally, despite its popularity, real estate investment is far from a sure thing. In fact, it involves a high degree of risk. The possibility always exists that an investor's property will decrease in value during the period it is held or that it will not generate enough income to make it profitable.

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Real estate investors hope to achieve various investment objectives. Their goals can be reached more effectively depending on the type of property and manner of ownership chosen. The most prevalent form of real estate investment is *direct ownership*. Both individuals and corporations may own real estate directly and manage it for appreciation or cash flow (income). Property held for appreciation is generally expected to increase in value while it's owned and to show a profit when it's sold. *Income property* is just that: property held for current income as well as a potential profit upon its sale.

APPRECIATION

Real estate is an avenue of investment open to those interested in holding property *primarily* for *appreciation*.

Two main factors affect appreciation: inflation and intrinsic value. Inflation is the increase in the amount of money in circulation. When more money is available, its value declines. When the value of money declines, wholesale and retail prices rise. This is essentially an operation of supply and demand, as discussed in Chapter 1. The intrinsic value of real estate is the result of a person's individual choices and preferences for a given geographical area. For example, property located in a pleasant neighborhood near attractive business and shopping areas has a greater intrinsic value to most people than similar property in a more isolated location. As a rule, the greater the intrinsic value, the more money a property commands upon its sale.

Unimproved Land

Quite often, investors speculate in purchases of either agricultural land or undeveloped land located in what is expected to be a major path of growth. In these cases, however, the property's intrinsic value and potential for appreciation are not easy to determine. This type of investment carries with it many inherent risks. How fast will the area develop? Will it grow sufficiently for the investor to make a good profit? Will the expected growth occur? More important, will the profits eventually realized from the property be great enough to offset the costs of holding it, such as property taxes? Because these questions often cannot be answered with any degree of certainty, lending institutions may be reluctant to lend money for the purchase of raw land.

Income tax laws do not allow the depreciation (cost recovery) of land. Also, such land may not be liquid (salable) at certain times under certain circumstances because few people will purchase raw or agricultural land on short notice. Despite all the risks, however, land has historically been a good inflation hedge if held long term. It can also be a source of income to

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offset some of the holding costs. For example, agricultural land can be leased out for crops, timber production or grazing.

Investment in land ultimately is best left to experts, and even they frequently make bad land investment decisions.

INCOME


The wisest initial investment for a person who wishes to buy and personally manage real estate may be the purchase of rental income property.

Cash flow

The object of directing funds into income property is to generate spendable income, usually called cash flow. **Cash flow** is the total amount of money remaining after all expenditures have been paid. These expenses include *taxes*, *operating costs* and *mortgage payments*. The cash flow produced by any given parcel of real estate is determined by at least three factors: amount of rent received, operating expenses and method of debt repayment.

Generally the amount of *rent* (income) that a property may command depends on a number of factors, including the property's location, physical appearance and amenities. If the cash flow from rents is not enough to cover all expenses, **negative cash flow** will result.

To keep cash flow high, an investor should attempt to *keep operating expenses reasonably low*. Such operating expenses include general maintenance of the building, repairs, utilities, taxes and tenant services (switchboard facilities, security systems and so forth).

 ***With many of the tax advantages of real estate investment being reduced or withdrawn by Congress, licensees should advise investors to analyze each proposed purchase carefully with an accountant. It is more important than ever to be sure an investment will cover its own expenses. Where negative cash flow is anticipated, the investor's tax bracket may be the deciding factor. (Income tax calculations are usually figured at the investor's marginal tax rate - that is, the rate at which his or her top dollar of income is taxed.)***

An investor often stands to make more money by investing with borrowed money, usually obtained through a mortgage loan or deed of trust loan. Low mortgage payments spread over a long period of time result in a higher cash flow because they allow the Investor to retain more income each month; conversely, high mortgage payments contribute to a lower cash flow.

Investment Opportunities

Traditional income-producing property include apartment and office buildings, hotels, motels, shopping centers and industrial properties. Historically, investors have found well-located, one-to four-family dwellings to be favorable investments. However, in recent years many communities have seen severe overbuilding of office space and shopping centers. The result has been high vacancy rates.

Leverage

Leverage is the use of borrowed money to finance an investment. As a rule, an Investor can receive a maximum return from the initial investment (the down payment and closing and other costs) by making a small down payment, paying a low interest rate and spreading mortgage payments over as long a period as possible.



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The effect of leveraging is to provide a return that reflects the result of market forces on the entire original purchase price, but that is measured against only the actual cash invested. For example, if an investor spends \$100,000 for rental property and makes a \$20,000 down payment, then sells the property five years later for \$125,000, the return over five years is \$25,000. Disregarding ownership expenses, the return is not 25 percent (\$25,000 compared to \$100,000), but 125 percent of the original amount invested (\$25,000 compared to \$20,000).

Risks are directly proportionate to leverage. A high degree of leverage translates into greater risk for the investor and lender because of the high ratio of borrowed money to the value of the real estate. Lower leverage results in a less risk. When values drop in an area or vacancy rates rise, the highly leveraged investor may be unable to pay even the financing costs of the property.

Equity Buildup

Equity buildup is that portion of the loan payment directed toward the principal rather than the interest, plus any gain in property value due to appreciation. In a sense, equity buildup is like money in the investor's bank account. This accumulated equity is not realized as cash unless the property is sold or refinanced. However, the equity interest may be sold, exchanged or mortgaged (refinanced) to be used as leverage for other investments.

Pyramiding Through Refinancing

An effective method for a real estate investor to increase his or her holdings without investing additional capital is through *pyramiding*. **Pyramiding** is simply the process of using one property to drive the acquisition of additional properties. Two methods of pyramiding can be used: *pyramiding through sale* and *pyramiding through refinance*.

In **pyramiding through selling**, an investor first acquires a *property*. He or she then improves the property for resale at a substantially higher price. The profit from the sale of the first property is used to purchase additional properties. Thus, the proceeds from a single investment (the point of the pyramid) provide the means for acquiring other properties. These properties are also improved and sold, and the proceeds are reinvested, until the investor is satisfied with his or her return. Of course, the disadvantage is that the proceeds from each sale are subject to capital gains taxation, as discussed below.

The goal of **pyramiding through refinancing**, on the other hand, is to use the value of the original property to drive the acquisition of additional properties while retaining all the properties acquired. The investor refinances the original property and uses the proceeds of the refinance to purchase additional properties. These properties are refinanced in turn to enable the investor to acquire further properties, and so on. By holding on to the properties, the investor increases his or her income producing property holdings while simultaneously delaying the capital gains taxes that would result from a sale.

TAX BENEFITS

One of the main reasons real estate investments were popular and profitable in the past is that tax laws allowed investors to use losses generated by such investments to shelter income from other sources. Although laws have changed and some tax advantages of owning investment real estate are altered periodically by Congress, with professional tax advice, an investor can still make a wise real estate purchase.

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CAPITAL GAINS

The tax law no longer favors long-term investments by reducing taxable gain (profit) on their sale or exchange. This federal policy is subject to change in response to various political and economic factors. Capital gain is defined as the difference between the adjusted basis of property and its net selling price. At various times, the tax law has excluded a portion of capital gains from income tax. The exclusions have ranged from 0 to 60 percent.

Basis

A property's **cost basis** determines the amount of gain to be taxed. The **basis** of the property is the investor's initial cost of the real estate. The investor adds to the basis the cost of any physical improvements subsequently made to the property. The amount of any depreciation claimed as a tax deduction (explained later) is subtracted from the basis. The result is the property's adjusted basis. When the investor sells the property, the amount by which the sales price exceeds the property's adjusted basis is the *capital gain*.

Example: Some time ago, an investor purchased a single family home for use as a rental property. The purchase price was \$45,000. The investor now sells the property for \$100,000. Shortly before the sale date, the investor makes \$3,000 worth of capital improvements to the home. Depreciation of \$10,000 on the property improvements has been taken during the term of the investor's ownership. The investor will pay a broker's commission of 7 percent of the sales price. The investor's closing costs will be \$600. The capital gain is computed as follows:

Selling price:		\$100,000
Less		
7% commission	\$ 7,000	
Closing costs	+ 600	
	\$ 7,600	- 7,600
Net sales price:		\$ 92,400
Basis		
Original cost	\$45,000	
Improvements	+ 3,000	
	\$48,000	
Less:		
Depreciation	(10,000)	
Adjusted basis	\$38,000	\$38,000
Total capital gain:		\$54,400

Current tax law specifies what percentage of capital gains is taxable as income. To determine the taxable amount, an investor multiplies the total capital gain by the current percentage.

EXCHANGES

Real estate investors can defer taxation of capital gains by making property exchanges. Even if property has appreciated greatly since its initial purchase, it may be exchanged for other property. A property owner will incur tax liability on a sale only if additional capital or property is also received. Note, however, that the tax is **deferred**, not **eliminated**. Whenever the investor sells the property, the capital gain will be taxed.



REAL ESTATE PRACTICE

To qualify as a tax-deferred exchange, the properties involved must be of *like kind* - that is, real estate for real estate of equal value. Any additional capital or personal property included with the transaction to even out the value of the exchange is called **boot**. The IRS requires tax on the boot to be paid at the time of the exchange by the party who receives it. The value of the boot is added to the basis of the property for which it is given. Tax-deferred exchanges are governed by strict federal requirements, and competent guidance from a tax professional is essential.

☞ **Example: A owns an apartment building with an adjusted basis of \$225,000 and a market value of \$375,000. A exchanges the building plus \$75,000 in cash for another apartment building having a market value of \$450,000. That building, owned by B, has an adjusted basis of \$175,000. A's basis in the new building is \$300,000 (the \$225,000 basis of the building exchanged plus the \$75,000 cash boot paid), and A has no tax liability on the exchange. B must pay tax on the \$75,000 boot received and has a basis of \$175,000 (the same as the previous building) in the building now owned.**

DEPRECIATION (COST RECOVERY)

Depreciation, or **cost recovery**, allows an investor to recover the cost of an income-producing asset through tax deductions over the asset's useful life. While investors rarely purchase property without expecting it to appreciate over time, the tax laws maintain that all physical structures deteriorate (and lose value) over time. Cost recovery deductions may be taken only on personal property and improvements to land. Furthermore, they can be taken only if the property is used in a trade or business or for the production of income. Thus, a cost recovery deduction cannot be claimed on an individual's personal residence, and *land cannot be depreciated*. Technically, land never wears out or becomes obsolete.

Depreciation taken periodically in equal amounts over an asset's useful life is called *straight-line depreciation*. For certain property purchased before 1987 it was also possible to have used an *accelerated cost recovery system (ACRS)* to claim greater deductions in the early years of ownership, gradually reducing the amount deducted in each year of useful life.

Deductions

In addition to tax deductions for depreciation, investors may be able to deduct losses from their real estate investments. The tax laws are very complex. The amount of loss that may be deducted depends on whether an investor actively participates in the day-to-day management of the rental property or makes management decisions. Other factors are the amount of the loss and the source of the income against which the loss is to be deducted. Investors who do not actively participate in the management or operation of the real estate are considered *passive investors*. Passive investors may not use losses to offset active income derived from active participation in real estate management, wages or income from stocks, bonds and the like. The tax code cites specific rules for active and passive income and losses and may be subject to changes.

Certain tax credits are allowed for renovation of older buildings, low-income housing projects and historic property. A **tax credit** is a direct reduction in the tax due rather than a deduction from income before tax is computed. Tax credits encourage the revitalization of older properties and the creation of low-income housing. The tax laws governing these issues are also complex.

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Real estate must be analyzed in conjunction with an investor's other investments and overall financial goals and objectives. Income tax consequences also have a significant bearing on an investor's decisions. *Competent tax advice should be sought to help an investor carefully evaluate the ramifications of an investment decision.*

Installment Sales

A taxpayer who sells real property and receives payment on an installment basis pays tax only on the profit portion of each payment received. Interest received is taxable as ordinary income. *Many complex laws apply to installment sales, and a competent tax adviser should be consulted.*

REAL ESTATE INVESTMENT SYNDICATES

A real estate investment syndicate is a business venture in which people pool their resources to own or develop a particular piece of property. This structure permits people with only modest capital to invest in large-scale operations. Typical syndicate projects include highrise apartment buildings and shopping centers. Syndicate members realize some profit from rents collected on the investment. The main return usually comes when the syndicate sells the property.

Syndicate participation can take many legal forms. For instance, syndicate members may hold property as tenants in common or joint tenants. Various kinds of partnership, corporate and trust ownership options are possible.

Private syndication generally involves a small group of closely associated or experienced Investors. Public syndication, on the other hand, involves a much larger group of investors who may or may not be knowledgeable about real estate as an investment. Any pooling of individuals' funds raises questions of securities registration under federal and state securities laws. These are commonly referred to as **blue-sky laws**.

To protect members of the public who are not sophisticated investors, but who may still be solicited to participate in syndicates, securities laws govern the offer and sale of securities. Real estate securities that fall under the definition of a public offering must be registered with state officials and the federal Securities and Exchange Commission (SEC). Pertinent factors include the number of prospects solicited, the total number of investors, the financial background and sophistication of the investors and the value or price per unit of investment. Salespersons of real estate securities may be required to obtain special licenses and state registration.

BUSINESS OWNERSHIPS

The following forms of business ownership are commonly formed to acquire, use and sell real estate.

SOLE PROPRIETORSHIP

The **sole proprietor**, who may or may not have employees, is a business only owner. The sole proprietor conducts business in his or her own name or trade name, reports business income on his or her individual income tax return and is responsible for the business debts. The sole proprietorship is the simplest form of business ownership.

- ♦ Disadvantage – Full liability. The sole proprietor has no shelter of liability as a corporation. The owner is fully responsible for his/her business debts.



REAL ESTATE PRACTICE

CORPORATION

The **corporation** is a separate, legal entity, apart from owners, that will exist for an indefinite period of time.

- ♦ It is composed of shareholders who elect a board of directors.
- ♦ The board of directors manages business on behalf of the shareholders.
- ♦ May own, lease and convey real property.
- ♦ The corporate seal implies authority of the party signing.
- ♦ Must be chartered by a state according to the laws and regulations of the state.
- ♦ Shares are freely transferable.
- ♦ Disadvantage - Double taxation. Usually a corporation is taxed on profits. When profits are distributed in the form of dividends, the shareholders must pay additional taxes.
- ♦ Advantage - Except in extreme cases, individual officers, directors and shareholders are not held accountable for corporate decisions and corporate debts.
- ♦ Generally speaking, the corporation is more difficult to obtain credit than other forms of business owners.
- ♦ An investor cannot take title as a joint tenant with a corporation due to its perpetual existence.

SUBCHAPTER S CORPORATION (S-CORP)

The **Subchapter S-Corporation (S-Corp)** is a corporation, which has elected to be treated as a partnership for tax purposes. It allows a business to operate in corporate form and yet not pay a corporate tax, thus avoiding the double tax feature. Each shareholder is taxable on his or her share of the corporations income, whether or not it is distributed to him or her. Similarly, the shareholder can report his or her share of the corporations ordinary losses and deduct them on an individual personal tax return.

- ♦ The number of shareholders is limited to **35**.
- ♦ All shareholders must be **individuals** rather than other corporations.
- ♦ No foreigner can be shareholders.

PARTNERSHIP

A **partnership** is a two or more persons carry on a business as co-owners for profit with the following characteristics:

A **general partnership** is organized so that all members of the group share equally in the managerial decisions, profits and losses involved with the investment. A certain member (or

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members) of the syndicate is designated to act as *trustee* for the group. The trustee holds title to the property and maintains it in the syndicate's name.

Under a **limited partnership** agreement, one party (or parties), usually a developer or real estate broker, organizes, operates and holds responsibility for the entire syndicate. This person is called the *general partner*. The other members of the partnership are merely investors; they have no voice in the organization and direction of the operation. These passive investors are called *limited partners*.

The limited partners share in the profits, and the general partner is compensated out of the profits. The limited partners stand to lose only as much as they invest-nothing more. Like their level of participation, their risk of loss is limited. The general partner is totally responsible for any excess losses incurred by the investment.

Partnership Characteristics

- ◆ General partners are “Jointly and severally” liable for partnership debts.
- ◆ General partner participates in management and may use his name in place of the firm name.
- ◆ This avoids double taxation.
- ◆ The partnership ceases upon the death of a general partner.
- ◆ The partnership agreement need not be in writing.
- ◆ The limited partnership agreement must be in writing.
- ◆ The limited partner's liability is limited to the amount invested or pledged.
- ◆ The limited partner has “no say” in management.
- ◆ This is the most common syndication in California.

LIMITED LIABILITY COMPANY

Almost all states permit business operation and property ownership by a **limited liability company (LLC)**. Although each state's law is unique, an LLC typically provides the single-level tax benefit of a partnership with a flexible organizational structure. In California, an LLC is created by filing a one-page form (*articles of organization*) with the Secretary of State. LLC members are not required to have a written operating agreement setting out their rights and responsibilities, although one is advisable. LLC members may adopt corporate formalities, such as resolutions and annual meetings, but are not required to do so.

Unlike a Subchapter S corporation, an LLC places *no restriction* on the **number** of shareholders who take part, and *who they are (foreigners are ok)*. The LLC provides something closer to the limited liability for corporate shareholders than the greater protection afforded to limited partners. Unlike limited partners, however, members of an LLC can take part in the running of the organization without incurring personal liability for business obligations.

☞ ***In California, an LLC incurs higher taxes and fees than either a general or limited partnership.***



REAL ESTATE PRACTICE

REAL ESTATE SYNDICATES

Real estate syndicates are organization or combination of investors who pool their capital for a real estate investment. By pooling their capital for investments, they are able to purchase a property that individually they could not buy.

JOINT VENTURE

Joint venture is similar to a general partnership but usually formed to accomplish a single project or aim.

TRUST

A **trust** is a form of property ownership. Title to property is conveyed by the trustor to the trustee. The property is held by the trustee on behalf of beneficiary. We will discuss two popular trusts: *Real Estate Investment Trust* and *Living Trust*.

REAL ESTATE INVESTMENT TRUST

By directing their funds into real estate investment trusts (REITs), real estate investors take advantage of the same tax benefits, as do mutual fund investors. A real estate investment trust does not have to pay corporate income tax as long as 95 percent of its income is distributed to its shareholders. Certain other conditions must also be met. To qualify as a REIT, at least 75 percent of the trust's income must come from real estate. Investors purchase certificates in the trust, which in turn invests in real estate or mortgages (or both.) Profits are distributed to investors.

REITs are subject to complex restrictions and regulations. A competent attorney should be involved at all stages of a REIT's development.

Real Estate Investment Trust is created through federal law, which permits the investor to form an association that would receive many of the benefits of a corporation but would not be subject to taxation as a corporation. REIT shares may be traded publicly.

- ◆ Investors have limited liability.
- ◆ Profits are not subject to double taxation.
- ◆ It must conform to the following:
 1. 90% or more of the ordinary income must be distributed to the shareholder annually.
 2. Capital gains, when distributed, are taxed as capital gains to each shareholder.
 3. It must be beneficially owned by at least 100 investors.
 4. 75% of the income must be from real estate investments.

The Corporations Commissioner controls all offerings.

- ◆ A permit must be obtained before an offering can be made to the public and must meet the fair, just, and equitable rule.

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- ♦ No permit is needed for Private Offering that is one in which is not sold to more than 35 investors; and these investors have a pre-existing personal or business relationship with the syndicator.
- ♦ The seller must have a real estate license or securities license.

LIVING TRUST

The **living trust** is an increasingly popular form of property ownership. A living trust can be used to hold title to property during the lifetime of the trustor, who is also the beneficiary of the trust. When the trustor dies, title to the property held in trust passes to a contingent beneficiary named in the trust document. In this way property can be transferred without going through the often expensive probate process. Married couple also can create a living trust, with the property held in trust going to the contingent beneficiary on the death of the second spouse.

- ♦ Can be an effective estate-planning tool that provides the easiest and quickest way to transfer property at death.
- ♦ Every living trust should be customized to the needs of the trustor.
- ♦ Creation of a living trust therefore requires the services of an attorney familiar with such documents.

👉 INTERNET WEB LINKS

www.consrv.ca.gov	California Division of Mines & Geology
www.dre.ca.gov/submenu.htm	DRE Subdivisions, Public Report
www.ca.gov/history/people.html	History – People of California
www.holiday-timeshares.com	Holiday Group
www.ired.com/dir/tiomeshar.htm	IRET Timeshare
www.timeshare-resorts.com	Timeshare Resorts, International
www.timeshare-users-group.com	Timeshare Users Group
www.timesharetravlers.com	Travels World Marketplace

Summary

Traditionally, real estate investment has offered an above-average rate of return while acting as an effective hedge against Inflation. It allows an investor to use other people's money through leverage. There may also be tax advantages to owning real estate. However, real estate is not a highly liquid investment and often carries a high degree of risk. Expert advice is often necessary.

Investment property held for appreciation purposes is generally expected to increase in value to a point at which its selling price covers holding costs and permits a profit. The two main factors that affect appreciation are inflation and the property's present and future intrinsic value. Real estate held for income purposes is generally expected to generate a steady flow of income, called **cash flow**, and to show a profit at the time of sale.

An investor who hopes to use maximum leverage in financing an investment should make a small down payment, pay low interest rates and spread mortgage payments over as long a period as possible. By holding and refinancing properties, a practice known as **pyramiding**, an



REAL ESTATE PRACTICE

Investor may substantially increase investment holdings without contributing additional capital. The highly leveraged investor has correspondingly high risk.

By exchanging one property for another with an equal or a greater selling value, an investor can defer paying tax on the gain realized until a sale is made. A total tax deferment is possible only if the investor receives no cash or other incentive to even out the exchange. If such cash or property is received, it is called boot, and it is taxed.

Depreciation (cost recovery) is a concept that allows an investor to recover in tax deductions the basis of an asset over its useful life. Only costs of improvements to land may be recovered, not costs for the land itself. The Tax Reform Act of 1986 greatly limited the potential for investment losses to shelter other income. But tax credits are still allowed for projects involving low-income housing and older buildings.

An investor may defer federal income taxes on a gain realized from the sale of an investment property through an installment sale of property.

Individuals may also invest in real estate through an Investment syndicate. These usually consist of general and limited partnerships. Other forms of real estate Investment include real estate investment trusts (REITs).

Real estate brokers and salespersons should be familiar with the rudimentary tax implications of real property ownership, but should refer clients to competent tax advisers for answers to specific questions.

CHAPTER QUIZ

1. Under which business structure would there be a probability of double taxation?
 - A. Sole Proprietorship
 - B. Partnership
 - C. Corporation
 - D. Joint Venture
2. "Cash Flow" is:
 - A. Equivalent to operating expense.
 - B. The total amount of spendable income left after expenses.
 - C. The use of borrowed money to finance an investment.
 - D. Selling costs plus depreciation.
3. The primary source of tax shelter in real estate investments comes from which of the following accounting concepts?
 - A. Recapture
 - B. Boot
 - C. Net operating income
 - D. Depreciation

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4. F made an initial real estate investment of \$45,000. F subsequently made \$20,000 worth of improvements to the property. If F subtracts depreciation from the initial cost and adds the cost of improvements, what will be the result?
- A. Adjusted basis
 - B. Capital gain
 - C. Basis
 - D. Salvage value
5. P, Q and R form an investment syndicate. All three members have equal managerial responsibility, and all three share equally in the profits and losses of the venture. What land of business arrangement do P, Q and R have?
- A. Real estate investment trust
 - B. Limited partnership
 - C. Real estate mortgage trust
 - D. General partnership
6. S, T and U form an investment syndicate. The parties agree as follows: S is given responsibility for managing and operating the venture; T and U will compensate S out of their shares of the venture's profits; T and U will be liable for losses only up to the amounts of their investment, while S will be responsible for any excess losses. What form of business partnership have S, T and U created?
- A. General
 - B. Limited
 - C. Passive
 - D. Investment security
7. In an installment sale of B's home, when is taxable gain received and reportable as income by B?
- A. In the year in which the sale is initiated
 - B. In the year in which the final installment payment is made by the buyer
 - C. In each year in which B receives installment payments
 - D. At any one time during the period in which B receives installment payments.
8. A tax entity, created by the Tax Reform Act of 1986, that issues securities backed by a pool of mortgages is a:
- A. REIT.
 - B. REMIC.
 - C. Limited partnership
 - D. Pyramid.
9. Y is selling an investment property. The original price was \$80,000. The selling price is \$125,000. Two years ago, Y made \$10,000 worth of improvements to the property. Depreciation is \$15,000. What is Y's basis in the property?
- A. \$65,000
 - B. \$75,000
 - C. \$85,000
 - D. \$90,000



REAL ESTATE PRACTICE

10. There are advantages and disadvantages to a corporation. Among the disadvantages are the following:

- A. You must take total responsibility for all actions
- B. Unlimited liability
- C. Double taxation
- D. Perpetual existence

Answers: 1-A, 2-B, 3-D, 4-A, 5-D, 6-B, 7-C, 8-B, 9-B, 10-C

CHAPTER 13: REAL ESTATE LEASES

Preview



A **lease** is a contract between an owner of real estate (the **lessor**) and a tenant (the **lessee**). It is a contract to transfer the lessor's rights to exclusive possession and use of the property to the tenant for a specified period of time. The lease establishes the length of time the contract is to run and the amount the lessee is to pay for use of the property. Other rights and obligations of the parties may be set forth as well.

In effect, the lease agreement combines two contracts. It is a conveyance of an interest in the real estate and a contract to pay rent and assume other obligations. The lessor grants the lessee the right to occupy the real estate and use it for purposes stated in the lease. In return, the landlord receives payment for use of the premises and retains a **reversionary right** to possession after the lease term expires. The lessor's interest is called a *leased fee estate plus reversionary right*.

The statute of frauds in most states requires lease agreements for more than one year to be in writing to be enforceable. If the lease cannot be performed within one year of being entered into, the statute of frauds also requires a written document. In general, verbal leases for one year or less that can be performed within a year of their making are enforceable. Written leases should be signed by both the lessor and lessee.

☞ ***Even though a lease that is agreed to orally may be enforceable, such as a lease for one year commencing the day of agreement, it is always better practice to put lease agreements in writing. A written lease provides concrete evidence of the terms and conditions to which the parties have agreed. Any written agreement should be signed by both the landlord and tenant.***

LEASEHOLD

The concept of the leasehold goes back to the early forms of ownership and possession.

Leasehold is a personal property right in real property. As one should know (from Principle's course), with less-than-freehold estates, there is no direct ownership of real estate. They are chattel real estates. A **chattel real estate** is a personal property estate in real property, such as a lease. We call this type of interest in a property a *lease* or *leasehold*.

Just as there are several types of freehold (ownership) estates, there are different kinds of leasehold estates.



REAL ESTATE PRACTICE

In a leasehold, the **lessor** is the owner of a fee estate or a holder of a life estate who gives up possession to all or part of his or her estate and holds a reversionary interest. The **lessee** is the tenant who receives the leasehold estate.

The landlord holds a **reversionary right** to the property, while the *possessory rights belong to the lessee*.

A **reversionary right** means the landlord grants the tenant the right to occupy (possess) the property, but he or she retains the right to retake possession after the lease or rental term has expired. **Possessory right** is tenants right to have a quiet possession during the leasehold.

LEASE

A **lease** is a contract between an owner of real estate (the lessor, landlord) and a tenant (the lessee). It is a contract to transfer the lessors rights to exclusive possession and use of the property to the tenant for a specified period of time. The lease establishes the length of time the contract is to run and the amount the lessee is to pay for use of the property. Other rights and obligations of the parties may be set forth as well.

In effect, the lease agreement combines two contracts. It is a conveyance of an interest in the real estate and a contract to pay rent and assumes other obligations. The lessor grants the lessee the right to occupy the real estate and use it for purpose states in the lease. In return, the landlord receives payment for use of the premises and retains a reversionary right to possession after the lease term expires. The lessors interest is called a *leased fee estate plus reversionary right*.

A lease is usually for a set time, typically one year or longer. A rental agreement is different in that it is usually made on a monthly basis and is renewable at the end of each period (week-to-week, month-to-month or any period-to-period up to one year).

Rental agreements do not expire; notice must be given by one of the parties. Written rental agreements have become the most commonly used real estate agreements in the United States. They are used frequently when renting apartments, duplexes, houses, condominiums and other types of residential property. The California Association of Realtors® (CAR) has a standard residential rental agreement that covers all the basic conditions desired in such a contract.

A copy of both the lease/rental agreement and the credit application to be filled out by the tenant can be found in Form 11-1.

☞ ***If no expiration date is given on a rental agreement and, unless stated otherwise, a 3-Day Notice by either party is required to terminate a month-to-month tenancy.***

A lease form is a written contract; therefore, you should carefully read each of its provisions and understand their implications.

TYPES OF LEASES

There are many different types of leases, and they are discussed below in details:

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Gross, Flat, Fixed or Straight Lease

A **gross lease** is for a fixed period of time at a set rate of rent for the use of the property. The lessor is responsible for property taxes, insurance and other property expenses. A gross lease is also sometimes known as a **flat, fixed** or **straight lease**.

Net Lease (Triple Net Lease)

A **net lease** is one where the tenant pays a fixed monthly rent as well as operating expenses (fixed or variable) such as taxes, utilities, maintenance, management or insurance.

The lessor receives only a net amount and does not pay for the other related property expenses. Sometimes the net lease is referred to a “*triple net lease*” because the lessee pays for (1) property taxes, (2) fire and hazard insurance and (3) assessments or other operating expenses.

Graduated / Index Lease

Also known as “**step-up lease**,” or “**index lease**.” A lease that provides for a varying rental rate, often based on future determination in an escalator clause.

An **escalator clause** is one that provides for an increase or decrease in rent, often based on the cost of living index (CPI: Consumer Price Index).

Percentage Lease

A **percentage lease** is a commercial (retail sales) lease in which the lessee pays, or may pay, a certain percentage of the gross sales to the lessor. The idea is that if the lessee has a good or excellent location, the lessor will also benefit. Most percentage leases are written for a base rental amount, paid in advance, with an additional amount due if a predetermined percentage of the gross income receipts exceed the base rental amount.

Percentage lease payments are based upon gross income receipts.

The higher the gross receipts the lower the rate. Typical rates:

- ♦ 50%: storage garage and parking lot.
- ♦ 1%: Grocery store chain.

Sandwich Lease

A **sandwich lease** is a leasehold interest that lies between the primary lease and the operating lease. An example is the position of a sub-lessor.

Ground Lease

A **ground lease** is for the use of land only, sometimes secured by improvements placed on the land by the user.



REQUIREMENTS OF A LEASE

No particular language is required so long as intent to lease property appears. Terms, however, must include:

- ♦ Name of parties.
- ♦ Description of premises.
- ♦ Amount of rental payments.
- ♦ Length of lease period.
- ♦ If length is more than one year, the lease must be in writing.
- ♦ If in writing, it must be signed by the lessor (landlord). The lessee (tenant) usually signs, but acceptance of the lease terms (occupancy) is the same as a signature.
- ♦ To record, it must be acknowledged by the lessor (landlord).

Leases for one year or less do not need to be in writing, but it makes good business sense to have all real estate agreements in writing. According to the Statute of Frauds, any lease lasting longer than one year from the date of signing must be in writing.

A lease for more than one year must be in writing and signed by the lessor; but if the lessee does not sign, moves in and pays rent, he or she is bound to the terms of the lease.

Hotels, motels and other types of lodging fall into the category of leases, even though the duration of use may be for a much shorter time and eviction or termination is handled differently for these daily or weekly rentals.

In addition to the minimum requirements, a number of contractual factors between a landlord and tenant should be considered before entering into a lease. Certain points that worth mentioning are:

- ♦ Lease duration
- ♦ Amount of rent
- ♦ Security deposits
- ♦ Assignment and subleasing provisions
- ♦ Rights and obligations
- ♦ Liabilities for injuries and repairs
- ♦ Conditions and provisions of a lease
- ♦ Termination of a lease or rental agreement.

13: REAL ESTATE LEASES

Lease Duration

There are certain statutory restrictions on the terms of certain leases:

1. Agricultural lands cannot be leased for more than 51 years
2. Property situated in a city or town cannot be leased for more than 99 years
3. A mineral, oil, or gas lease cannot be longer than 99 years after work begins
4. A minor or incompetent can possess property only for the time a court has approved.

Rent

Rent is the amount of money paid for the use of a property. It is important to state both the specific amount of rent and when the rent is to be paid to the landlord. With a periodic tenancy, if the rent is to be paid in advance, or any time other than the end of the term, it should be stated in the agreement. By law, rent becomes due only at the end of the term, unless the lease agreement states otherwise or if it is customary to make payments at a different time.

Contract Rent vs. Economic Rent

The actual amount of rent to be paid is called **contract rent**. Contract Rent is the payment designated in a lease contract, at the time the lease is signed, for the use of the property. This amount must be distinguished from the economic rent. **Economic rent** is the amount of rent that a property might be expected to yield if it was available for lease in the current market. The economic rent and contract rent of a given property might differ if the lessor is receiving more or less rent than the property should reasonably yield.

If a rental property is sold, the rents of the tenants are prorated in escrow.

For income tax purposes, the amount of rent paid in advance must be included in the landlords income for that year. If the landlord collects first months rent and security deposit, both are considered current year income.

Security Deposits

A **Security Deposit** provides the landlord with funds to pay for damages or unpaid rent when the tenant vacates. It is in the landlords and tenants best interests to have an inspection of the premises before the tenant moves in and before the tenant moves out.

A **Statement of Property Condition** (see below) is a report filled out by the landlord, in the presence of the tenant, that states the condition of the premises on moving in and moving out. If both parties to a lease or rental agreement complete this form together, the chances of any disputes arising, with regards to damages and the security deposit, are greatly reduced.

Form 13-1: Statement of Property Condition



REAL ESTATE PRACTICE



CALIFORNIA
ASSOCIATION
OF REALTORS®

STATEMENT OF CONDITION (MOVE IN/MOVE OUT)

Premises Address 123 Main Street, Main City, CA 90000 Unit No. _____

Occupant(s) James Smith, Diana Smith MOVE-IN Date _____

When completing this form, check the Premises carefully, and be specific in all items noted. Use additional paper, if necessary.

SMOKE DETECTOR(S) has (have) been tested on MOVE-IN, and found to be operative, except: _____

LIVING ROOM AND DINING ROOM ITEMS: doors, locks, carpeting, floors, baseboards, walls, ceiling, electrical fixtures, electrical switches and outlets, windows coverings, windows, screens, and other items: _____

MOVE-IN CONDITION	MOVE-OUT CONDITION

KITCHEN ITEMS: floors, baseboards, walls, ceiling, electrical fixtures, electrical switches and outlets, cooktop oven, hood and fan, refrigerator, plumbing fixtures, sink, disposal, cabinets, counters, window coverings, windows, screens, and other items: _____

MOVE-IN CONDITION	MOVE-OUT CONDITION

Occupant acknowledges receipt of copy of this page, which constitutes Page _____ of _____ Pages.
Occupant's Initials (_____) (_____)

THIS FORM HAS BEEN APPROVED BY THE CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.). NO REPRESENTATION IS MADE AS TO THE LEGAL VALIDITY OR ADEQUACY OF ANY PROVISION IN ANY SPECIFIC TRANSACTION. A REAL ESTATE BROKER IS THE PERSON QUALIFIED TO ADVISE ON REAL ESTATE TRANSACTIONS. IF YOU DESIRE LEGAL OR TAX ADVICE, CONSULT AN APPROPRIATE PROFESSIONAL.

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525 South Virgil Avenue, Los Angeles, California 90020

OFFICE USE ONLY
Reviewed by Broker
or Designee _____
Date _____



STATEMENT OF CONDITION (MIMO-11 PAGE 1 OF 3) REVISED 4/98

Jerry fung
JF 2373 S Hacienda Blvd . Hacienda Heights CA 91745

Phone (626)336 6191

Fax: (626)336 8565

T7871409 ZFX

13: REAL ESTATE LEASES

Premises Address 123 Main Street, Main City, CA 90000 Unit No. _____

BEDROOM ITEMS: doors, lock, carpeting, floors, baseboards, walls, ceiling, electrical fixtures, electrical switches and outlets, window coverings, windows, screens, closet, closet doors and tracks, and other items: _____

BEDROOM 1 MOVE-IN CONDITION	BEDROOM 1 MOVE-OUT CONDITION

BEDROOM 2 MOVE-IN CONDITION	BEDROOM 2 MOVE-OUT CONDITION

BEDROOM 3 MOVE-IN CONDITION	BEDROOM 3 MOVE-OUT CONDITION

OTHER ITEMS/AREAS: (If applicable) Entry door and window locks, heating and air conditioning, equipment, patio or balcony, yard areas, fencing, garage or carport, and _____

MOVE-IN CONDITION	MOVE-OUT CONDITION

OFFICE USE ONLY
Reviewed by Broker
or Designee _____
Date _____



Occupant acknowledges receipt of copy of this page, which constitutes Page _____ of _____ Pages.

Occupant's Initials (_____) (_____)

STATEMENT OF CONDITION (MIMO-11 PAGE 2 OF 3) REVISED 4/98

T7871409 ZFX



BATHROOM ITEMS: doors, locks, carpeting or flooring, baseboards, walls, ceiling, electrical fixtures, electrical switches and outlets, window coverings, windows, screens, tub or shower, shower door or curtain, toilet, sink, medicine cabinet, counter, towel racks, fan, and other items: _____

[illegible]

Landlord or Agent _____ Date _____

Landlord or Agent _____ Date _____



EQUAL HOUSING
OPPORTUNITY

T7871409.ZFX

13: REAL ESTATE LEASES

Maximum rental agreement deposits for **residential** properties are:

- ♦ Unfurnished = 2 months rent
- ♦ Furnished = 3 months rent

(There is no law restricts the amount of security deposit for the commercial properties).

Security (and “cleaning”) deposits for residential leases in California must be refunded, in full, within twenty-one days of the tenant vacating the premises unless there is damage to the property or required cleaning. If part (or all) of the security deposit is to be withheld from the tenant, the landlord must furnish the tenant, within the same twenty-one day period, an itemized, written statement.

Assignment and Subleasing Provisions

The tenant, without a clause to the contrary, may assign or sublease the property. An **Assignment** is a transfer of the entire lease, whereas a **Sublease** is a transfer of less than the entire time or space of the lease.

In an **assignment**, the assignee becomes the tenant of the original lessor. The assignee is primarily liable on the lease, while the assignor retains secondary liability. Instead of assigning, the lessee would be better off surrendering the premises to the lessor and letting the assignee become a tenant on a new lease. If the lessor agrees to this, the original lessee will be free from any liability on the lease.

In a **sublease**, the lessee becomes a lessor (sublessor) and the sublessee is the tenant of the original lessee, not the tenant of the original lessor. Under a sublease, the lessee remains primarily liable on the lease. A sublease can be for the same term or less than the term of the original lease and can be for all or part of the leased premises.

No privity of the contract between the sublessee and the lessor exists. If the original lessee is evicted or the lease otherwise terminates, the rights of the sublessee also terminate. The sublessee cannot have any greater rights than the original lessee had, because the sublessee's rights were granted by the sublessor.

Example: if there is a two-year lease, then an assignment could be for those two years, or a sublease could be for one year of the two-year lease.

☞ ***A sublease transfers “possession,” but not “ownership” of real property.***

When a lessee or sublessee subleases a property, he or she holds a sandwich lease. A Sandwich Lease is a leasehold interest in a property that lies between the primary (ownership) interest and the possessory (tenancy) interest. The holder of a sandwich lease is both a tenant and landlord to the same property.

LEASE AGREEMENTS

Most states require no special wording to establish the landlord-tenant relationship. The lease may be written, oral or implied, depending on the circumstances and the requirements of the



REAL ESTATE PRACTICE

statute of frauds. The law of the state where the real estate is located must be followed to ensure the validity of the lease. Form 13.2 is an example of a typical residential lease.

REQUIREMENTS OF A VALID LEASE

The elements of a valid lease are Capacity, Legal objective, Offer and Acceptance, and Consideration.

A lease is a form of contract. To be valid, a lease must meet essentially the same requirements as any other contract:

Offer and acceptance. The parties must reach a mutual agreement on all the terms of the contract.

Consideration. The lease must be supported by valid consideration. Rent is the normal consideration given for the right to occupy the leased premises. However, the payment of rent is not essential as long as consideration was granted in creating the lease itself. Sometimes, for instance, this consideration is labor performed on the property. Because a lease is a contract, it is not subject to subsequent changes in the rent or other terms unless these changes are in writing and executed in the same manner as the original lease.

Capacity to contract. The parties must have the legal capacity to contract.

Legal objectives. The objectives of the lease must be legal.

The leased premises should be clearly described. The legal description of the real estate should be used if the lease covers land, such as a ground lease. If the lease is for a part of a building, such as an apartment, the space itself or the apartment designation should be described specifically. If supplemental space is to be included, the lease should clearly identify it.

*☞ **Preprinted lease agreements are usually better suited to residential leases. Commercial leases are generally more complex, have different legal requirements and may include complicated calculations of rent and maintenance costs. Drafting a commercial lease-or a complex residential lease, for that matter-may constitute the practice of law. Unless the real estate licensee is also an attorney, legal counsel should be sought.***

POSSESSION OF PREMISES

The lessor, as the owner of the real estate, is usually bound by the implied covenant of *quiet enjoyment*. Quiet enjoyment does not have anything to do *with* barking dogs or late-night motorcycles. The covenant of quiet enjoyment is a presumed promise by the lessor that the lessee may take possession of the premises. The landlord further guarantees that he or she will not interfere in the tenant's possession or use of the property.

The lease may allow the landlord to enter the property to perform maintenance, to make repairs or for other stated purposes. The tenant's permission is usually required.

If the premises are occupied by a holdover tenant or an adverse claimant at the beginning of the new lease period, most states require the landlord to take whatever measures are necessary to recover actual possession. In a few states, however, the landlord is bound only to give the tenant the right of possession; it is the tenant who must bring a court action to secure actual possession.

13: REAL ESTATE LEASES

USE OF PREMISES

A lessor may restrict a lessee's use of the premises through provisions included in the lease.

Use restrictions are particularly common in leases for stores or commercial space. For example, a lease may provide that the leased premises are to be used *“only as a real estate office and for no other purpose.”* In the absence of such clear limitations, a lessee may use the premises for any lawful purpose.

TERM OF LEASE

The term of a lease is the period for which the lease will run. It should be stated precisely, including the beginning and ending dates, together with a statement of the total period of the lease. For instance, a lease might run “for a term of 30 years beginning June 1, 2001, and ending May 31, 2031.” A perpetual lease for an inordinate amount of time or an indefinite term usually will be ruled invalid. However, if the language of the lease and the surrounding circumstances clearly indicate that the parties intended such a term, the lease will be binding on the parties. Some states prohibit leases that run for 100 years or more.

SECURITY DEPOSIT

Most leases require the tenant to provide some form of security deposit to be held by the landlord during the lease term. If the tenant defaults on payment of rent or destroys the premises, the lessor may keep all or part of the deposit to compensate for the loss. Some state laws set maximum amounts for security deposits and specify how they must be handled. Some prohibit security deposits from being used for both nonpayment of rent and property damage. Some require that lessees receive annual interest on their security deposits.

Other safeguards against nonpayment of rent may include an advance rental payment, contracting for a lien on the tenant's property or requiring the tenant to have a third person guarantee payment.

☞ ***A lease should specify whether a payment is a security deposit or an advance rental. If it is a security deposit, the tenant is usually not entitled to apply it to the final month's rent. If it is an advance rental, the landlord must treat it as income for tax purposes.***

IMPROVEMENTS

Neither the landlord nor the tenant is required to make any improvements to the leased property. The tenant may, however, make improvements with the landlord's permission. Any alterations generally become the landlord's property; that is, they become fixtures. However, the lease may give the tenant the right to install trade fixtures. Trade fixtures may be removed before the lease expires provided the tenant restores the premises to their previous condition, with allowance for the wear and tear of normal use.

Accessibility

The federal Fair Housing Act makes it illegal to discriminate against prospective tenants on the basis of physical disability. Tenants with disabilities must be permitted to make reasonable modifications to a property at their own expense. However, if the modifications would interfere with a future tenant's use, the landlord may require that the premises be restored to their original condition at the end of the lease term.



REAL ESTATE PRACTICE

☞ ***The Americans with Disabilities Act (ADA) applies to commercial, nonresidential property in which public goods or services are provided. The ADA requires that such properties either be free of architectural barriers or provide reasonable accommodations for people with disabilities.***

Maintenance of Premises

Many states now require a residential lessor to maintain dwelling units in a habitable condition. Landlords must make any necessary repairs to common areas, such as hallways, stairs and elevators, and maintain safety features, such as fire sprinklers and smoke alarms. The tenant does not have to make any repairs, but must return the premises in the same condition they were received, with allowances for ordinary wear and tear.

Destruction of Premises

In leases involving *agricultural land*, the courts have held that when improvements are damaged or destroyed, the tenant is obligated to pay rent to the end of the term. The tenant's liability does not depend on whether the damage was his or her fault. This ruling has been extended in most states to include *ground leases* for land on which the tenant has constructed a building. In many instances, it also includes leases that give possession of an entire building to the tenant. In this case, the tenant leases the land on which that building is located, as well as the structure itself. Insurance is available to cover such contingencies.

A tenant who leases only part of a building, such as office or commercial space or a residential apartment, however, is **not** required to continue to pay rent after the leased premises are destroyed. In some states, if the property was destroyed as a result of the landlord's negligence, the tenant can even recover damages.

Assignment and Subleasing

When a tenant transfers all his or her leasehold interests to another person, the lease has been assigned. On the other hand, when a tenant transfers less than all the leasehold interests by *leasing* them to a new tenant, he or she has **subleased** (or sublet) the property. **Assignment** and subleasing are permitted whenever a lease does not prohibit them.

In most cases, the sublease or assignment of a lease does not relieve the original lessee of the obligation to pay rent. The landlord may, however, agree to waive the former tenant's liability. Most leases prohibit a lessee from assigning or subletting without the lessor's consent. This permits the lessor to retain control over the occupancy of the leased premises. As a rule, the lessor must not unreasonably withhold consent. The sublessor's (original lessee's) interest in the real estate is known as a *sandwich lease*.

RECORDING A LEASE

Possession of leased premises is considered **constructive notice** to the world of the lessee's leasehold interests. Anyone who inspects the property receives actual notice. For these reasons, it is usually considered *unnecessary* to record a lease.

13: REAL ESTATE LEASES

OPTIONS

A lease may contain an option that grants the lessee the privilege of renewing the lease. The lessee must, however, give notice of his or her intention to exercise the option. Some leases grant the lessees the option to purchase the leased premises. This option normally allows the tenant the right to purchase the property at a predetermined price within a certain time period, possibly the lease term. Although it is not required, the owner may give the tenant credit toward the purchase price for some percentage of the rent paid. The lease agreement is a primary contract over the option to purchase.

☞ All of these general statements concerning provisions of a lease are controlled largely by the terms of the agreement and state law. Great care must be exercised in reading the entire lease document before signing it because every clause in the lease has an economic and a legal impact on either the landlord or the tenant. While preprinted lease forms are available, there is no such thing as a standard lease. When complicated lease situations arise, legal counsel should be sought.

Calculating Percentage Lease Rents

Percentage leases usually call for a minimum monthly rent plus a percentage of gross sales income exceeding a stated annual amount. For example, a lease might require minimum rent of \$1,300 per month plus 5 percent of the business's sales exceeding \$160,000.

On an annual sales volume of \$250,000, the annual rent would be calculated as follows:

$\$1,300 \text{ per month} \times 12 \text{ months} = \$15,600$
 $\$250,000 - \$160,000 = \$90,000$
 $\$90,000 \times .05 (5\%) = \$4,500$
 $\$15,600 \text{ base rent} + \$4,500 \text{ percentage rent} = \$20,100 \text{ total rent}$

A **lease purchase** is used when a tenant wants to purchase the property, but is unable to do so. Perhaps the tenant cannot obtain favorable financing or clear title, or the tax consequences of a current purchase would be unfavorable. In this arrangement, the purchase agreement is the primary consideration, and the lease is secondary. Part of the periodic rent is applied toward the purchase price of the property until it is reduced to an amount for which the tenant can obtain financing or purchase the property outright, depending on the terms of the lease purchase agreement.

Agricultural landowners often lease their land to tenant farmers, who provide the labor to produce and bring in the crop. An owner can be paid by a tenant in one of two ways: as an agreed on rental amount in cash in advance (**cash rents**) or as a percentage of the profits from the sale of the crop when it is sold (**sharecropping**).

DISCHARGE OF LEASES

As with any contract, a lease is discharged when the contract terminates. Termination can occur when all parties have fully performed their obligations under the agreement. In addition, the parties may agree to cancel the lease. If the tenant, for instance, offers to surrender the leasehold interest, and if the landlord accepts the tenant's offer, the lease is terminated. A tenant who simply abandons leased property, however, remains liable for the terms of the lease-including the rent. The terms of the lease will usually indicate whether the landlord is obligated to try to rerent the space. If the landlord intends to sue for unpaid rent, however, most



REAL ESTATE PRACTICE

states require an attempt to mitigate damages by rerenting the premises to limit the amount owed.

The lease does not terminate if the parties die or if the property is sold. *There are two exceptions to this general rule.* A lease from the owner of a *life estate* ends when the life tenant dies. Similarly, the death of either party terminates a tenancy at will. In all other cases, the heirs of a deceased landlord are bound by the terms of existing valid leases.

If leased real estate is sold or otherwise conveyed, the new landlord takes the property subject to the rights of the tenants. A lease agreement may, however, contain language that permits a new landlord to terminate existing leases. The clause, commonly known as a *sale clause*, requires that the tenants be given some period of notice before the termination. Because the new owner has taken title subject to the rights of the tenants, the sale clause enables the new landlord to claim possession and negotiate new leases under his or her own terms and conditions.

BREACH OF LEASE

A tenancy may also be terminated by operation of law, as in a bankruptcy or condemnation proceeding.

When a tenant breaches any lease provision, the landlord may sue the tenant to obtain a judgment to cover past-due rent, damages to the premises or other defaults. Likewise, when a landlord breaches any lease provision, the tenant is entitled to certain remedies. The rights and responsibilities of the landlord-tenant relationship are usually governed by state law.

SUIT FOR POSSESSION - ACTUAL EVICTION

When a tenant breaches a lease or improperly retains leased premises, the landlord may regain possession through a legal process known as **actual eviction**. The landlord must serve notice on the tenant before commencing the lawsuit. Most lease terms require at least a ten-day notice in the case of default. In many states, however, only a five-day notice is necessary when the tenant defaults in the payment of rent. When a court issues a judgment for possession to a landlord, the tenant must vacate the property. If the tenant fails to leave, the landlord can have the judgment enforced by a court officer, who forcibly removes the tenant and the tenant's possessions. The landlord then has the right to reenter and regain possession of the property.

TENANTS' REMEDIES - CONSTRUCTIVE EVICTION

If a landlord breaches any clause of a lease agreement, the tenant has the right to sue and recover damages against the landlord. If the leased premises become unusable for the purpose stated in the lease, the tenant may have the right to abandon them. This action, called **constructive eviction**, terminates the lease agreement. The tenant must prove that the premises have become unusable *because of the* conscious *neglect of the* landlord. To claim constructive eviction, the tenant must leave the premises while the conditions that made the premises uninhabitable exist.

☞ **Example:**

1. *T's* lease requires the landlord to furnish heat. The landlord fails to repair a defective furnace, and no heat is provided to *T's* apartment during the winter months. *T* is forced to abandon the apartment. Because the lack of heat was due to the landlord's negligence, *T* has been constructively evicted.

13: REAL ESTATE LEASES

2. F's lease requires the landlord to furnish water. Although the landlord carefully maintains the building's plumbing system, the pipes develop a leak, and F's apartment is without water for several weeks while the problem is being repaired. F abandons the apartment. Because the lack of water was not due to the landlord's negligence, however, F has not been constructively evicted.
3. H owns a nightclub and a neighboring apartment building. B leased an apartment from H. The noise from the nightclub in the late evening and early morning was intense, and B complained about it to H. H posted a sign in the nightclub that said, "Shhhh: We Have Neighbors!" but the noise continued. Finally, B abandoned the apartment, and H sued to recover rent. The court held that B had been constructively evicted because of the loud noise.

Pro-Tenant Legislation

For the most part, leases are drawn up primarily for the benefit of the landlord. However, due to tenant's rights movements and increased consumer awareness, several states have adopted some variation of the *Uniform Residential Landlord and Tenant Act*. This model law addresses the need for both parties to a lease to fulfill certain basic obligations. The act address such issues as

The landlord's right of entry;

Maintenance of the premises;

The tenant's protection against retaliation by the landlord for complaints; and

The disclosure of the property owners' names and addresses to the tenants.

The act further establishes the specific remedies available to both the landlord and the tenant if a breach of the lease agreement occurs.

CIVIL RIGHTS LAWS

The fair housing laws affect landlords and tenants just as they do sellers and purchasers. All persons must have access to housing of their choice without any differentiation in the terms and conditions because of their race, color, religion, national origin, sex, handicap or familial status. State and local municipalities may have their own fair housing laws that add protected classes such as age and sexual orientation. Withholding an apartment that is available for rent, segregating certain persons in separate sections of an apartment complex or parts of a building and charging different amounts for rent or security deposits to persons in the protected classes all constitute violations of the law. The fair housing laws will be discussed in greater detail in our continuing education course.

It is important that landlords realize that changes in the laws stemming from the federal Fair Housing Amendments Act of 1988 significantly alter past practices, particularly as they affect individuals with disabilities (discussed previously) and families with children. The fair housing laws require that the same tenant criteria be applied to families with children that are applied to adults. A landlord cannot charge a different amount of rent or security deposit because one of the tenants is a child. While landlords have historically argued that children are noisy and destructive, the fact is that many adults are noisy and destructive as well.

RIGHTS AND OBLIGATIONS OF PARTIES

The following subjects should be considered in the contract:



REAL ESTATE PRACTICE

1. Rent is the consideration paid for the use of the property. It is legally due at the end of term; yet, under contract terms, it is usually paid in advance.
2. Every lease has an implied covenant by a lessor (landlord) to give the lessee (tenant) quiet enjoyment and possession. The covenant is breached if:
 - ♦ The premises become unfit or unsuitable for occupancy.
 - ♦ The lessor (landlord) enters and makes extensive and unwarranted alterations.
 - ♦ The entire premises are condemned.
 - ♦ If the property is a dwelling house and becomes unfit for human occupation from causes other than lessees (tenants) negligence. The lessee (tenant) may give the lessor (landlord) notice to repair. If lessor (landlord) fails to do so, the lessee (tenant) may:
 - Spend up to one months rent in repairs, not more than twice in any 12 month period; or,
 - Abandon the premises and break the lease.
 - The lessee (tenant) may assign or sublease the premises when the lease does not prohibit such action. Violation of a prohibition merely makes the contract voidable by the lessor (landlord).

Liabilities for Injuries

Generally, when the entire premises are leased, the landlord is not liable for injuries to the tenant or any guests that resulted from a defective condition on the premises. This is true even if reasonable care would have disclosed the defects. In apartments or situations where the tenant does not lease the entire property, the liability for injury in the common areas belongs to the landlord. Therefore, it is the landlords responsibility to either repair defective conditions in the common areas or be liable for injuries resulting from them. If a landlord has knowledge of such defects or disrepair, but conceals the fact from the tenant, the landlord is liable for any resulting injuries.

Its easy to see why landlords should carry a large amount of liability insurance. Building defects may cause serious injury that could result in a lawsuit against the landlord. The tenant may also carry a renters liability policy to protect against injuries sustained by others while visiting his or her apartment. This type of protection is usually contained in a “renters” or contents” policy, which protects the tenants from most losses, including liability and personal property damages.

The California State & Bar Association, in conjunction with CAR, has developed a standard combination lease and rental agreement form. This lease contains a number of conditions and provisions that both groups believe provide a good lease contract. As well as explaining who is responsible for any breach, this lease covers most of the common problems that may arise. Form 13-1 is an Application to Rent and Receipt for Rental Deposit and Application Screening Fee form. Form 13-2 is the Residential Lease or Month-to-Month Rental Agreement.

13: REAL ESTATE LEASES

Form 13-1: Application to Rent and Receipt for Rental Deposit (2 pages)



CALIFORNIA
ASSOCIATION
OF REALTORS®

APPLICATION TO RENT RECEIPT FOR DEPOSIT/SCREENING FEE (C.A.R. Form LRA, Revised 4/01)

I. APPLICATION TO RENT

THIS SECTION TO BE COMPLETED BY APPLICANT. A SEPARATE APPLICATION TO RENT IS REQUIRED FOR EACH OCCUPANT 18 YEARS OF AGE OR OVER.

Application to rent property at 123 Main St., Main City, CA 90001 ("Premises").

FULL NAME OF APPLICANT Buyer Name Date of birth _____

Soc. Sec. no. _____ Driver's license no. _____ State _____ Expires _____

Phone Number: Home _____ Work _____ Other _____

Email _____

Current address _____ Previous address _____

City/State/Zip _____ City/State/Zip _____

Name of landlord/manager _____ Name of landlord/manager _____

Landlord/manager's phone _____ Landlord/manager's phone _____

How long at current address? _____ How long at this address? _____

Reason for leaving current address _____ Reason for leaving this address _____

Name(s) of all other proposed occupant(s) and relationship to applicant _____

Proposed pet(s) (number and type) _____

Current employer _____ Supervisor _____ Length of employment _____

Employer's address _____ Phone _____

Position or title _____ Gross income \$ _____ per _____

Previous employer _____ Supervisor _____ Length of employment _____

Employer's address _____ Phone _____

Position or title _____ Gross income \$ _____ per _____

Other income \$ _____ per _____ Source _____

Auto make _____ Model _____ Year _____ License no. _____ State _____ Color _____

In case of emergency, person to notify _____ Relationship _____

Address _____ Phone _____

Does applicant plan to use liquid filled furniture? ☐ No ☐ Yes Type _____

Has applicant been a party to an unlawful detainer action or filed bankruptcy within the last seven years? ☐ No ☐ Yes

If yes, explain _____

Has applicant or any proposed occupant ever been convicted of or pleaded no contest to a felony? ☐ No ☐ Yes

If yes, explain _____

Name of creditor	Account number	Monthly payment	Balance due

Name of bank	Account number	Address/Branch	Type of Account

Applicant represents the above information to be true and complete, and hereby authorizes Landlord or manager to (i) verify the information provided and (ii) obtain credit report on applicant.

Date _____ Time _____

Applicant _____

Buyer Name

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LRA-11 (PAGE 1 OF 2)

Applicant and Landlord/Manager acknowledge receipt of a copy of this page.

Applicant's Initials (_____) (_____)

Landlord/Manager's Initials (_____) (_____)

Reviewed by

Broker or Designee _____ Date _____



APPLICATION TO RENT RECEIPT FOR DEPOSIT/SCREENING FEE (LRA-11 PAGE 1 OF 2)



REAL ESTATE PRACTICE

Property Address: 123 Main St., Main City, CA 90001

Date: _____

II. RECEIPT FOR DEPOSIT

THIS SECTION TO BE COMPLETED BY AGENT, LANDLORD OR MANAGER.

Applicant has deposited the sum of \$ _____ as a deposit on the Premises. The deposit is evidenced by:

☐ Cashier's Check, ☐ Personal Check, or ☐ other _____, payable to _____, to be held uncashed until approval of the Application To Rent. If deposit is in cash, deposit shall be ☐ held in Broker's Trust Account or ☐ given to Owner. The executed lease or rental agreement may require additional sums to be paid, as a security deposit, or for other purposes. If the Application to Rent is approved, the deposited sum shall be applied to total sums due upon execution of a lease or rental agreement. If the Application to Rent is not approved within _____ days, the deposit shall be returned to Applicant.

III. SCREENING FEE

THIS SECTION TO BE COMPLETED BY AGENT, LANDLORD OR MANAGER.

In addition to the deposit, Applicant has paid a nonrefundable screening fee of \$ _____, applied as follows: (The screening fee may not exceed \$30.00 (adjusted annually from 1-1-98 commensurate with the increase in the Consumer Price Index.))

\$ _____ for credit reports;

\$ _____ for _____ (other out-of-pocket expenses); and

\$ _____ for processing.

The undersigned has read the foregoing and acknowledges receipt of a copy.

Applicant Signature _____

Date _____

Buyer Name

The undersigned has received the deposit and screening fee indicated above.

Landlord or Manager or Agent Signature _____

Date _____

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525 South Virgil Avenue, Los Angeles, California 90020

Reviewed by

Broker or Designee _____ Date _____



LRA-11 (PAGE 2 OF 2)

13: REAL ESTATE LEASES

Form 13-2: Residential Lease or Month-to-Month Rental Agreement (4 pages)



CALIFORNIA
ASSOCIATION
OF REALTORS®

RESIDENTIAL LEASE OR MONTH-TO-MONTH RENTAL AGREEMENT

(C.A.R. Form LR, Revised 10/01)

Dynasty Realty
Jeffrey Ops, Steven Crapes

("Landlord") and

("Tenant") agree as follows:

1. PROPERTY:

A. Landlord rents to Tenant and Tenant rents from Landlord, the real property and improvements described as: 123 Main Street, Main City,
CA 90001 ("Premises").

B. The following personal property is included: _____

2. TERM: The term begins on (date) _____ ("Commencement Date"), (Check A or B):

☐ A. **Month-to-month:** and continues as a month-to-month tenancy. Either party may terminate the tenancy by giving written notice to the other at least 30 days prior to the intended termination date, subject to any applicable local laws. Such notice may be given on any date.

☒ B. **Lease:** and shall terminate on (date) _____ at _____ ☐ AM ☐ PM.

Any holding over after the term of this Agreement expires, with Landlord's consent, shall create a month-to-month tenancy which either party may terminate as specified in paragraph 2A. Rent shall be at a rate equal to the rent for the immediately preceding month, unless otherwise notified by Landlord, payable in advance. All other terms and conditions of this Agreement shall remain in full force and effect.

3. RENT:

A. Tenant agrees to pay rent at the rate of \$ _____ per month for the term of the Agreement.

B. Rent is payable in advance on the 1st (or ☐ day of each calendar month, and is delinquent on the next day.

C. If Commencement Date falls on any day other than the first day of the month, rent shall be prorated based on a 30-day period. If Tenant has paid one full month's rent in advance of Commencement Date, rent for the second calendar month shall be prorated based on a 30-day period.

D. **PAYMENT:** The rent shall be paid by ☐ cash, ☐ personal check, ☐ money order, ☐ cashier check, ☐ other _____, to
(name) _____ (phone) _____ at
(address) _____,
(or at any other location specified by Landlord in writing to Tenant) between the hours of _____ and _____
on the following days _____.

4. SECURITY DEPOSIT:

A. Tenant agrees to pay \$ _____ as a security deposit. Security deposit will be ☐ transferred to and held by the Owner of the Premises; or ☐ held in Owner's Broker's trust account.

B. All or any portion of the security deposit may be used, as reasonably necessary, to: (1) cure Tenant's default in payment of rent, Late Charges, non-sufficient funds ("NSF") fees, or other sums due; (2) repair damage, excluding ordinary wear and tear, caused by Tenant or by a guest or licensee of Tenant; (3) clean Premises, if necessary, upon termination of tenancy; and (4) replace or return personal property or appurtenances. **SECURITY DEPOSIT SHALL NOT BE USED BY TENANT IN LIEU OF PAYMENT OF LAST MONTH'S RENT.** If all or any portion of the security deposit is used during tenancy, Tenant agrees to reinstate the total security deposit within five days after written notice is delivered to Tenant. Within three weeks after Tenant vacates the Premises, Landlord shall: (1) furnish Tenant an itemized statement indicating the amount of any security deposit received and the basis for its disposition; and (2) return any remaining portion of security deposit to Tenant.

C. No interest will be paid on security deposit unless required by local ordinance.

D. If security deposit is held by Owner, Tenant agrees not to hold Broker responsible for its return. If security deposit is held in Owner's Broker's trust account, and Broker's authority is terminated before expiration of this Agreement, and security deposits are released to someone other than Tenant, then Broker shall notify Tenant, in writing, where and to whom security deposit has been released. Once Tenant has been provided such notice, Tenant agrees not to hold Broker responsible for security deposit.

5. MOVE-IN COSTS RECEIVED/DUE:

Category	Total Due	Payment Received	Balance Due	Date Due
Rent from _____ to _____ (date)			\$0.00	
*Security Deposit			\$0.00	
Other _____			\$0.00	
Other _____			\$0.00	
Total	\$0.00	\$0.00	\$0.00	

*The maximum amount that Landlord may receive as security deposit, however designated, cannot exceed two month's rent for an unfurnished Premises, or three month's rent for a furnished premises.

6. PARKING: (Check A or B)

☐ A. Parking is permitted as follows: _____

The right to parking ☐ is, ☐ is not, included in the rent charged pursuant to paragraph 3. If not included in the rent, the parking rental fee shall be an additional \$ _____ per month. Parking space(s) are to be used for parking operable motor vehicles, except for trailers, boats, campers, buses or trucks (other than pick-up trucks). Tenant shall park in assigned space(s) only. Parking space(s) are to be kept clean. Vehicles leaking oil, gas or other motor vehicle fluids shall not be parked on the Premises. Mechanical work or storage of inoperable vehicles is not allowed in parking space(s) or elsewhere on the Premises.

OR ☐ B. Parking is not permitted on the Premises.

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LR-11 REVISED DATE 10/01 (PAGE 1 OF 4)

Landlord and Tenant acknowledge receipt of copy of this page.

Landlord's Initials (_____) (_____)

Tenant's Initials (_____) (_____)

Reviewed by

Broker or Designee _____ Date _____



RESIDENTIAL LEASE OR MONTH-TO-MONTH RENTAL AGREEMENT (LR-11 PAGE 1 OF 4)



REAL ESTATE PRACTICE

Premises: 123 Main Street, Main City, CA 90001

Date: _____

7. STORAGE: (Check A or B)

- ☐ **A.** Storage is permitted as follows: _____
The right to storage space ☐ is, ☐ is not, included in the rent charged pursuant to paragraph 3. If not included in rent, storage space shall be an additional \$ _____ per month. Tenant shall store only personal property that Tenant owns, and shall not store property that is claimed by another or in which another has any right, title, or interest. Tenant shall not store any improperly packaged food or perishable goods, flammable materials, explosives, or other inherently dangerous material.

OR ☐ **B.** Storage is not permitted on the Premises.

- 8. LATE CHARGE/NSF CHECKS:** Tenant acknowledges that either late payment of rent or issuance of a NSF check may cause Landlord to incur costs and expenses, the exact amount of which are extremely difficult and impractical to determine. These costs may include, but are not limited to, processing, enforcement and accounting expenses, and late charges imposed on Landlord. If any installment of rent due from Tenant is not received by Landlord within 5 (or ☐ _____) calendar days after date due, or if a check is returned NSF, Tenant shall pay to Landlord, respectively, an additional sum of \$ _____ as Late Charge and \$25.00 as a NSF fee, either or both of which shall be deemed additional rent. Landlord and Tenant agree that these charges represent a fair and reasonable estimate of the costs Landlord may incur by reason of Tenant's late or NSF payment. Any Late Charge or NSF fee due shall be paid with the current installment of rent. Landlord's acceptance of any Late Charge or NSF fee shall not constitute a waiver as to any default of Tenant. Landlord's right to collect a Late Charge or NSF fee shall not be deemed an extension of the date rent is due under paragraph 3, or prevent Landlord from exercising any other rights and remedies under this Agreement, and as provided by law.

- 9. CONDITION OF PREMISES:** Tenant has examined Premises, all furniture, furnishings, appliances, landscaping, if any, and fixtures, including smoke detector(s).

(Check one:)

- ☐ **A.** Tenant acknowledges that these items are clean and in operative condition, with the following exceptions _____

OR ☐ **B.** Tenant's acknowledgment of the condition of these items is contained in an attached statement of condition (such as C.A.R.'s MIMO-11).

OR ☐ **C.** Tenant will provide Landlord a list of items that are damaged or not in operable condition within 3 (or ☐ _____) days after Commencement Date, not as a contingency of this Agreement but rather as an acknowledgment of the condition of the Premises.

OR ☐ **D.** Other: _____

- 10. NEIGHBORHOOD CONDITIONS:** Tenant is advised to satisfy him or herself as to neighborhood or area conditions, including schools, proximity and adequacy of law enforcement, crime statistics, registered felons or offenders, fire protection, other governmental services, proximity to commercial, industrial or agricultural activities, existing and proposed transportation, construction and development that may affect noise, view, or traffic, airport noise, noise or odor from any source, wild and domestic animals, other nuisances, hazards, or circumstances, facilities and condition of common areas, conditions and influences of significance to certain cultures and/or religions, and personal needs, requirements and preferences of Tenant.

- 11. UTILITIES:** Tenant agrees to pay for all utilities and services, and the following charges: _____, which shall be paid for by Landlord. If any utilities are not separately metered, Tenant shall pay Tenant's proportional share, as reasonably determined by Landlord.

- 12. OCCUPANTS:** The Premises are for the sole use as a personal residence by the following named persons only: _____

- 13. PETS:** No animal or pet shall be kept on or about the Premises without Landlord's prior written consent, except _____

- 14. RULES/REGULATIONS:** Tenant agrees to comply with all rules and regulations of Landlord, which are at any time posted on the Premises or delivered to Tenant. Tenant shall not, and shall ensure that guests and licensees of Tenant shall not, disturb, annoy, endanger, or interfere with other tenants of the building or neighbors, or use the Premises for any unlawful purposes, including, but not limited to, using, manufacturing, selling, storing, or transporting illicit drugs or other contraband, or violate any law or ordinance, or commit a waste or nuisance on or about the Premises.

- 15. CONDOMINIUM/PLANNED UNIT DEVELOPMENT:** ☐ (If checked) The Premises is a unit in a condominium, planned unit, or other development governed by a homeowners' association ("HOA"). The name of the HOA is _____. Tenant agrees to comply with all covenants, conditions and restrictions, bylaws, rules and regulations and decisions of HOA. Landlord shall provide Tenant copies of rules and regulations, if any. Tenant shall reimburse Landlord for any fines or charges imposed by HOA or other authorities, due to any violation by Tenant, or the guests or licensees of Tenant.

16. MAINTENANCE:

- A.** Tenant shall properly use, operate and safeguard Premises, including if applicable, any landscaping, furniture, furnishings, and appliances, and all mechanical, electrical, gas and plumbing fixtures, and keep them clean and sanitary. Tenant shall immediately notify Landlord, in writing, of any problem, malfunction or damage. Tenant shall pay for all repairs or replacements caused by Tenant, or guests of Tenant, excluding ordinary wear and tear. Tenant shall pay for all damage to Premises as a result of failure to report a problem in a timely manner. Tenant shall pay for repair of drain blockages or stoppages, unless caused by defective plumbing parts or tree roots invading sewer lines.

- B.** ☐ Landlord ☐ Tenant shall water the garden, landscaping, trees and shrubs, except _____

- C.** ☐ Landlord ☐ Tenant shall maintain the garden, landscaping, trees and shrubs, except _____

- 17. ALTERATIONS:** Tenant shall not make any alterations in or about the Premises without Landlord's prior written consent, including: painting, wallpapering, adding or changing locks, installing antenna or satellite dish(es), placing signs, displays or exhibits, or using screws, fastening devices, large nails or adhesive materials.

18. KEYS/LOCKS:

- A.** Tenant acknowledges receipt of (or Tenant will receive ☐ prior to the Commencement Date, or ☐ _____):
☐ _____ key(s) to Premises, ☐ _____ remote control device(s) for garage door/gate opener(s),
☐ _____ key(s) to mailbox, ☐ _____
☐ _____ key(s) to common area(s), ☐ _____

- B.** Tenant acknowledges that locks to the Premises ☐ have, ☐ have not, been rekeyed.

- C.** If Tenant rekeys existing locks or opening devices, Tenant shall immediately deliver copies of all keys to Landlord. Tenant shall pay all costs and charges related to loss of any keys or opening devices. Tenant may not remove locks, even if installed by Tenant.

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Landlord and Tenant acknowledge receipt of copy of this page.

Landlord's Initials (_____) (_____) _____

Tenant's Initials (_____) (_____) _____

Reviewed by _____ Date _____

Broker or Designee _____



LR-11 REVISED DATE 10/01 (PAGE 2 of 4)

RESIDENTIAL LEASE OR MONTH-TO-MONTH RENTAL AGREEMENT (LR-11 PAGE 2 OF 4)

T8207241.ZFX

13: REAL ESTATE LEASES

Premises: 123 Main Street, Main City, CA 90001

Date: _____

- 19. ENTRY:** Tenant shall make Premises available to Landlord or representative for the purpose of entering to make necessary or agreed repairs, decorations, alterations, or improvements, or to supply necessary or agreed services, or to show Premises to prospective or actual purchasers, tenants, mortgagees, lenders, appraisers, or contractors. Landlord and Tenant agree that twenty-four (24) hours notice (oral or written) shall be reasonable and sufficient notice. In an emergency, Landlord or representative may enter Premises at any time without prior notice.
- 20. SIGNS:** Tenant authorizes Landlord to place For Sale/Lease signs on the Premises.
- 21. ASSIGNMENT/SUBLETTING:** Tenant shall not sublet all or any part of Premises, or assign or transfer this Agreement or any interest in it, without prior written consent of Landlord. Unless such consent is obtained, any assignment, transfer or subletting of Premises or this Agreement or tenancy, by voluntary act of Tenant, operation of law, or otherwise, shall be null and void, and at the option of Landlord, terminate this Agreement. Any proposed assignee, transferee or sublessee shall submit to Landlord an application and credit information for Landlord's approval, and if approved, sign a separate written agreement with Landlord and Tenant. Landlord's consent to any one assignment, transfer or sublease, shall not be construed as consent to any subsequent assignment, transfer or sublease and does not release Tenant of Tenant's obligation under this Agreement.
- 22. ☐ LEAD PAINT (CHECK IF APPLICABLE):** Premises was constructed prior to 1978. In accordance with federal law, Landlord gives and Tenant acknowledges receipt of the disclosures on the attached form (such as C.A.R. Form FLD-11) and a federally approved lead pamphlet.
- 23. POSSESSION:** If Landlord is unable to deliver possession of Premises on Commencement Date, such Date shall be extended to date on which possession is made available to Tenant. If Landlord is unable to deliver possession within 5 (or ☐ _____) calendar days after agreed Commencement Date, Tenant may terminate this Agreement by giving written notice to Landlord, and shall be refunded all rent and security deposit paid.
- 24. TENANT'S OBLIGATIONS UPON VACATING PREMISES:** Upon termination of Agreement, Tenant shall: (a) give Landlord all copies of all keys or opening devices to Premises, including any common areas; (b) vacate Premises and surrender it to Landlord empty of all persons; (c) vacate any/all parking and/or storage space; (d) deliver Premises to Landlord in the same condition as referenced in paragraph 9; (e) clean Premises, including professional cleaning of carpet and drapes; (f) give written notice to Landlord of Tenant's forwarding address; and (g) _____.
- All improvements installed by Tenant, with or without Landlord's consent, become the property of Landlord upon termination.
- 25. BREACH OF CONTRACT/EARLY TERMINATION:** In addition to any obligations established by paragraph 24, in event of termination by Tenant prior to completion of the original term of Agreement, Tenant shall also be responsible for lost rent, rental commissions, advertising expenses and painting costs necessary to ready Premises for rental.
- 26. TEMPORARY RELOCATION:** Tenant agrees, upon demand of Landlord, to temporarily vacate Premises for a reasonable period, to allow for fumigation, or other methods, to control wood destroying pests or organisms, or other repairs to Premises. Tenant agrees to comply with all instructions and requirements necessary to prepare Premises to accommodate pest control, fumigation or other work, including bagging or storage of food and medicine, and removal of perishables and valuables. Tenant shall only be entitled to a credit of rent equal to the per diem rent for the period of time Tenant is required to vacate Premises.
- 27. DAMAGE TO PREMISES:** If, by no fault of Tenant, Premises are totally or partially damaged or destroyed by fire, earthquake, accident or other casualty, which render Premises uninhabitable, either Landlord or Tenant may terminate Agreement by giving the other written notice. Rent shall be abated as of date of damage. The abated amount shall be the current monthly rent prorated on a 30-day basis. If Agreement is not terminated, Landlord shall promptly repair the damage, and rent shall be reduced based on the extent to which the damage interferes with Tenant's reasonable use of Premises. If damage occurs as a result of an act of Tenant or Tenant's guests, only Landlord shall have the right of termination, and no reduction in rent shall be made.
- 28. INSURANCE:** Tenant's or guest's personal property and vehicles are not insured by Landlord or, if applicable, HOA, against loss or damage due to fire, theft, vandalism, rain, water, criminal or negligent acts of others, or any other cause. Tenant is to carry Tenant's own insurance (renter's insurance) to protect Tenant from any such loss.
- 29. WATERBEDS:** Tenant shall not use or have waterbeds on the Premises unless: (a) Tenant obtains a valid waterbed insurance policy; (b) Tenant increases the security deposit in an amount equal to one-half of one month's rent; and (c) the bed conforms to the floor load capacity of Premises.
- 30. WAIVER:** The waiver of any breach shall not be construed as a continuing waiver of the same or any subsequent breach.
- 31. NOTICE:** Notices may be served at the following address, or at any other location subsequently designated:
Landlord: _____ Tenant: _____
- 32. TENANT ESTOPPEL CERTIFICATE:** Tenant shall execute and return a tenant estoppel certificate delivered to Tenant by Landlord or Landlord's agent within 3 days after its receipt. The tenant estoppel certificate acknowledges that this Agreement is unmodified and in full force, or in full force as modified, and states the modifications. Failure to comply with this requirement shall be deemed Tenant's acknowledgment that the tenant estoppel certificate is true and correct, and may be relied upon by a lender or purchaser.
- 33. JOINT AND INDIVIDUAL OBLIGATIONS:** If there is more than one Tenant, each one shall be individually and completely responsible for the performance of all obligations of Tenant under this Agreement, jointly with every other Tenant, and individually, whether or not in possession.
- 34. ☐ MILITARY ORDINANCE DISCLOSURE:** (If applicable and known to Landlord) Premises is located within one mile of an area once used for military training, and may contain potentially explosive munitions.
- 35. TENANT REPRESENTATIONS; CREDIT:** Tenant warrants that all statements in Tenant's rental application are accurate. Tenant authorizes Landlord and Broker(s) to obtain Tenant's credit report at time of application and periodically during tenancy in connection with approval, modification, or enforcement of this Agreement. Landlord may cancel this Agreement: (a) before occupancy begins; (b) upon disapproval of the credit report(s); or (c) at any time, upon discovering that information in Tenant's application is false. A negative credit report reflecting on Tenant's record may be submitted to a credit reporting agency if Tenant fails to fulfill the terms of payment and other obligations under this Agreement.
- 36.** If Landlord has entered into a contract for periodic pest control treatment of the Premises, Landlord shall give tenant a copy of the notice originally given to Landlord by the pest control company.

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LR-11 REVISED DATE 10/01 (PAGE 3 OF 4)

Landlord and Tenant acknowledge receipt of copy of this page.

Landlord's Initials (_____) (_____)

Tenant's Initials (_____) (_____)

Reviewed by

Broker or Designee _____ Date _____



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RESIDENTIAL LEASE OR MONTH-TO-MONTH RENTAL AGREEMENT (LR-11 PAGE 3 OF 4)



REAL ESTATE PRACTICE

Premises: 123 Main Street, Main City, CA 90001 Date: _____

37. DATA BASE DISCLOSURE: NOTICE: The California Department of Justice, sheriff's departments, police departments serving jurisdictions of 200,000 or more, and many other local law enforcement authorities maintain for public access a data base of the locations of persons required to register pursuant to paragraph (1) of subdivision (a) of Section 290.4 of the Penal Code. The data base is updated on a quarterly basis and a source of information about the presence of these individuals in any neighborhood. The Department of Justice also maintains a Sex Offender Identification Line through which inquiries about individuals may be made. This is a "900" telephone service. Callers must have specific information about individuals they are checking. Information regarding neighborhoods is not available through the "900" telephone service.

38. OTHER TERMS AND CONDITIONS/SUPPLEMENTS: _____

The following ATTACHED supplements are incorporated in this Agreement: _____

39. ATTORNEY FEES: In any action or proceeding arising out of this Agreement, the prevailing party between Landlord and Tenant shall be entitled to reasonable attorney fees and costs.

40. ENTIRE CONTRACT: Time is of the essence. All prior agreements between Landlord and Tenant are incorporated in this Agreement, which constitutes the entire contract. It is intended as a final expression of the parties' agreement, and may not be contradicted by evidence of any prior agreement or contemporaneous oral agreement. The parties further intend that this Agreement constitutes the complete and exclusive statement of its terms, and that no extrinsic evidence whatsoever may be introduced in any judicial or other proceeding, if any, involving this Agreement. Any provision of this Agreement that is held to be invalid shall not affect the validity or enforceability of any other provision in this Agreement.

41. AGENCY:

A. Confirmation: The following agency relationship(s) are hereby confirmed for this transaction:

Listing Agent: (Print firm name) Dynasty Realty is the agent of
(check one) ☐ the Landlord exclusively; or ☒ both the Landlord and Tenant.

Leasing Agent: (Print firm name) _____ (if not same as Listing Agent) is the agent of
(check one) ☐ the Tenant exclusively; or ☐ the Landlord exclusively; or ☐ both the Tenant and Landlord.

B. Disclosure: ☐ (If checked): The term of this lease exceeds one year. A disclosure regarding real estate agency relationships (such as C.A.R. form AD-11), has been provided to Landlord and Tenant, who each acknowledge its receipt.

42. ☐ INTERPRETER/TRANSLATOR: The terms of this Agreement have been interpreted/translated for Tenant into the following language:

_____. Interpretation/translation service has been provided by (print name) _____, who has the following Driver's License or other identification number: _____.

Tenant has been advised to rely on, and has in fact solely relied on the interpretation/translation services of the above-named individual, and not on the Landlord or other person involved in negotiating the Agreement. If the Agreement has been negotiated primarily in Spanish, Tenant has been provided a Spanish language translation of this Agreement pursuant to the California Civil Code. (C.A.R. form LR-14-S fulfills this requirement.)

Signature of interpreter/translator _____ Date _____

Landlord and Tenant acknowledge and agree that Brokers: (a) do not guarantee the condition of the Premises; (b) cannot verify representations made by others; (c) cannot provide legal or tax advice; (d) will not provide other advice or information that exceeds the knowledge, education or experience required to obtain a real estate license. Furthermore, if Brokers are not also acting as Landlord in this Agreement, Brokers: (e) do not decide what rental rate a Tenant should pay or Landlord should accept; and (f) do not decide upon the length or other terms of tenancy. Landlord and Tenant agree that they will seek legal, tax, insurance and other desired assistance from appropriate professionals.

Tenant Jeffrey Ops Date _____

Tenant Steven Crapes Date _____

Landlord _____ Date _____
(Owner or Agent with authority to enter into this lease) Dynasty Realty

Landlord _____ Date _____
(Owner or Agent with authority to enter into this lease)

Landlord Address _____ Telephone _____

Agency relationships are confirmed as above. Real estate brokers who are not also Landlord in this Agreement are not a party to the Agreement between Landlord and Tenant.

Real Estate Broker _____ By _____ Date _____
(Leasing Firm Name)

Address _____ Telephone _____ Fax _____

Real Estate Broker Dynasty Realty By _____ Date _____
(Listing Firm Name)

Address _____ Telephone _____ Fax _____

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Reviewed by _____
Broker or Designee _____ Date _____



LR-11 REVISED DATE 10/01 (PAGE 4 OF 4)

RESIDENTIAL LEASE OR MONTH-TO-MONTH RENTAL AGREEMENT (LR-11 PAGE 4 OF 4)

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13: REAL ESTATE LEASES

TERMINATION OF A LEASE

As we have mentioned a lease may be terminated in many ways, voluntarily or involuntarily. We will discuss the termination notice required for the various leasehold estates and five most common reasons for termination.

Termination Notice

A lease ends at the expiration of the term and without notice. Rental agreements terminate by a written notice that must be at least one rental period in length.

- ◆ Estate for years ends at the expiration of terms. No notice is required.
- ◆ Periodic tenancy requires notice equal to the period of tenancy but not beyond one months notice.
- ◆ Tenancy at will requires 30 days notice.
- ◆ Tenancy at sufferance requires no notice.

Surrender

Surrender is the giving up of a lease or other estate, thus terminating any further obligations. Leases may be surrendered either by mutual agreement of the parties or through operation of law.

A lease or rental agreement may be terminated, at any time, by the mutual agreement of both parties. In fact, if you are thinking about breaking a lease, it is a good idea to talk to the landlord first. He or she may want to terminate the agreement just as much as you do, or at least suggest a way to sublease the unit.

It is generally considered a good idea to try to negotiate your way out of a rental contract instead of creating hard feelings with a breach of the contract. It is only natural to feel guilty about breaking a lease or rental agreement.

If you do not try to communicate your problems or circumstances to the landlord, he or she cannot help feeling that you do not care. Most people will be more sympathetic if you explain the situation to them. This will give them a chance to help you. Allow the landlord a chance to minimize any loss either of you might suffer.

If a tenant abandons a property without cause, he or she has, by “operation of law,” surrendered the property back to the landlord. Any cost for legal action by the landlord, plus the cost of any rental loss, may be charged to the tenant. The losses will be minimized if the landlord recovers possession and re-leases the premises quickly. A landlord can bring a lawsuit against the tenant for the lost rents, advertising expenses and repairs or cleaning.

If a tenant rent is 14 days delinquent and the landlord has reasonable cause to believe that the lessee has abandoned the premises, the lessor may bring action to reclaim the property. The lease is terminated 15 to 18 days after the lessor posts a Notice of Belief of Abandonment in a conspicuous place (door, window) on the premises. This will occur unless the lessee pays the rent or notifies the landlord that the premises have not been abandoned and he or she does not wish to surrender the leasehold estate.



Expiration

A lease ends, without notice, at the expiration of the term. Rental agreements are usually terminated by either party with a 30-day written notice, unless a longer period is agreed to by both parties. As stated before, if the rental period is less than a month, only that much time is required. “Tenancies at Will” require no less than a 30-day written “notice to vacate” to be served upon the tenant, or a 30-day notice given to the landlord by a vacating tenant. The 30-day notice may be made at any time during the rental period, with the balance of the rent due prorated. Any condition in a rental agreement may be changed with a 30-day written notice.

Destruction

If a structure is destroyed, there is usually a clause in the contract that automatically terminates the lease. If the damage is light, the tenant may stay while the landlord makes repairs. The lessee has the right to vacate the lease if the property is condemned.

☞ ***Selling a rental property is “subject to the rights of tenants in possession.” It does not terminate leases.***

Breach of Conditions

Both lessor and lessee have certain legal grounds for termination of a lease.

The violation of any conditions of the lease is a breach of contract and may terminate the agreement. When real estate agents are involved in a leasing transaction, both the lessee and lessor have the responsibility of being informed of all contractual conditions and understand that violation of the conditions may cause termination.

Lessors Grounds for Termination

- ◆ Use of the premises for unauthorized or illegal purposes.
- ◆ Breach of condition by lessee (tenant),
- ◆ Destruction of the premises if there is no covenant to repair.
- ◆ Default in payment of rent.

Remedies of Lessor (Landlord) for Default in Rent Payments

Lessor (landlord) may,

1. Sue for each installment as it becomes due whether the lessee (tenant) stays in possession or not.
2. Retake possession, relet, and sue for damages.
3. Serve “3 day Notices to Pay or Quit” and file “Unlawful Detainer” actions (court actions).

Lessees (tenants) Grounds for Termination


- ◆ Violation of the lessors (landlords) duty to place him in quiet possession.

13: REAL ESTATE LEASES

- ♦ Violation of the lessors (landlords) duty to repair.
- ♦ Breach of condition by the lessor (landlord).
- ♦ Destruction of the premises with no covenant to repair.

Lack of Quiet Possession

A tenant is entitled to the quiet possession and enjoyment of the premises. The lease or rental agreement is made with the assumption that the tenant will have use of the premises and enjoy a quiet, uninterrupted stay. The landlord has the responsibility to maintain reasonable quiet on the premises for his or her tenants, and must not harass them unduly. Failure in either responsibility can give a tenant grounds for terminating a lease.

 ***A lessor (landlord) gives quiet enjoyment to the lessee (tenant). This means without disturbance from holder of the paramount title (owner).***

The California Civil Code permits the landlord to enter a tenants unit under the following conditions:

1. Emergencies
2. Necessary repairs
3. To show premises to prospective tenants, buyers or appraisers
4. If the tenant has abandoned the premises
5. With a court order to enter.

No notice to the tenant is required if the landlord believes the tenant has abandoned the premises or it is an emergency. Otherwise, 24 hours is considered sufficient notice.

Lack of Habitability

The landlord of a rented home, whether the home is a house, a condominium or an apartment, has the implied responsibility to keep the premises maintained in a condition that meets at least bare living requirements: Hazardous conditions cannot exist that threaten the tenants health or safety.

Habitability Obligations (Civil Code Section 1941.1) - Landlords legal minimum obligations

The landlords minimum habitability obligations are:

1. Effective waterproofing of roof and exterior walls, including unbroken windows and doors.
2. Plumbing and gas facilities installation maintained in good working order.
3. A water supply capable of hot and cold running water, fixtures and connection to a sewage disposal system.
4. Heating facilities maintained in good working order.
5. Electrical lighting maintained in good working order.



REAL ESTATE PRACTICE

6. Building and grounds kept clean, sanitary free from all accumulations of debris, filth, rubbish, garbage and rodents.
7. An adequate number of rubbish receptacles.
8. Floors, stairways and railings maintained in good repair.

Tenants Obligations

A tenants affirmative obligations to a landlord for reasonable care and habitability are:

1. Keep his or her part of the premises as clean and sanitary as possible.
2. Dispose of garbage and trash in a clean and sanitary manner.
3. Properly use the plumbing, electrical and gas fixtures and keep them as clean as their condition permits.
4. Not permit any person on the premises to willfully destroy, deface, damage, impair or remove any part of the structure, facilities or equipment.
5. Occupy the premises for sleeping, cooking, dining or other purposes for which they were designed or intended.

If the landlord does not live up to this implied warranty of habitability, the tenant is not obligated to pay all the rent. However, a tenant must give notice of any necessary repairs to the landlord. The landlord has a reasonable amount of time to make any necessary repairs. A *“reasonable amount of time”* is determined by the type of repair needed. If the landlord, after a reasonable amount of time, has failed to make the necessary repairs, the tenant has two methods of recourse:

1. Spend up to 1 months rent (cannot exceed 1 months rent) in repairs (max. twice in a 12 consecutive month period).
2. Abandon the premises, which terminates the lease or rental agreement.

EVICTIION OR OPERATION OF LAW

If a tenant does not pay the rent, or the tenant does illegal acts on the premises, legal action is available to the landlord. **Eviction** *is the legal process of removing a tenant because there is a breach of the lease or rental agreement.* An alternative would be for the landlord to sue for each payment (installment) as it becomes due. This is true whether the tenant remains in possession or abandons the premises. But at this point most landlords elect to evict the lessee. if the tenant moves and the landlord leases the property, the landlord can only sue for the rent lost while the property was vacant. *A retaliatory eviction is the unlawful process whereby a landlord evicts a tenant in response to complaint lodged by the tenant.*

Remember; it is unlawful for the landlord to lock out tenants, take the tenants property, remove doors, shut off utilities or trespass. The landlord must protect the health and safety of tenants, obey fair housing laws and give 24 hours notice before entering a rental

13: REAL ESTATE LEASES

When the tenant refuses to give up possession but does not pay the rent, the landlord normally serves a “three-day notice” and, if necessary, files an “unlawful detainer” action. A **“3-DAY NOTICE TO PAY”** is a legal document that informs the tenant that he or she has three business days to pay all past due rent or vacate the property. A **3-day notice to quit** states that the tenant has breached the lease or rental agreement and has three business days to surrender (quit) the premises or face an unlawful detainer court action. It is referred to as an eviction notice. After serving the three-day notice, a minimum one-day grace period is recommended to ensure proper service.

Unlawful Detainer

An **unlawful detainer** is a document, filed with the court that asserts the charges against the tenant. After it is served, the tenant has five days to surrender possession or answer the complaint. Once again, it is suggested that at least a one-day grace period be allowed.

☞ **An unlawful/detainer action is used by the offended lessor (landlord) to gain possession.**

If the tenant loses or does not answer the unlawful detainer complaint, a judge may issue a writ of possession. A **writ of possession** is a court order directing the sheriff to remove the tenant from the premises within five days. Often, the landlord will have to account for the storage of the tenants personal property. This can be complicated, so a landlord should consult an attorney before obtaining an unlawful detainer or writ of possession. Although an entire eviction process could take only fifteen working days, it will most likely take a longer period of time. If the tenant answers the complaint, the matter could take several months.

☞ **A lessor goes to court to get possession.**

SPECIAL PURPOSE LEASES

In this section we will cover several unique types of leases designed to meet specific needs.

SALE-LEASEBACK

A **sale-leaseback** occurs when an owner sells his or her property to another party and leases it back for a stated period of time; the original owner becomes the lessee. This is also a financing device, but it is used mostly for commercial buildings where large business concerns are involved. The main reason for this type of lease is that a large company usually builds structures to its specifications. A large amount of money is required, therefore the company sells the building to get back most of its invested capital. By doing this, the company increases its working capital.

Large investors, such as insurance companies and pension funds, will purchase or build such a property, provided they get a well written, long-term lease. Of course the credit rating and financial position of the lessee must be outstanding. This is one device that nets a high rental income to the investor and allows the business concern a better cash flow. Chain stores, such as department stores and discount stores, use this device frequently.

The original owner of property in a sale-leaseback becomes the lessee. All lease payments are deductible from taxable income if it is business property (nonresidential).



LEASE-PURCHASE OPTION

A **lease-purchase option** exists only when a tenant leases a property with the option to purchase it at some future date. This gives the lessee the chance to occupy the property and to decide if it suits his or her needs before purchasing it. This is the “try before you buy” idea.

This type of option can also be used as a financing device. If current interest rates for financing are high, it gives the tenant an additional period of time during which interest rates may decrease. Time may also be needed to raise enough money for the down payment. This option must be carefully written and all terms must be clear and definite to be legally enforceable.

SUMMARY

A lease is an agreement that grants one person the right to use the property of another in return for consideration.

A leasehold estate that runs for a specific length of time creates an estate for years; one that runs for an Indefinite period creates an estate from period to period, year to year, month to month). An estate at will runs as long as the landlord permits: and an estate at sufferance is possession without the consent of the landlord. A leasehold estate is classified as personal property.

The requirements of a valid lease include offer and acceptance, consideration, capacity to contract and legal objectives. In addition, state statutes of frauds generally require that any lease that will not be completed within one year of the date of its making must be in writing to be enforceable in court. Most leases also include clauses relating to rights and obligations of the landlord and tenant, such as the use of the premises, subletting, judgments, and maintenance of the premises and termination of the lease period.

A lease may be terminated by the expiration of the lease period, the mutual agreement of the parties or a breach of the lease by either the landlord or tenant. In most cases, neither the death of the tenant nor the landlord's sale of the rental property terminates a lease.

If a tenant defaults on any lease provision, the landlord may sue for a money judgment, actual eviction or both. If the premises have become uninhabitable due to the landlord's negligence or failure to correct within a reasonable time, the tenant may have the remedy of constructive eviction-that is, the right to abandon the premises and refuse to pay rent until the premises are repaired.

The fair housing laws protect the rights of tenants. Besides prohibiting discrimination based on race, color, religion, familial status, national origin and sex, the laws address the rights of individuals with disabilities and families with children.

The Americans with Disabilities Act provides for access to goods and services by people with disabilities.

There are several basic types of leases, including net leases, gross leases and percentage leases. These leases are classified according to the method used in determining the rental rate of the property.

13: REAL ESTATE LEASES

CHAPTER QUIZ

- Which of the following would automatically terminate a lease?
 - Total destruction of the property
 - Sale of the property
 - Failure of the tenant to pay rent
 - Constructive eviction
- A ground lease is usually:
 - Short term.
 - For 100 years or longer.
 - Long term.
 - A gross lease.
- Jeff still has five months remaining on a one-year apartment lease. When Jeff moves to another city, he transfers possession of the apartment to Steven for the entire remaining term of the lease. Steven pays rent directly to Jeff. Under these facts, Jeff is a(n):
 - Assignor.
 - Sublessor.
 - Sublessee
 - Lessor.
- J and Y enter into a commercial lease that requires a monthly rent based on a minimum set amount plus an additional amount determined by the tenant's gross receipts exceeding \$5,000. This type of lease is called a:
 - Standard lease
 - Gross lease
 - Percentage lease
 - Net lease.
- If a tenant moved out of a rented store building because access to the building was blocked as a result of the landlord's negligence:
 - The tenant would have no legal recourse against the landlord.
 - The landlord would be liable for the rent until the expiration date of the lease.
 - The landlord would have to provide substitute space.
 - The tenant would be entitled to recover damages from the landlord.
- P's tenancy for years will expire in two weeks. P plans to move to a larger apartment across town when the current tenancy expires. What must P do to terminate this agreement?
 - P must give the landlord two weeks' prior notice.
 - P must give the landlord one week's prior notice.
 - P needs to do nothing; the agreement will terminate automatically.
 - The agreement will terminate only after P signs a lease for the new apartment.
- When a tenant holds possession of a landlord's property without a current lease agreement and without the landlord's approval:
 - The tenant is maintaining a gross lease.



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- B. The landlord can file suit for possession.
 - C. The tenant has no obligation to pay rent.
 - D. The landlord may be subject to a constructive eviction.
8. Under the terms of a residential lease, the landlord is required to maintain the water heater. If a tenant is unable to get hot water because of a faulty water heater that the landlord has failed to repair, all of the following remedies would be available to the tenant **except**
- A. Suing the landlord for damages.
 - B. Suing the landlord for back rent.
 - C. Abandoning the premises under constructive eviction.
 - D. Terminating the lease agreement.
9. Michelle has assigned her apartment lease to Bob, and the landlord has agreed to the assignment. If Bob fails to pay the rent, who is liable?
- A. Bob *is* primarily liable; Michelle is secondarily liable.
 - B. *Michelle* is primarily liable; Bob is secondarily liable.
 - C. Only Michelle is liable.
 - D. Only Bob is liable.
10. Which of the following describes a net lease?
- A. An agreement in which the tenant pays a fixed rent and the landlord pays all taxes, insurance and so forth on the property
 - B. A lease in which the tenant pays rent plus maintenance and property charges
 - C. A lease in which the tenant pays the landlord a percentage of the monthly income derived from the property
 - D. An agreement granting an individual a leasehold interest in fishing rights for shoreline properties

Answers: 1-A, 2-C, 3-B, 4-C, 5-D, 6-C, 7-B, 8-B, 9-A, 10-B

CHAPTER 14: PROPERTY MANAGEMENT



Preview

Property management is a real estate specialization. It involves the leasing, managing, marketing and overall maintenance of real estate owned by others, usually rental property. Property management can include services in residential property, commercial properties as well as industrial properties.

A property manager:

- ♦ Maintains the owner's investment and
- ♦ Ensures that the property produces income.

LANDLORD AND TENANT (LESSOR AND LESSEE)

A landlord and tenant relationship is created when the owner gives the possession and use of his or her property to another for rent or other consideration. The **landlord (lessor)** is the owner of the property being rented or leased. The landlord, or his or her agent, may lease only the land, the land and buildings or only the buildings or parts of the buildings. The **tenant (lessee)** is the person or persons renting or leasing the property.

PROPERTY MANAGER

In ever growing numbers, real estate brokers are now functioning as real property managers. A **property manager** is a licensed real estate person who is paid to oversee the proper management and operations of rental and commercial property. A property management company in California must be run by a licensed real estate broker and may include licensed salespeople working as property managers. Property managers include, for example, those who only engage in the management of one and two-family homes as well as agents who oversee large projects such as office and industrial complexes, apartment buildings and condominiums.

The property manager is responsible for maintaining the owner's investment and making sure the property earns income. This can be done in several ways. The physical property must be maintained in good condition. Suitable tenants must be found, rent must be collected and employees must be hired and supervised. The property manager is responsible for budgeting and controlling expenses, keeping proper accounts and making periodic reports to the owner. In



REAL ESTATE PRACTICE

all of these activities, the manager's primary goal is to operate and maintain the physical property in such a way as to preserve and enhance the owner's capital investment.

Some property managers work for property management companies. These firms manage properties for a number of owners under management agreements (discussed later). Other property managers are independent. The property manager has an agency relationship with the owner, which involves greater authority and discretion over management decisions than an employee would have. A property manager or an owner may employ building managers to supervise the daily operations of a building. In some cases, these individuals may be residents of the building.

When a property manager secures business from any of these sources, a good reputation is often the manager's best advertising. A manager who consistently demonstrates the ability to increase property income over previous levels should have little difficulty finding new business.

Before contracting to manage any property, however, the professional property manager should be certain that the building owner has realistic income expectations. Necessary maintenance, unexpected repairs and effective marketing all take time and money. If the owner has unreasonable expectations, the manager's time will be wasted.

PROPERTY MANAGEMENT CONTRACT

It is good business practice for a property manager, managing properties for an owner, to have a well-written contract with the property owner that sets forth the responsibilities of both parties. This should include the terms and period of the contract, policies pertaining to the management of the premises, management fees and the powers granted the agent by the owner.

This agreement creates an agency relationship between the owner and the property manager. The property manager usually is considered to be a general agent. As an agent, the property manager is charged with the fiduciary responsibilities of care, obedience, accounting, loyalty and disclosure. After entering into an agreement with a property owner, a manager handles the property the same way the owner would. In all activities, the manager's first responsibility is to realize the highest return on the property in a manner consistent with the owner's instructions.

Like any other contract involving real estate, the management agreement should be in writing. It should include the following points:

- ◆ Description of the property
- ◆ Time period the agreement covers
- ◆ Definition of the management's responsibilities. All the manager's duties should be specifically stated in the contract. Any limitations or restrictions on what the manager may do should be included.
- ◆ *Statement of the owner's purpose.* The owner should clearly state what he or she wants the manager to accomplish. One owner may want to maximize net income, while another will want to increase the capital value of the investment. What the manager does depends on the owner's long-term goals for the property.
- ◆ *Extent of the manager's authority.* This provision should state what authority the manager is to have in matters such as hiring, firing and supervising employees; fixing rental rates for space; and making expenditures and authorizing repairs. Repairs that exceed a certain expense limit may require the owner's written approval.

14: PROPERTY MANAGEMENT

- ♦ *Reporting.* The frequency and detail of the manager's periodic reports on operations and financial position should be agreed on. These reports serve as a means for the owner to monitor the manager's work. They also form a basis for both the owner and manager to spot trends that are important in shaping management policy.
- ♦ *Management fee.* The fee may be based on a percentage of gross or net income, a fixed fee, or some combination of these and other factors. Management fees are subject to the same antitrust considerations as sales commissions. That is, they cannot be standardized in the marketplace; standardization would be viewed as price fixing. The fee must be negotiated between the agent and the principal. In addition, the property manager may be entitled to a commission on new rentals and renewed leases.

Allocation of costs. The agreement should state which of the property manager's expenses—such as office rent, office help, telephone, advertising and association fees—will be paid by the manager. Other costs will be paid by the owner.

Form 14-1 illustrates a copy of the Property Management contract used by CAR.

Form 14-1: Property Management Agreement.



REAL ESTATE PRACTICE



CALIFORNIA
ASSOCIATION
OF REALTORS®

PROPERTY MANAGEMENT AGREEMENT

James Smith ("Owner"), and

Dynasty Realty ("Broker"), agree as follows:

1. **APPOINTMENT OF BROKER:** Owner hereby appoints and grants Broker the exclusive right to rent, lease, operate, and manage the property (ies) known as 123 Main Street, Main City, CA 90000, and any additional property which may later be added to this Agreement, ("Property"), upon the terms below, for the period beginning on (date) February 1, 2001 and ending on (date) February 28, 2003, at 11:59 p.m. (If checked:) ☒ Either party may terminate this Agreement on at least 30 days written notice 1 months after the original commencement date of this Agreement. After the exclusive term expires, this Agreement shall continue as a Non-Exclusive Agreement which either party may terminate by giving at least 30 days written notice to the other.

2. **BROKER ACCEPTANCE:** Broker accepts the appointment and grant, and agrees to:

A. Use due diligence in the performance of this Agreement.

B. Furnish the services of its organization for the rental, leasing, operating, and management of the Property.

3. **AUTHORITY AND POWERS:** Owner grants Broker the authority and power, at Owner's expense, to:

A. **ADVERTISING:** Display FOR RENT, FOR LEASE, and similar signs on the Property; advertise the availability for rental or lease of the Property, or any part of it.

B. **RENTAL/LEASING:** Initiate, sign, renew, or cancel rental agreements and leases for the Property, or any part of it; collect and give receipts for rents, other charges, and security deposits. Any lease executed by Broker for Owner shall not exceed 3 year(s). Unless Owner authorizes a lower amount, rent shall: ☒ be a minimum of \$ 2,500.00 per month; OR ☐ see attachment.

C. **TENANCY TERMINATION:** Sign and serve in Owner's name notices which are required or appropriate; commence and prosecute actions to evict tenants; recover possession of the Property in Owner's name; recover rents and other sums due; and when expedient, settle, compromise, and release claims, actions and suits, and/or reinstate tenancies.

D. **REPAIR/MAINTENANCE:** Make, cause to be made, and/or supervise repairs, improvements, alterations, and decorations to the Property; purchase and pay bills for services and supplies. Broker shall obtain prior approval of Owner on all expenditures over \$ 300.00 for any one item. Prior approval shall not be required for monthly or recurring operating charges, or, if in Broker's opinion, emergency expenditures over the maximum are needed to protect the Property or other property(ies) from damage, prevent injury to persons, avoid suspension of necessary services, avoid penalties or fines, or suspension of services to tenants required by a lease or rental agreement or by law. Broker shall not advance Broker's own funds in connection with the Property or this Agreement.

E. **CONTRACTS/SERVICES:** Contract, hire, supervise and/or discharge firms and persons, including utilities, required for the operation and maintenance of the Property. Broker may perform any of Broker's duties through attorneys, agents, employees, or independent contractors, and, except for persons working in Broker's firm, shall not be responsible for their acts, omissions, defaults, negligence, and/or costs of same.

F. **EXPENSE PAYMENTS:** Pay expenses and costs for the Property from Owner's funds held by Broker, unless otherwise directed by Owner. Expenses and costs may include, but are not limited to, property management fees and charges, expenses for goods and services, property taxes and other taxes, Owner's Association dues, assessments, loan payments, and insurance premiums.

G. **SECURITY DEPOSITS:** Receive security deposits from tenants, which deposits shall be ☒ given to Owner, or ☐ placed in Broker's trust account. Owner shall be responsible to tenants for return of security deposits held by Owner.

H. **TRUST FUNDS:** Deposit all receipts collected for Owner, less any sums properly deducted or disbursed, in a financial institution whose deposits are insured by an agency of the United States government. The funds shall be held in a trust account separate from Broker's personal accounts. Broker shall not be liable in event of bankruptcy or failure of a financial institution.

I. **RESERVES:** Maintain a reserve in Broker's trust account of: \$ _____.

J. **DISBURSEMENTS:** Disburse Owner's funds, held in Broker's trust account, in the following order:

1. Compensation due Broker under paragraph 6.
2. All other operating expenses, costs, and disbursements payable from Owner's funds held by Broker.
3. Reserves and security deposits held by Broker.
4. Balance to Owner.

K. **OWNER DISTRIBUTION:** Remit funds monthly, (or ☐ _____), to Owner.

L. **OWNER STATEMENTS:** Render monthly, (or ☐ _____), statements of receipts, expenses and charges for each Property.

Owner and Broker acknowledge receipt of copy of this page, which constitutes Page 1 of _____ Pages.

Owner's Initials (_____) (_____) Broker's Initials (_____) (_____)

THIS FORM HAS BEEN APPROVED BY THE CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.). NO REPRESENTATION IS MADE AS TO THE LEGAL VALIDITY OR ADEQUACY OF ANY PROVISION IN ANY SPECIFIC TRANSACTION. A REAL ESTATE BROKER IS THE PERSON QUALIFIED TO ADVISE ON REAL ESTATE TRANSACTIONS. IF YOU DESIRE LEGAL OR TAX ADVICE, CONSULT AN APPROPRIATE PROFESSIONAL.

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525 South Virgil Avenue, Los Angeles, California 90020

OFFICE USE ONLY
Reviewed by Broker
or Designee _____
Date _____



PROPERTY MANAGEMENT AGREEMENT (PMA-11 PAGE 1 OF 3)

Jerry fung
JF 2373 S Hacienda Blvd . Hacienda Heights CA 91745

Phone (626)336 6191

Fax: (626)336 8565

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14: PROPERTY MANAGEMENT

Owner Name: James Smith

Date February 1, 2001

4. OWNER RESPONSIBILITIES: Owner shall:

- A. Provide all documentation and records required by Broker to manage and operate the Property.
- B. Indemnify, defend and hold harmless Broker, and all persons in Broker's firm, regardless of responsibility, from all costs, expenses, suits, liabilities, damages, attorney's fees, and claims of every type, including but not limited to those arising out of injury or death of any person, or damage to any real or personal property of any person, including Owner, in any way relating to the management, rental, security deposits, or operation of the Property by Broker, or any person in Broker's firm, or the performance or exercise of any of the duties, powers, or authorities granted to Broker.
- C. Carry and pay for: (i) public and premises liability insurance in an amount of no less than \$1,000,000; and (ii) property damage and worker's compensation insurance adequate to protect the interests of Owner and Broker. Broker shall be named as an additional insured party on Owner's policies.
- D. Pay any late charges, penalties, and/or interest imposed by lenders or other parties for failure to make payment to those parties, if the failure is due to the fact that there are insufficient funds in Broker's trust account available for such payment.

5. LEAD-BASED PAINT DISCLOSURE:

- A. ☒ The Property was constructed on or after January 1, 1978.
- OR B. ☐ The Property was constructed prior to 1978.

- (1) Owner has no knowledge of lead-based paint or lead-based paint hazards in the housing except: _____
- (2) Owner has no reports or records pertaining to lead-based paint or lead-based hazards in the housing, except the following, which Owner shall provide to Broker: _____

6. COMPENSATION:

- A. Owner agrees to pay Broker fees in the amounts indicated below for:
- (1) Management: 6% of yearly leased fee payable in advance
 - (2) Renting or Leasing: 6% of one year's leased fee
 - (3) Evictions: to be paid by landlord
 - (4) Preparing Property for rental, lease, or sale: _____
 - (5) Managing Property during extended periods of vacancy: _____
 - (6) An overhead and service fee added to the cost of all work performed by, or at the direction of, Broker: _____
 - (7) Other: _____
- B. This Property Management Agreement ("Agreement") does not include providing on-site management services, property sales, re-financing, preparing Property for sale or re-financing, modernization, fire or major damage restoration, rehabilitation, obtaining income tax, accounting, or legal advice, representation before public agencies, advising on proposed new construction, debt collection, counseling, attending Owner's Association meetings, or _____
- If Owner requests Broker to perform services not included in this Agreement, a fee shall be agreed upon before these services are performed.
- C. Broker may divide compensation, fees and charges due under this Agreement in any manner acceptable to Broker.
- D. Owner further agrees that:
- (1) Broker may receive fees and charges from tenants for (i) requesting an assignment of lease or sublease of the Property, (ii) processing credit applications, and (iii) any returned checks, and (iv) any other services that are not in conflict with this Agreement.
 - (2) Broker may perform any of Broker's duties, and obtain necessary products and services, through affiliated companies or organizations in which Broker may own an interest. Broker may receive fees, commissions, and/or profits from these affiliated companies or organizations. Broker has an ownership interest in the following affiliated companies or organizations: _____
- Broker shall disclose to Owner any other such relationships as they occur. Broker shall not receive any fees, commissions, or profits from unaffiliated companies in the performance of this Agreement, without prior disclosure to Owner.

(3) Other: _____

7. **AGENCY RELATIONSHIPS:** Broker shall act as the agent for Owner in any resulting transaction. Depending upon the circumstances, it may be necessary or appropriate for Broker to act as agent for both Owner and tenant. Broker shall, as soon as practical, disclose to Owner any election to act as a dual agent representing both Owner and tenant. If tenant is procured directly by Broker or an associate licensee in Broker's firm, Owner hereby consents to Broker acting as dual agent for Owner and such tenant. Owner understands that Broker may have or obtain property management agreements on other property, and that potential tenants may consider, make offers on, or lease through Broker, property the same as or similar to Owner's Property. Owner consents to Broker's representation of other owners' properties before, during, and after the expiration of this Agreement.
8. **NOTICES:** Any written notice to Owner or Broker required under this Agreement shall be served by sending such notice by first class mail to that party at the address below, or at any different address which the parties may later designate for this purpose. Notice shall be deemed received three calendar days after deposit into the United States mail.

Owner and Broker acknowledge receipt of copy of this page, which constitutes Page 2 of _____ Pages.

Owner's Initials (_____) (_____) Broker's Initials (_____) (_____)

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OFFICE USE ONLY
Reviewed by Broker
or Designee _____
Date _____

PROPERTY MANAGEMENT AGREEMENT (PMA-11 PAGE 2 OF 3)

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REAL ESTATE PRACTICE

Owner Name: James Smith

Date February 1, 2001

9. DISPUTE RESOLUTION

A. MEDIATION: Owner and Broker agree to mediate any dispute or claim arising between them out of this Agreement, or any resulting transaction before resorting to arbitration or court action, subject to paragraph 9C below. Mediation fees, if any, shall be divided equally among the parties involved. If any party commences an action based on a dispute or claim to which this paragraph applies, without first attempting to resolve the matter through mediation, then that party shall not be entitled to recover attorney's fees, even if they would otherwise be available to that party in any such action. THIS MEDIATION PROVISION APPLIES WHETHER OR NOT THE ARBITRATION PROVISION IS INITIALED.

B. ARBITRATION OF DISPUTES: Owner and Broker agree that any dispute or claim arising between them out of the obligation to pay compensation under this Agreement, which is not settled through mediation, shall be decided by neutral, binding arbitration, subject to paragraph 9C below. The arbitrator shall be a retired judge or justice, or an attorney with at least five years of residential income real estate transactional law experience, unless the parties mutually agree to a different arbitrator, who shall render an award in accordance with substantive California Law. In all other respects, the arbitration shall be conducted in accordance with Part III, Title 9 of the California Code of Civil Procedure. Judgment upon the award of the arbitrator(s) may be entered in any court having jurisdiction. The parties shall have the right to discovery in accordance with Code of Civil Procedure §1283.05.

"NOTICE: BY INITIALING IN THE SPACE BELOW YOU ARE AGREEING TO HAVE ANY DISPUTE ARISING OUT OF THE MATTERS INCLUDED IN THE 'ARBITRATION OF DISPUTES' PROVISION DECIDED BY NEUTRAL ARBITRATION AS PROVIDED BY CALIFORNIA LAW AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. BY INITIALING IN THE SPACE BELOW YOU ARE GIVING UP YOUR JUDICIAL RIGHTS TO DISCOVERY AND APPEAL, UNLESS THOSE RIGHTS ARE SPECIFICALLY INCLUDED IN THE 'ARBITRATION OF DISPUTES' PROVISION. IF YOU REFUSE TO SUBMIT TO ARBITRATION AFTER AGREEING TO THIS PROVISION, YOU MAY BE COMPELLED TO ARBITRATE UNDER THE AUTHORITY OF THE CALIFORNIA CODE OF CIVIL PROCEDURE. YOUR AGREEMENT TO THIS ARBITRATION PROVISION IS VOLUNTARY."

"WE HAVE READ AND UNDERSTAND THE FOREGOING AND AGREE TO SUBMIT DISPUTES ARISING OUT OF THE MATTERS INCLUDED IN THE 'ARBITRATION OF DISPUTES' PROVISION TO NEUTRAL ARBITRATION." Owner's Initials _____ / _____ Broker's Initials _____ / _____

C. EXCLUSIONS FROM MEDIATION AND ARBITRATION: The following matters are excluded from Mediation and Arbitration hereunder: (a) A judicial or non-judicial foreclosure or other action or proceeding to enforce a deed of trust, mortgage, or installment land sale contract as defined in Civil Code §2985; (b) An unlawful detainer action; (c) The filing or enforcement of a mechanic's lien; (d) Any matter which is within the jurisdiction of a probate, small claims, or bankruptcy court; and (e) An action for bodily injury or wrongful death, or for latent or patent defects to which Code of Civil Procedure §337.1 or §337.15 applies. The filing of a court action to enable the recording of a notice of pending action, for order of attachment, receivership, injunction, or other provisional remedies, shall not constitute a violation of the mediation and arbitration provisions.

10. EQUAL HOUSING OPPORTUNITY: The Property is offered in compliance with federal, state, and local anti-discrimination laws.

11. ATTORNEY'S FEES: In any action, proceeding, or arbitration between Owner and Broker regarding the obligation to pay compensation under this Agreement, the prevailing Owner or Broker shall be entitled to reasonable attorney's fees and costs, except as provided in paragraph 9A.

12. ADDITIONAL TERMS: _____

13. ENTIRE CONTRACT: All prior discussions, negotiations, and agreements between the parties concerning the subject matter of this Agreement are superseded by this Agreement, which constitutes the entire contract and a complete and exclusive expression of their agreement, and may not be contradicted by evidence of any prior agreement or contemporaneous oral agreement. This Agreement and any supplement, addendum, or modification, including any photocopy or facsimile, may be executed in counterparts.

Owner warrants that Owner is the owner of the Property or has the authority to execute this contract. Owner acknowledges that Owner has read and understands this Agreement, and has received a copy.

Owner _____ Date _____

Owner _____ Date _____

Owner (Print Name) James Smith

Owner (Print Name) _____

Address _____

Address _____

City _____ State _____ Zip _____

City _____ State _____ Zip _____

Phone _____ Fax _____ E-mail _____

Phone _____ Fax _____ E-mail _____

social security/tax ID # (for tax reporting purposes)

social security/tax ID # (for tax reporting purposes)

Real Estate Broker Dynasty Realty

Address _____

By _____

By _____

Phone _____

Fax _____

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PROPERTY MANAGEMENT AGREEMENT (PMA-11 PAGE 3 OF 3)

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MANAGEMENT FUNCTIONS

A property manager's specific responsibilities are determined by the management agreement. Certain duties, however, are found in most agreements. These include budgeting, capital expenditures, setting rental rates, selecting tenants, collecting rent, maintaining the property and complying with legal requirements.

BUDGETING EXPENSES

Before attempting to rent any property, the property manager should develop an *operating budget*. The budget should be based on anticipated revenues and expenses. In addition, it must reflect the owner's long-term goals. In preparing a budget, the manager should allocate money for *continuous, fixed expenses* such as employees' salaries, property taxes and insurance premiums.

Next, the manager should establish a cash *reserve fund* for variable expenses such as repairs, decorating and supplies. The amount allocated for the reserve fund can be computed from the previous yearly costs of the variable expenses.

Capital expenditures

The owner and the property manager may decide that modernization or renovation of a property will enhance its value. In this case, the manager should budget money to cover the costs of remodeling. The property manager should either be thoroughly familiar with the *principle of contribution* (discussed in Appraisal Chapter) or seek expert advice when estimating any expected increase in value. In the case of large-scale construction, the expenses charged against the property's income should be spread over several years.

The cost of equipment to be installed in a modernization or renovation must be evaluated over its entire useful life. This is called life cycle costing. This term simply means that both the initial and the *operating* costs of equipment over its expected life must be measured to compare the total cost of one type of equipment with that of another.

Renting the Property

Effective rental of the property is essential. However, the role of the property manager in managing a property should not be confused with that of a broker who acts as a leasing agent. The manager must be concerned with the long-term financial health of the property; the broker is concerned solely with renting space. The property manager may use the services of a leasing agent, but that agent does not undertake the full responsibility of maintaining and managing the property.

Setting rental rates

Rental rates are influenced primarily by supply and demand. The property manager should conduct a detailed survey of the competitive space available in the neighborhood, emphasizing similar properties. In establishing rental rates, the property manager has four long-term considerations:

1. The rental income must be sufficient to cover the property's fixed charges and operating expenses.
2. The rental income must provide a fair return on the owner's investment.



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3. The rental rate should be in line with prevailing rates in comparable buildings. It may be slightly higher or slightly lower depending on the strength of the property.
4. The current vacancy rate in the property is a good indicator of how much of a rent increase is advisable. A building with a low vacancy rate (that is, few vacant units) is a better candidate for an increase than one with a high vacancy rate.

A rental rate for residential space is usually stated as the monthly rate *per unit*. Commercial lease - including office, retail and industrial space rental - are usually stated according to either annual or monthly rates *per square foot*.

If the vacancy level is high, the manager should attempt to determine why. An elevated level of vacancy does not necessarily indicate that rents are too high. Instead, the problem may be poor management or a defective or an undesirable property. The manager should attempt to identify and correct the problems first rather than immediately lower rents. On the other hand, a high occupancy rate may mean that rental rates are too low. Whenever the occupancy level of an apartment house or office building exceeds 95 percent, serious consideration should be given to raising rents. First, however, the manager should investigate the rental market to determine whether a rent increase is warranted.

Selecting Tenants

A building manager's success depends on establishing and maintaining sound, long-term relationships with his or her tenants. The first and most important step is selection. The manager should be sure that the premises are suitable for a tenant in size, location and amenities. Most important, the manager should be sure that the tenant is able to pay for the space.

A commercial tenants business should be compatible with the building and the other tenants. The manager must consider the business interests of his or her current tenants as well as the interests of the potential tenant. The types of businesses or services should be complementary, and the introduction of competitors into the same property should be undertaken with care. This not only pleases existing tenants, but also helps diversify the owner's investment, and makes profitability more likely. Some commercial leases bar the introduction of similar businesses.

If a commercial tenant is likely to expand in the future, the manager should consider the property's potential for expansion.

The residential property manager must be sure to comply with all federal, state and local fair housing laws in selecting tenants (see Chapters 16 and 20). Although fair housing laws do not apply to commercial properties, commercial property managers need to be aware of federal, state and local antidiscrimination and equal opportunity laws that may govern industrial or retail properties.

Collecting rents

A property manager should accept only those tenants who can be expected to meet their financial obligations. The manager should investigate financial references, check with local credit bureaus and, when possible, interview a prospective tenants former landlord.

The terms of rental payment should be spelled out in the lease agreement, including

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- Time and place of payment;
- Provisions and penalties for late payment; and
- Provisions for cancellation and damages in case of nonpayment.

The property manager should establish a firm and consistent collection plan. The plan should include a system of notices and records that complies with state and local law.

Every attempt must be made to collect rent without resorting to legal action. Legal action is costly and time consuming and does not contribute to good tenant relations. In some cases, however, legal action is unavoidable. In these instances, a property manager must be prepared to initiate and follow through with the necessary legal steps. Obviously, legal action must be taken in cooperation with the property owner's or management firm's legal counsel.

Maintaining Good Relations with Tenants

The ultimate success of a property manager depends on the ability to maintain good relations with tenants. Dissatisfied tenants eventually vacate the property. A high tenant turnover rate results in greater expenses for advertising and redecorating. It also means less profit for the owner due to uncollected rents.

An effective property manager establishes a good communication system with tenants. Regular newsletters or posted memoranda help keep tenants informed and involved. Maintenance and service requests must be attended to promptly, and all lease terms and building rules must be enforced consistently and fairly. A good manager is tactful and decisive and acts to the benefit of both owner and occupants.

The property manager must be able to handle residents who do not pay their rents on time or who break building regulations. When one tenant fails to follow the rules, the other tenants often become frustrated and dissatisfied. Careful recordkeeping shows whether rent is remitted promptly and in the proper amount. Records of all lease renewal dates should be kept so that the manager can anticipate expiration and retain good tenants who might otherwise move when their leases end.

Maintaining the Property

One of the most important functions of a property manager is the supervision of property maintenance. A manager must learn to balance the services provided with their costs—that is, to satisfy tenants' needs while minimizing operating expenses.

To maintain the property efficiently, the manager must be able to assess the building's needs and how best to meet them. Staffing and scheduling requirements vary with the type, size and geographic location of the property, so the owner and manager usually agree in advance on maintenance objectives. In some cases, the best plan may be to operate a low-rental property, with minimal expenditures for services and maintenance. Another property may be more lucrative if kept in top condition and operated with all possible tenant services. A well-maintained, high-service property can command premium rental rates.

A primary maintenance objective is to protect the physical integrity of the property over the long term. For example, preserving the property by repainting the exterior or replacing the heating



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system helps decrease long-term maintenance costs. Keeping the property in good condition involves four types of maintenance:

1. Preventive maintenance
2. Repair or corrective maintenance
3. Routine maintenance
4. Construction

☞ Preventive maintenance helps prevent problems and expenses. Corrective maintenance corrects problems after they've occurred. Routine maintenance keeps up with everyday wear and tear.

Preventive maintenance includes regularly scheduled activities such as painting and seasonal servicing of appliances and systems. Preventive maintenance preserves the long-range value and physical integrity of the building. This is both the most critical and the most neglected maintenance responsibility. Failure to perform preventive maintenance invariably leads to greater expense in other areas of maintenance.

Repair or corrective maintenance involves the actual repairs that keep the building's equipment, utilities and amenities functioning. Repairing a boiler, fixing a leaky faucet and mending a broken air-conditioning unit are acts of corrective maintenance.

A property manager must also supervise the **routine maintenance** of the building. Routine maintenance includes such day-to-day duties as cleaning common areas, performing minor carpentry and plumbing adjustments and providing regularly scheduled upkeep of heating, air-conditioning and landscaping. Good routine maintenance is similar to good preventive maintenance. Both head off problems before they become expensive.

☞ One of the major decisions a property manager faces is whether to contract for maintenance services from an outside firm or hire on-site employees to perform such tasks. This decision should be based on a number of factors, including the size of the building; complexity of the tenants' requirements; and availability of suitable labor.

A commercial or an industrial property manager often is called on to make **tenant improvements**. These are alterations to the interior of the building to meet a tenant's particular space needs. Such construction *alterations* range from simply repainting or recarpeting to completely gutting the interior and redesigning the space by erecting new walls, partitions and electrical systems. Tenant improvements are especially important when renting new buildings. In new construction, the interiors are usually left incomplete so that they can be adapted to the needs of individual tenants. One matter that must be clarified is which improvements will be considered trade fixtures (personal property belonging to the tenant) and which will belong to the owner of the real estate. Trade fixtures are discussed in the Real Estate Principles course. .

Modernization or renovation of buildings that have become functionally obsolete and thus unsuited to today's building needs is also important. (See Appraisal Chapter for a definition of

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functional obsolescence.) The renovation of a building often enhances the building's marketability and increases its potential income.

HANDLING ENVIRONMENTAL CONCERNS

The environment is an increasingly important property management issue. A variety of environmental issues, from waste disposal to air quality, must be addressed by the property manager. Tenant concerns, as well as federal, state and local regulations, determine the extent of the manager's environmental responsibilities. While property managers are not expected to be experts in all of the disciplines necessary to operate a modern building, they are expected to be knowledgeable in many diverse subjects, most of which are technical in nature. Environmental concerns are one such subject.

The property manager must be able to respond to a variety of environmental problems. He or she may manage structures containing asbestos or radon or be called on to arrange an environmental audit of a property. Managers must see that any hazardous wastes produced by their employers or tenants are properly disposed of. Even the normally non-hazardous waste of an office building must be controlled to avoid violation of laws requiring segregation and recycling of types of wastes. Of course, a property manager may want to provide recycling facilities for tenants even if he or she is not required by law to do so. On-site recycling creates an image of good citizenship that enhances the reputation (and value) of a commercial or residential property.

The Americans with Disabilities Act

The *Americans with Disabilities Act* (ADA) has had a significant impact on the responsibilities of the property manager, both in building amenities and in employment issues.

Title I of the ADA provides for the employment of qualified job applicants regardless of their disability. Any employer with 15 or more employees must adopt nondiscriminatory employment procedures. In addition, employers must make reasonable accommodations to enable individuals with disabilities to perform essential job functions.

Property managers must also be familiar with Title III of the ADA, which prohibits discrimination in commercial properties. The ADA requires managers to ensure that people with disabilities have full and equal access to facilities and services. The property manager typically is responsible for determining whether a building meets the ADA's accessibility requirements. The property manager must also prepare and execute a plan for restructuring or retrofitting a building that is not in compliance. ADA experts may be consulted, as may architectural designers who specialize in accessibility issues.

To protect owners of existing structures from the massive expense of extensively remodeling, the ADA recommends *reasonably achievable accommodations* to provide access to the facilities and services. New construction and remodeling, however, must meet higher standards of accessibility and usability because it costs less to incorporate accessible features in the design than to retrofit. Though the law intends to provide for people with disabilities, many of the accessible design features and accommodations benefit everyone.

RISK MANAGEMENT

There are four alternative risk management techniques:

- ♦ Avoid,
- ♦ Control,



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- ♦ Transfer or
- ♦ Retain.

Enormous monetary losses can result from certain unexpected or catastrophic events. As a result, one of the most critical areas of responsibility for a property manager is **risk management**. Risk management involves answering the question, “What happens if something goes wrong?” The perils of any risk must be evaluated in terms of options. In considering the possibility of a loss, the property manager must decide whether it is better to

- ♦ Avoid it, by removing the source of risk (for instance, a swimming pool may pose an unacceptable risk if a day-care center is located in the building);
- ♦ Control it, by preparing for an emergency before it happens (1,y installing sprinklers, fire doors and security systems, for example);
- ♦ Transfer it, by shifting the risk onto another party (that is, by taking out an insurance policy); or
- ♦ Retain it, by deciding that the chances of the event occurring are too small to just if the expense of any other response (an alternative might be to take out an insurance policy with a large *deductible*, which is usually considerably less expensive).

SECURITY OF TENANTS

The physical safety of tenants of the leased premises is an important issue for property managers and owners. Recent court decisions in several parts of the country have held owners and their agents responsible for physical harm that was inflicted on tenants by intruders. These decisions have prompted property managers and owners to think about how to protect tenants and secure apartments from intruders.

TYPES OF INSURANCE

Insurance is one way to protect against losses. Many types of insurance are available. An *insurance audit* should be performed by a competent, reliable insurance agent who is familiar with insurance issues for the type of property involved. The audit will indicate areas in which greater or lesser coverage is recommended and will highlight particular risks. The final decision, however, must be made by the property owner.

Some common types of coverage available to income property owners and managers follow:

- ♦ *Fire and hazard.*
Fire insurance policies provide coverage against direct loss or damage to property from a fire on the premises. Standard fire coverage can be extended to include other hazards such as windstorm, hail, smoke damage or civil insurrection.
- ♦ *Consequential loss, use and occupancy.*
Consequential loss insurance covers the results, or consequences, of a disaster. Consequential loss can include the loss of rent or revenue to a business that occurs if the business’s property cannot be used.

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- ♦ *Contents and personal property.*
This type of insurance covers building contents and personal property during periods when they are not actually located on the business premises.
- ♦ *Liability.*
Public liability Insurance covers the risks an owner assumes whenever the public enters the building. A claim paid under this coverage is used for medical expenses by a person who is injured in the building as a result of the owner's negligence. Claims for medical or hospital payments for injuries sustained by building employees hurt in the course of their employment are covered by state laws known as **workers' compensation acts**. These laws require a building owner who is an employer to obtain a workers' compensation policy from a private insurance company.
- ♦ *Casualty.*
Casualty insurance policies include coverage against theft, burglary, vandalism and machinery damage as well as health and accident insurance. Casualty policies are usually written on specific risks, such as theft, rather than being all-inclusive.
- ♦ *Surety bonds.*
Surety bonds cover an owner against financial losses resulting from an employee's criminal acts or negligence while performing assigned duties.

Many insurance companies offer **multi-peril policies** for apartment and commercial buildings. Such a policy offers the property manager an insurance package that includes standard types of commercial coverage, such as fire, hazard, public liability and casualty. Special coverage for earthquakes and floods is also available.

Claims

Two possible methods can be used to determine the amount of a claim under an insurance policy. One is the depreciated or actual cash value of the damaged property. That is, the property is not insured for what it would cost to replace it, but rather for what it was originally worth, less the depreciation in value that results from use and the passage of time. The other method is *current replacement cost*. In this sort of policy, the building or property is insured for what it would cost to rebuild or replace it today.

When purchasing insurance, a manager must decide whether a property should be insured at full replacement cost or at a depreciated cost. Full replacement cost coverage is generally more expensive than depreciated cost.

RENT CONTROL - RESIDENTIAL

Property managers must also be familiar with rent control laws in their city.

Rent Control is government regulation of the amount of rent a landlord may charge tenants. In its usual form the government restricts, by percentage, annual increases in rental payments. Such restrictions may be applied at the city, county and even the state level. Commercial, industrial and luxury rentals are generally exempt from this control.

Rent control was originated by well-meaning politicians to relieve an inflated rental market. However, it has, in effect, worsened the situation by reducing the supply in the face of an ever-increasing demand.



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In the opinion of many informed real estate analysts, rent control is a form of economic suicide. It discourages new construction by removing economic incentives for developers. This results in a limited supply of new units available to deserving renters.

Landlords, victimized by this profit squeeze, are often forced to convert their apartments into condominiums. This further reduces the number of units available in the open market.

The real solution to the rental crunch will not involve more government regulation. The answer lies in the government providing more incentives and increased profits to developers, thereby increasing availability and allowing rents to settle at their natural level on the open market.

Rent Control - Commercial

By California law, no governmental agency can adopt any rent control restrictions on nonresidential property. Nonresidential property is defined as all rental space except dwelling units, mobilehome parks and residential hotels. However, public entities can establish requirements for notice relating to the termination of a nonresidential lease.

RESIDENT MANAGER

California law requires that rental unit building of **16** units or more must have a resident manager in the employ of the owner or property management company living on the premises. ***Resident managers are tenants of the property who rent units, handle tenants complaints and maintain the premises.*** They are not required to have a real estate license.

A resident manager does not need a real estate license to manage property where he or she is living, but does need one if he or she manages other properties.

TRUST ACCOUNTS

A broker, when receiving a buyers money deposit (and instructions), either opens an escrow, gives it to the principal, or puts it in the brokers trust fund account. If not instructed otherwise, the money must go into the brokers trust fund account by the next business day.

Commingling is the mixing together of the funds of a principal and a licensee. Commingling is a violation of the Commissioners regulation.

Conversion is the unlawful misappropriation and use of a clients funds by a licensee. A broker, who upon receipt spends his or principals deposit without the principals authorization, has converted. This is a much more serious violation with heavy criminal penalties.

THE MANAGEMENT PROFESSION

Most metropolitan areas have local associations of building and property owners and managers that are affiliates of regional and national associations. The Institute of Real Estate Management (IREM) is one of the affiliates of the National Association of REALTORS®. It awards the Certified Property Manager (CPM) designation. The Building Owners and Managers Association (BOMA) International is a federation of local associations of building owners and managers. The Building Owners and Managers Institute (BOMI) International, an independent institute affiliated with BOMA, offers training courses leading to several designations: Real Property Administrator (RPA), Systems Maintenance Administrator (SMA) and Facilities Management Administrator (FMA). In addition, many specialized professional organizations

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provide information and contacts for apartment and condominium association managers, shopping center managers and others.

Summary

Property management is a specialized service provided to owners of income producing properties. The owner's managerial function may be delegated to an individual or a firm with particular expertise in the field. The manager as agent of the owner, becomes the administrator of the project and assumes the executive functions required for the care and operation of the property.

A management agreement establishes the agency relationship between owner and manager. It must be prepared carefully to define and authorize the manager's duties and responsibilities.

Projected expenses, the manager's analysis of the building's condition and local rent patterns form the basis for determining rental rates for the property. Once a rent schedule is established, the property manager is responsible for soliciting tenants whose needs are suited to the available space. The tenants must be financially capable of meeting the proposed rents. The manager collects rents, maintains the building, hires necessary employees, pays taxes for the building and deals with tenant problems.

Maintenance includes safeguarding the physical integrity of the property and performing routine cleaning and repairs. It also includes making tenant improvements, such as adapting the interior space and overall design of the property to suit tenants' needs.

INTERNET WEB LINKS

tenant.net/other_areas/calif	Tenant Association
www.ca-apartment.org	Apartment Owners Association

CHAPTER QUIZ

1. A property manager who enters into a management agreement with an owner is usually a:
 - A. Special agent.
 - B. General agent.
 - C. Universal agent.
 - D. Designated agent.
2. Property manager J hires W as the full-time maintenance person for one of the buildings she manages. While repairing a faucet in one of the apartments, W steals a television set. J could protect the owner against this type of loss by purchasing:
 - A. Liability insurance.
 - B. Workers' compensation insurance.
 - C. A surety bond.
 - D. Casualty insurance.



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3. Whatever remains of a leasee's (tenant's) security and cleaning deposit must be refunded within how many days after he or she vacates the premises?
 - A. 21
 - B. 30
 - C. 45
 - D. 60
4. A transfer of less than the entire time or space of a lease is called a (an):
 - A. Assignment
 - B. Sublease
 - C. Estate from period-to-period
 - D. Defeasable transfer
5. Rent control in California CANNOT be imposed on which of the following?
 - A. Retail stores
 - B. Office buildings
 - C. Manufacturing sites
 - D. All of the above
6. A guest slips on an icy apartment building stair and is hospitalized. A claim against the building owner for medical expenses may be paid under which of the following policies held by the owner?
 - A. Workers' compensation
 - B. Casualty
 - C. Liability
 - D. Fire and hazard
7. When a property manager is establishing a budget for the building, all of the following should be included as an operating expense, **except**
 - A. Heating oil.
 - B. Cleaning supplies.
 - C. Foundation repairs.
 - D. Management fees.
8. Tenant improvements are:
 - A. Always construed to be fixtures.
 - B. Adaptations of space to suit tenants needs.
 - C. Removable by the tenant.
 - D. Paid for by the landlord.
9. California law requires that an apartment building have a residential manager when it consists of:
 - A. 4 units or more
 - B. 16 units or more
 - C. 20 units or more

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D. 50 units or more

10. Whittaker Towers, a highrise apartment building, burns to the ground. What type of insurance covers the landlord against the resulting loss of rent?

- A. Fire and hazard
- B. Liability
- C. Consequential loss, use and occupancy
- D. Casualty

Answers: 1-B, 2-C, 3-A, 4-B, 5-D, 6-C, 7-C, 8-B, 9-B, 10-C

CHAPTER 15: REAL ESTATE APPRAISAL



Preview

A prudent homeowner needs to be constantly aware of the value of their property. The decision to buy, sell or even to refinance a property will all hinges upon the understanding of the property value and a real estate appraisers estimate of its value. In this chapter we will discuss:

- ♦ The definition of appraisal; the state license requirements;
- ♦ The concepts of value; the principles of value, distinguish between market value and utility value;
- ♦ The appraisal process and three approaches to derive the value used in an appraisal process.
- ♦ Discuss what is depreciation their causes and their remedies.

APPRAISAL

An appraisal is the *estimate* or *opinion of value* of a property on the open market as of specific date. It is not a fixing or determination of value.

LICENSE REQUIREMENTS

The passing of **Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)** by congress results in virtually all the states to require appraiser to have a license issued by the state. In California, appraiser regulation is the responsibility of the **Office of Real Estate Appraisers (OREA)**, which is part of the Business, Transportation and Housing Agency. As of November 1992, all appraisers in California are required to have a license issued by the state for dealing with federal related transactions.

Students interested in applying appraiser license may contact OREA office at the following address:

Office of Real Estate Appraisers
1225 R Street, Suite 100
Sacramento, CA. 95814.

For more information, visit their web at: ➡ www.orea.ca.gov



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TYPES OF APPRAISER LICENSE

There are four levels or classifications of real estate appraiser licensing and certification. They are listed below, along with a description of the scope of practice for each level.

Trainee

Must work under the technical supervision of a licensed appraiser. May assist on any appraisal within the scope of practice of the supervising appraiser.

Prerequisites:

Education: A minimum of **90 hours** of appraisal related education covering the specific topics required by the Appraiser Qualifications Board (AQB with at least 15 hours on the Uniform Standards of Professional Appraisal Practice (USPAP).

Full License

May appraise 1 to 4 unit residential properties up to a transaction value of \$1,000,000 and non-residential property up to a transaction value of \$250,000.

This includes the appraisal of vacant land where the highest and best use is for 1 to 4 unit residential purposes.

Prerequisites:

Education: A minimum of **90 hours** of appraisal related education covering the specific topics required by the Appraiser Qualifications Board (AQB with at least 15 hours on USPAP).

Experience: Minimum of **2000 hours** of acceptable appraisal experience.

Certified Residential

Appraisal of one to four unit residential properties without regard to transaction value or complexity. Appraisal of non-residential property up to a transaction of \$250,000.

Prerequisites

Education: A minimum of **120 hours** of appraisal related education covering the specific topics required by the Appraiser Qualifications Board (AQB with at least 15 hours on USPAP).

Experience: Minimum of **2500 hours** and two and one-half years of acceptable appraisal experience.

Certified General

Appraisal of all real estate without regard to transaction value or complexity.

An appraiser needs to understand the concepts of “value” before he employs the techniques and methods to appraise a property.

Prerequisites

Education: A minimum of **180 hours** of appraisal related education covering the specific topics required by the Appraiser Qualifications Board (AQB) with at least 15 hours on USPAP.

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Experience: Minimum of **3000 hours** and two and one-half years of acceptable appraisal experience. At least 1500 hours of the experience must be non-residential properties.

CONCEPTS OF VALUE (WORTH)

The word “**value**” means worth. Value can be described as the relationship between the thing desired and the potential purchaser. It is the ability of one commodity to command other commodities in exchange. It is the present worth of further benefits. Below are the major classifications:

UTILITY VALUE (VALUE-IN-USE)

It is the value or importance (**value-in-use**) of an object to a particular owner or user who may have no intention of exposing it on the open market. It is a *subjective value* created in the “minds eye of the beholder.” Because the value of property to an owner may be emotional, as well as economical, thus value-in-use is often referred to as “**subjective value**.” Subjective value applies more to a single-family home than to rental property.

☞ *An example of subjective value is like beauty, which exists in the “minds eye” of the beholder.*

Market Value (Value in Exchange)

It is the value based on the “*willing buyer and willing seller*” concept. It is also known as “**objective value**.” It is the “**value-in-exchange**” based on supply and demand. It can be briefly defined as the most probable (highest) price the property should bring on the open market (seller not being obligated to sell, buyer not being obliged to buy), in an “**arms-length transaction**” within a reasonable length to affect the sale. The phrase “arms length” came from “arms length **bargaining**” which means that both parties were in equal bargaining positions; i.e., that neither had an advantage over the other and neither owed any particular obligation to the other.

In an arms-length transaction, the following must be satisfied:

- ◆ Neither party is acting under duress;
- ◆ The property has been on the market a reasonable length of time;
- ◆ Both parties are acting with full knowledge of the property’s assets and defects;
- ◆ No unusual circumstances exist, such as a sale between related parties, nor creative financing involved.

Market value is least affected by the original cost. Cost is past expenditures in acquiring or in producing the property. The cost would approximate the value if the improvements are new and represent the highest and best use.

⇒ *A widely used definition of **market value** is quoted here:*

“The highest price in terms of money which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus.



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Implicit in this definition is the consummation of a sale as of a specific date and the passing of title from seller to buyer under conditions whereby."

1. Buyer and seller are typically motivated;
2. Both parties are well informed or well advised, and each is acting in what he considers his own best interest;
3. A reasonable time is allowed for exposure in the open market;
4. Payment is made in terms of cash or in terms of financial arrangements comparable thereto;
5. The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale."

Market Price (Single Instance)

Appraisers make important distinctions between the terms of **"Value"**, **"Price"** and **"Cost."**

Market price, commonly referred to as sale or transaction price, is an accomplished fact. Market price represents what a particular purchaser agreed to pay and a particular seller agreed to accept under the particular circumstances surrounding their transaction.

Cost (Expenditures)

Cost, as used in appraisal, represents a measure of past expenditures in acquiring or producing the property. It applies to production, not exchange. Cost is the total dollar expenditure for labor, materials, legal services, financing, taxes, and entrepreneurial overhead and profit. Cost is either retrospective fact or a current estimate.

Assessed Value (Tax Rolls)

Assessed value is a value based on a uniform schedule for tax rolls in *"ad valorem"* taxation. The schedule may not conform to market value, but usually has some relation to a market value base.

Insurable Value (Replacement Cost)

Insurable value is based on the concept of replacement and/or reproduction cost of physical items subject to losses from hazards. Insurable value designates the amount of insurance that may or should be carried on destructible portions of a property to indemnify the owner in the event of loss.

Investment Value (Business Value)

Investment value is the value of an investment to a particular investor and a given investment. When measured in dollars, it is the highest price an investor would pay for an investment in view of its perceived capacity to satisfy a desire, need or investment goal. In colloquial use, investment value may refer to the *"reasoned value"* of a given investment from the viewpoint of a typical, rather than actual, investor.

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Investment value appraisals are fairly common when the appraiser is employed by a potential purchaser of an existing investment or income-producing property, or by a developer of a new property.

ELEMENTS OF VALUE (DUST)

Four essential elements: **Demand, Utility, Scarcity, and Transferability.**

Demand

Demand is the desire for a commodity must exist. Must be implemented by purchasing power. The greater the demand will increase the value of the commodity.

Utility (Usefulness)

Utility is usefulness of the commodity. It includes the capacity to produce. Building restrictions and zoning ordinances affect utility. The more useful a property, the greater its potential value.

Scarcity

Scarcity means lack of abundance. When utility exists, the more scarce an item, the greater its value. Over-supply or over-abundance of a commodity diminishes its value.

Transferability (Marketable)

A commodity must be transferable as to use, or the title must be **marketable**.

If all four elements are present in a favorable combination, a property's value may increase. If one or more elements are missing, a property's value may be stagnant or even decline.

FORCES INFLUENCING VALUE

The value of real estate is created, maintained, modified and destroyed by the interplay of four forces.

Physical Force Those that affect the physical aspects of the property, such as size and shape of the parcel, the location, climate, and soil conditions.

Economic Force Include changes in income levels, employment opportunities, the cost of money and credit, taxes, and the availability of energy and natural resources.

Political Force Such as changes in zoning, building codes government loans, government housing, etc.

Social Force Such as changes in population growth and decline, family size, birth, divorce and death rates, attitudes toward education, recreation.

FACTORS INFLUENCING VALUE

Location

Location is the most important factor influencing the value of real estate. The quality of a neighborhood and its surrounding community has a tremendous impact upon the property.



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The neighborhood where you want to buy is more important than the house because it is desirability of the area that sets value. An individual can change the appearance of a his or her house, but he or she alone cannot change the appearance of the neighborhood.

Amenities

Amenities are conditions of agreeable living or beneficial influence from property ownership. Amenity properties are usually single-family residences; they are pleasing features and are usually not considered on non-owner occupied property.

Example: View of the ocean, city lights increase the value of a home, Jacuzzis, swimming pools and tennis courts.

Blighted Area

Blighted area is a declining area in which real property values continue to decline, such as rapidly deteriorating buildings, heavy rate of crime incidents, and encroaching inharmonious property usages. Barriers such as river, lake, or hill act as a buffer.

Building Restrictions and Zoning

These may operate to increase or decrease values. Zone changes from residential to commercial use may enhance the value of land.

- ♦ Non Conforming Use - An inconsistent use is allowed.
- ♦ Down Zoning - The act of rezoning a tract of land for a less intensive use than the existing use or permitted use. It usually brings the value down.

Character of Soil

The weight bearing qualities of soil may affect construction costs.

- ♦ Sandy subsoil requires extensive foundations.
- ♦ Adobe soil reduces percolation and may create drainage problems.

Directional Growth

Directional growth refers to the manner and direction in which the city tends to expand. Properties in the path of this growth tend to increase in value.

Exposure

The shady side of the street is preferred by shoppers, lots for retail stores on the south or west side of the street are preferred, as pedestrians seek shady side and displayed merchandise is not damaged by the sun. The southwest corner of an intersection is the best.

Grades/Topography

The variations from level land to hillside properties are defined as topography.

- ♦ Cost of grading is an important consideration on hillside lots.

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- ◆ Level land tends to create monotony.
- ◆ Erosion may also be a part of slope or drainage problems.
- ◆ Rolling hills create a pleasing sight, and above problems can easily be offset by an excellent view.

Obsolescence

Obsolescence is caused by economic changes and decreasing functional utility. Old-fashioned appliances, construction, and architecture, are the major cause for loss of value.

Orientation

Orientation is placing a house on its lot with regard to its exposure to the rays of the sun, prevailing winds, and privacy from the street and protection from outside noises. The exposure of a house to the sun and weather elements may influence a persons decision to buy a house. If the wind usually blows from the northwest, it is best for the house to face the northwest. In this case the house can be a shield for backyard entertaining. The exposure to the sun is a different matter. Most people prefer the sun to shine on their backyard, so the backyard should face the south or the west.

Plottage (Assemblage)

Plottage is the added increment of value of several parcels under one owner as opposed to the same number under separate owners. By assembling the parcels, a higher and better use can be attained. The process of combining (merging) multiple parcels into one is known as plottage.

Private Restrictions

Private restrictions are stipulations made by subdividers, developers, or individual sellers to restrict use for the benefit of all purchasers.

Size

Width and depth of a parcel often determine its possible use. Today, home buyers desire wider lots.

Shape

Parcels of irregular shape generally cannot be developed as advantageously as rectangular lots.

Unearned Increment

Unearned increment is the increase in the value of real estate due to no effort on the part of the owner. It is often due to an increase in population or inflation.

THE ECONOMIC PRINCIPLES OF VALUATION

Understanding these principles is essential to an understanding of the purpose, techniques, and procedures of valuation.



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PRINCIPLE OF SUPPLY AND DEMAND

The demand for a commodity is created partly by its scarcity and partly by its desirability.

- ♦ Desire influences demand and can be created through education and advertising.
- ♦ Desire must be backed by *purchasing power*.

PRINCIPLE OF HIGHEST AND BEST USE

Principle of highest and best use is defined as the optimum use, which is most likely to produce the greatest net return to the land and/or building over a given period of time. It is the *most profitable, physically possible, economically feasible* and *legally permissible* use. Where a site has existing improvements, the highest and best use of the site as if vacant may be different from the existing use. Determining the highest and best use is among the first thing to do.

- ♦ It would result in the best use of land.
- ♦ An appraiser would make a site analysis to determine highest and best use.
- ♦ Real estate has the greatest value when it is the maximum utilization of available resources.

PRINCIPLE OF CHANGE

Principle of change is always present. It is the law of cause and effect. The state or condition existing today evolved from yesterday and is the forecast or shadow of tomorrow. The appraiser must attempt to interpret future trends and influences that affect value. A **trend** is a series of related changes brought about by cause and effect. The subsidiary principle is the principle of integration and disintegration.

PRINCIPLE OF INTEGRATION AND DISINTEGRATION

All property goes through 3 stages

1. **Integration:** Growth and Development. This is the stage when the property is being developed, streets are improved and homes are built. The property values tend to increase during this stage.
2. **Equilibrium:** Static and stable neighborhood. This is the maturity stage for the community. It is the safest phase for the homeowner, and property values remain static or stable and tends to be at it highest point.
3. **Disintegration:** Decline and decay. This is the stage when the property declines in value or decays. It is when buildings show some wear and tear and start to deteriorate. As the useful life of the property declines, lower social or economic groups move into the area.

PRINCIPLE OF REGRESSION

The **Regression Principle** states that the worth of the better property will be adversely affected by its presence among lesser properties.

For example, if a house that would easily be worth \$400,000, in a neighborhood of similar homes were built in a neighborhood of \$250,000 homes, it would not sell for \$400,000. Anyone

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in the market for \$400,000 house would not want to live in a tract where the average price of a house was \$250,000. Because of its superiority, the houses value was brought down by the surrounding homes.

The same principle applies to the over-improved home. When owners invest very large sums in major additions, lavish landscaping but other residents do not improve their homes, the house is no longer similar to the others. The owner of the over-improved house will not receive full value for the cost of improvements they have made.

PRINCIPLE OF PROGRESSION

The **Principle of Progression** states that the value of a lesser home will be increased in value by its location in a neighborhood of better homes. This kind of home is called fix-up home being having the potential of “**Fixer-Upper**.” When dissimilar properties are constructed in the same neighborhood, the worth of the lesser property is enhanced by its presence among better properties.

This is the opposite to the Principle of regression.

PRINCIPLE OF SUBSTITUTION

The **Principle of Substitution** states that when two or more commodities with about the same utility are available, the one with the lowest price receives the greatest demand. Market value is indicated by the value of an equally desirable substitute property. Although it is applied to all three (3) appraisal approaches, it is the basis of the market data approach and provides the basis for the following premises:

- ♦ Value of the property tends to coincide with the value indicated by the actions of informed buyers in the market for comparable.
- ♦ The cost of producing, through new construction, and equally desirable substitute property usually sets the *upper* limit of value.
- ♦ The amount the owner is entitled to is based on that value “indicated by the actions of informed buyers in the market for comparable properties.”

PRINCIPLE OF INCREASING AND DECREASING RETURNS

Principle of increasing and decreasing returns states that when larger and larger amounts are invested, the rate of return increases. When the maximum rate of return is reached, however, any increase in investment will reduce the rate of return.

Example:

\$50,000 invested in 4-units yields 8% return.
\$90,000 invested in 8-units yields 9%
\$120,000 invested in 16-units yields 8.5%

Therefore, the highest and best use of land would be investing in 8 units.

PRINCIPLE OF CONFORMITY / HOMOGENEITY

The **Principle of Conformity** states that the maximum value is realized when a high degree of economical and sociological similarity exists and is maintained in the neighborhood.

Conformity may be similar due to:



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- ♦ Income of neighborhood families.
- ♦ Types of homes - Single and/or multiple family residence, 1 or 2 story, architectural styles and upkeep.

The word “*similar*” is the key. It is not identical, if all the tract homes are identical, as if they were all made with the same cookie cutter, the maximum value is not present.

PRINCIPLE OF CONTRIBUTION

The **Principle of Contribution** states that the value of a particular component is measured in terms of its contribution to the value of the whole property. Consequently, cost does not necessarily equal value.

It is the same as the principle of increasing and decreasing returns but is applied to only a specific portion of the improvements.

Example: An owner of a 12-unit apartment is renting unfurnished apartments. If he converts these to furnished apartments, will the additional investment contribute to an overall increase in his rate of return?

PRINCIPLE OF SURPLUS PRODUCTIVITY

Surplus productivity is defined as the net income remaining after the four agents of production has been paid. It may be attributed to the land in its present use. Since the value of land depends on its own earning power, the dollar amount of surplus becomes a basis for land value. Surplus productivity is dependent upon the principles of balance and increasing and decreasing returns and the proper apportionment of the four agents of production.

PRINCIPLE OF ANTICIPATION

Principle of Anticipation states value is created by the expectation of benefits to be derived in the future. The future, not the past, is important in deriving estimates of value. Value may be defined as the present worth of the rights to all prospective future benefits, tangible and intangible, accruing to the ownership of real estate. In most cases, the quantity, quality, and duration of future benefits may be estimated in the light of past experience as disclosed by analysis of the property being appraised.

PRINCIPLE OF BALANCE

Principle of Balance states maximum value is achieved when the agents of production are in economical balance. There is a theoretical point of equilibrium in each property that will produce the greatest net return. An imbalance exists when a building represents an under improvement or over-improvement in relation to its site. The use of goods and services resulting from these agents produces gross income. Gross income is first applied to labor, capital, coordination and finally to land.

PRINCIPLE OF COMPETITION

Principle of Competition states profit tends to breed competition and excess profit tends to encourage ruinous competition. Commercial properties are affected by competition, both positively and negatively. As businesses are attracted to a particular area, interest in the area

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generally will increase. At a certain point, however, the market will be saturated and some businesses will suffer. Profit is defined by that portion of the net income produced by real property over and above the costs of labor, capital, coordination and land.

DEPRECIATION

Depreciation can be defined in general as loss in value due from any cause. It can be loss in value to real property improvements caused by deterioration or obsolescence.

CHARACTERISTICS OF DEPRECIATION

- ♦ It is a loss in value in accounting procedure to use as a deduction for income tax purposes. *Land does not depreciate.*
- ♦ An accountant is concerned *with book depreciation* as a basis for income tax deduction; an appraiser is concerned with actual depreciation as being an *actual decline in value*.

There are three main types of causes of depreciation, they will be discussed next. Some forms of depreciation are **curable**, because they can be remedied by a repair to the property. Others are considered **incurable** because there is no easy or economical way to remedy them.

PHYSICAL DETERIORATION (CURABLE)

Physical deterioration is the loss in value due to normal wear and tear. As a building gets older, its age will start to show visibly. Since most types of physical deterioration can be repaired, we usually think of it as curable depreciation.

They are results from the following inherent causes:

- ♦ Wear and tear from ordinary use.
- ♦ Negligent care (deferred maintenance).
- ♦ Damage by dry rot, termites, etc.

☞ ***Physical deteriorations are usually curable.***

FUNCTIONAL OBSOLESCENCE (MAY BE CURABLE)

Functional obsolescence is the loss in value due to outmoded style or non-usable features. They are results from the following inherent causes:

- ♦ Poor architectural design, layout and style are no longer desirable.
- ♦ Lack of modern facilities (air conditioning).
- ♦ Changes in styles of market in construction, construction methods, or materials (e.g., one car garage).
- ♦ Usually curable, but should examine the cost to cure the defect.

☞ ***Examples of functional obsolescence are like one car garage; out-dated kitchen and four bedrooms, one bathhouse.***



ECONOMIC/ SOCIAL OBsolescence (INCURABLE)

Economic obsolescence (or social obsolescence) is the loss in value due to changes in the neighborhood and is external to the property itself. They are results from the following external causes:

- ◆ Down zoning or land-use changes or legislative restrictions (taxes).
- ◆ Economic recession, unemployment, and other economical upheavals.
- ◆ Misplaced improvements (Principle of Regression).
- ◆ Change of flight pattern at airport.
- ◆ Oversupply of like properties.

☞ *The saying “More buildings are torn down than fall down” refers to economical obsolescence.*

They are always **incurable**. If a freeway is built next to your property, your home will decrease in value because of the noise and nuisance factor. On the other hand, if the freeway is three blocks away, your house will increase in value because of improved freeway access. If social or economic factors cause a neighborhood to become shabby and run-down, the value of your property will decrease accordingly.

Computing Depreciation

With the tax reform act, straight-line depreciation is the only allowed depreciation for use for newly acquired property. Other depreciation methods like sum-of-digits, 150% decline balances are all excluded from use.

Accrued Depreciation and Recapture for Depreciation

Accrued depreciation is the loss in value that has already occurred. Accrued (past) depreciation is used in an appraisal technique called the cost approach.

Recapture for depreciation is an estimate for depreciation that will occur in the future. A recapture for depreciation is used in an appraisal technique called the income approach.

Straight Line Depreciation (Age Life)

The **straight-line method** is the easiest to understand and the least complicated to use. An equal value is given to each year of the economic life of the improvements, in other words, the value of improvements is depreciated over remaining life of improvements.

Example: If the cost of improvement is \$275,000, and the economic life is 27.5 years, the annual depreciation would be: $\$275,000 / 27.5 = \$10,000$ per year.

A building with an economic life of 50 years would depreciate 2 percent (100 percent / 50 years = 2 percent) in value each year. **Actual age** is the current (real) age of the building. When using the age life method, an appraiser will use an age other than the actual age of the building. This is known as the effective age. **Effective age** is determined by the condition of the building rather than the age. If a building has been maintained, its effective age may be less than the

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actual age; if there has been inadequate maintenance, it may be greater. **Economic life** is the estimated number of years-anticipated usefulness of the improvements. It is usually shorter than the physical life. Economic life is also known as *theoretical life*.

Life of Improvement

Three possible choices:

- ♦ **Residential** Rental Property: **27.5** year life.
- ♦ Commercial or industrial Property: 31.5-year life.
- ♦ Optional on either above: 40-year life.

Characteristics

- ♦ Obsolescence causes more loss of value than physical deterioration.
- ♦ Obsolescence is a cause of depreciation, not method of providing for depreciation.
- ♦ Appreciation is an increase in value, which can result from inflation or from the interaction of supply and demand forces. All real estate improvements suffer some form of depreciation, but simultaneously are appreciating.
- ♦ Depreciation for appraisal purposes is different from depreciation for income tax purposes.
- ♦ The appraiser looks at depreciation as being an actual decline in value.
- ♦ CPA uses book-depreciation as a basis for an income tax deduction.

Properties bought after December 31, 1986 must select the straight-line method, regardless of what the previous owner used.

Properties bought before December 31, 1986 may use other methods like sum-of-the-years digits, 200% declining balance, 175% declining balance and 125% declining balance. Accelerated methods are no longer available on new acquisitions.

APPRAISAL PROCESS

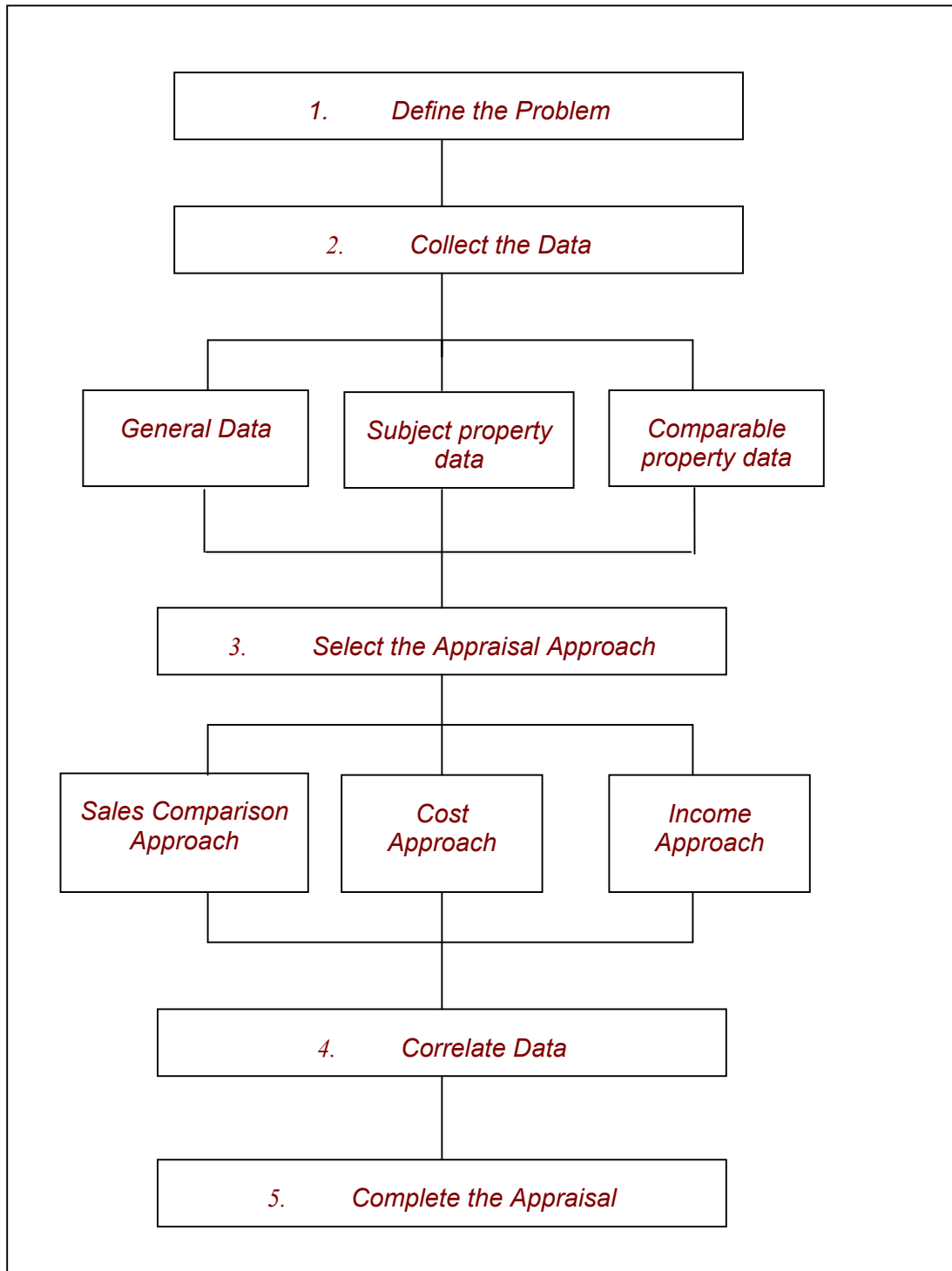
An appraiser follows the following major steps in appraising, figure 15.1 shows these steps:

Figure 15-1: Appraisal Process



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THE APPRAISAL PROCESS



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DEFINE THE PROBLEM

The first step in the appraisal process is to define the scope and establishes purpose and date of the appraisal. The appraiser is most interested in the date a purchase contract will be signed or the date the price is agreed upon, depending on the purpose of the appraisal. There are many reasons why an owner is paying for an appraisal. The usual reasons for an appraisal are transfer of ownership; obtain a loan value; condemnation; insurance value; tax assessment value or rental value.

The first objective of an appraisal is to determine the **highest and best use**. When appraising a property with a building of no value, the appraiser should appraise the land for highest and best use and deduct demolition costs. The highest and best use increases productivity (net return) to the owner. Appraisers must do a site analysis to determine highest and best use.

If an appraiser is uncertain about the legal status of improvements, he should estimate the legal significance or the items and give his reasons.

COLLECT DATA (GENERAL DATA & SPECIFIC DATA)

The next step is to make a preliminary survey and list the data needed and the sources for the data. There are logical reasons why one home is worth more than another that appears comparable, and why the choice of a neighborhood is as important, or even more important than the house itself. There are also differences needs to be taking into consideration of one home than another. There are two types of data an appraiser needs to be taking into consideration:

General Data (Region, City and Neighborhood)

The gathering of general data (regional, city or county and neighborhood information) allows us to understand whether the area is prospering, holding its own or declining and, if so, why.

Region

A state can be divided into economic regions for analysis purposes. Example, San Diego, Los Angeles, San Francisco, Sacramento, etc.

The condition of the nations economy can be reflected in the California real estate market and can affect the ease with which financing is available. But real estate markets are essentially regional and local. If the regional or local economy is expanding, people are working and can afford to buy homes because lending institutions are eager to grant loans.

In a recession, jobs are less secure, confidence is low and financing may not be as easy to obtain. So, the economic mood of the nation as a whole can indirectly affect the economic mood in California, but it is the local and regional economy that directly affects the mood in a particular real estate market. A regional economy is affected by upturns and also downtrends. Not only do large areas reflect the national picture, but they also respond to more localized forces, such as rapid growth of large cities and industrial complexes and the down-sizing of defense-related industries.

City or County

A desirable city or county is a growing area where people can get good jobs and where people want to live. If the city is undesirable or even unsafe, people want to leave. Features to look for



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in cities, besides the availability of job and safety, are good public facilities, parks, good school systems and active citizens who care and take part in the city's affairs.

Neighborhood

A residential neighborhood is normally a limited area where the homes are physically similar and where the occupants have a certain degree of social and economic background in common. It may cover from one square mile to a few square miles. Boundaries may be defined by physical, social or economic differences. The neighborhood in which you live is usually a more important factor than the house itself. This is because the surroundings of a house influence the property value even more than the house itself does.

The selection or acceptance of a neighborhood should come before the actual decision of whether to buy a particular house or not.

Neighborhoods are always changing, sometimes at a fast pace, but usually at a slow, steady pace. We have discussed earlier the four primary forces that affect value of a neighborhood.

Specific Data (Site Analysis)

Specific data are data about the site, location, improvements and title etc. The most important economic characteristic is area preference (location).

There is plenty of land but the exact location of each parcel makes it unlike any other on earth. Its location is the major factor that determines its value.

A site is a particular parcel within a neighborhood. Since each parcel is unique, the individual site that one selects for a home should be chosen with care. There are several site selection factor that affect the value of the home, but the personal needs and objectives of the buyer should be of the utmost concern. An appraiser should be familiar with the advantages and disadvantages of different lots, and adjust (add or subtract the lot value) between cul-de-sac lot, corner lot, T-Intersection lot, Interior lot and Flag lot. The characteristics of each of these lots were discussed earlier.

- ◆ Other factors of site are like size and shape of lot, soil characteristics, orientation and improvements.
- ◆ Assessed value is relatively unimportant in determining value.
- ◆ Buyers information (credit, income) is unimportant in determining value of property.
- ◆ An appraiser should collect all data, which might influence the value, for example, improvements, neighborhood, noise level, etc.

SELECT THE APPRAISAL APPROACH

Select the specific approach and collect specific data for that approach, such as sales data, cost data and income and expense data. The different approach to appraisal will be discussed shortly.

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CORRELATE DATA (RECONCILE DATA)

An appraiser needs to weigh all facts and data collected and reconcile estimated values for final value estimate. This will be discussed in detail shortly.

COMPLETE APPRAISAL

An appraiser needs to weigh all facts and data collected and reconcile estimated values for final value estimate. This will be discussed in detail shortly.

Other Facts

- ♦ All appraisers must adhere to the Code of Ethics
 - A. Cannot base a fee on the percentage of the final value estimate.
 - B. Must disclose their own interest, if any in the property appraised.
- ♦ An appraiser is most interested in the date a purchase contract is signed or the date the price is agreed upon.
- ♦ When appraising a property with a building of no value, the appraiser should appraise the land for highest and best use and deduct demolition costs.
- ♦ If an appraiser is uncertain about the legal status of improvements, he should estimate the significance of the items and give his reasons.
- ♦ If an appraiser is asked to appraise a property owned by a corporation in which he has stock, he should accept the assignment and state his interest in the written report.
- ♦ An appraiser who does not use proper methods is guilty of felony.
- ♦ The American Institute of Real Estate Appraisers (AIREA) members may use the professional designation MAI (Member of Appraisers Institute).

THREE APPROACHES TO APPRAISING

An appraiser has various methods to appraise property depending on the type of property and available data. We will discuss three approaches here.

MARKET DATA APPROACH (SALES COMPARISON)

The **market comparison approach** simply takes the current selling prices of similar properties and adjusts those prices for any differences.

The appraiser finds three (or more) recently sold properties that are similar (comparable) to the property that is the subject of the appraisal. The appraiser analyzes each sale and notes significant difference between the comparable properties and the subject property. The appraiser *adjusts* the sale prices of the *comparable properties* to arrive at an indicated value for the subject property. It can be expressed as following formula:

$$\text{Subject Property Value} = \text{Sale Price of Comparable Properties} \pm \text{Adjustments.}$$



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The market approach to value is based on the principal of substitution. The *principle of substitution* states that a buyer will not pay more for a home if he or she can buy something similar and for less.

Require descriptions of comparable properties that have been sold recently. If the comparable property has an item not present in the subject property, the appraiser subtracts the value of the item from the comparable property's selling price. Likewise, if the subject property has an item not present in the comparable property, the appraiser adds the value of the item to the comparable property's selling price, the resulting figure gives the appraiser the subject property's value.

Characteristics of Market Data Approach

- ♦ It is the most common and easiest to learn and most adaptable for real estate persons.
- ♦ Lend itself well to the valuation of residential properties (houses and condominiums) and lots and vacant land.
- ♦ Consider Amenities - fireplace, swimming pool, spa, tennis court, garden, gourmet kitchen, etc.
- ♦ Marketability and desirability of a property are the primary concerns when appraising a residential property.
- ♦ Rental schedules are usually established by market comparison.
- ♦ Adjustments for differences: Comparables are adjusted to the subject property.
- ♦ Adjusting for the differences is the most difficult and important step in the process. The market data approach is limited when market conditions are rapidly changing.
- ♦ If the comparable have a feature that the subject property does not, the appraiser would subtract the value of the feature from the sales prices of the comparable.
- ♦ Time of sale - If too far in the past, it must be adjusted for inflationary trends.
- ♦ Location of property - Some neighborhoods bring better prices.
- ♦ Physical characteristics - View lot, larger parcel, railroad tracks.
- ♦ Creative Financing - Seller carry-back could create a higher price than normal for the area.
- ♦ A home located near the center of a subdivision would be most desirable.

Sources of Data

- ♦ Actual sales verified through the multiple listing service (MLS), recorders records, or brokers files (comparable sales).
- ♦ Assessors office is the best source for actual age of the property.

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- ♦ Listing prices indicate maximum value. Unsold listings if has been listed for a long time, it is usually overpriced and suggests an upper limit of value.
- ♦ Offered prices indicate lowest probable value.

Advantages of the Market Approach

- ♦ The market comparison approach is easy to learn, and with a little experience it is easy to apply.
- ♦ It reflects a good market value for single family residences (houses and condos) and vacant lots.

Disadvantages of the Market Approach

- ♦ In an inactive market, there is an inability to locate enough recent sales.
- ♦ Errors in judgment for adjusting differences in square footage, age and amenities can develop.
- ♦ Financing often influences the final selling price.
- ♦ Least reliable when there are rapid economic changes. If market prices are increasing rapidly, the comparables, which are based on the past sales prices, lag behind. If pricing are decreasing rapidly, the comparables, which are based on past sales prices, still remain high.

COST APPROACH (REPLACEMENT COST)

The **cost approach** is the process of calculating the cost of the land and buildings and then subtracting the accrued depreciation to arrive at the current value of the property.

It is the estimate of value by using the cost new of replacing or reproducing the subject improvements. In this approach, the appraiser begins with the present cost of improvements on the subject property, subtracts the amount by which these improvements have depreciated and then adds in the value of the site alone to arrive at an indicated value.

The formula may exemplify the concept for the cost approach is:

$$\text{☞ } \text{Subject Property Value} = \text{Cost of improvement (Reproduction or Replacement Cost)} - \text{Accrued Depreciation} + \text{Site Value.}$$

There are two types of cost approach to estimate the cost of improvement, that is, reproduction cost and replacement cost.

Replacement Cost

Replacement cost is the cost of building a new, similar building using the current construction methods, design and materials and having the same *use* as the subject property but without the identical specifications.



Reproducing Cost

Reproducing cost is the cost of reproducing a new building of exact duplication or replica of design and materials as the subject property. This process is rarely used, it is difficult if not impossible to do.

It is usually used on special purpose buildings, which have a unique architecture style.

Characteristics of Cost Approach

- ♦ Used on service buildings - public schools, city halls, and libraries.
- ♦ More appropriate for appraising new buildings because the depreciation becomes harder to calculate as the building increases in age.
- ♦ The cost approach is ideal for appraising newly constructed buildings, and unique, special purpose properties and public buildings such as churches, libraries.
- ♦ Preferred for special purpose or unique structures as they have few, if any, market comparable sales. Special purpose structures, such as a church, temple, schools and libraries are best appraised by the cost approach, since there are few market comparable sales.
- ♦ Site value will be determined by the sales comparison approach or another appropriate method.
- ♦ Of the three approaches, the cost approach tend to set the upper limit of value (highest price someone will buy). Most homebuyers or investors prefer a newer building over an older one if the price is about the same. Why not build if the construction cost of a newer building is close to the sales price of an older building?

Steps in Cost Appraising

1. Estimate current replacement costs to replace, or construct on improvements.
2. Determine the amount of depreciation.
3. Subtract the accrued depreciation of improvements from new replacement cost.
4. Add the value of the land.
5. The value of the vacant land is determined by comparing the lot of the property to be appraised with similar lots that have just been sold. The market comparison approach is used by the appraiser to estimate the lot value of the appraised property.

Four Methods of Computing Cost New

Square foot, cubic foot, unit-in-place and quantity survey.

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Square Foot Method

Using this approach, an appraiser multiplies the cost per square foot of an improvement by the size of the square feet. This method is the most frequently used by appraisers.

- ◆ Costs are reduced to units per square foot of floor area measured from the outside wall dimensions.
- ◆ The fastest and least expensive cost methods.
- ◆ Cost to build a two-story will be less than a one-story of the same square footage.

$$\text{☞ } \text{Square feet} = \text{Length} \times \text{Width}.$$

Cubic Foot Method

Similar to square foot method but instead of multiplying the unit cost with square feet, the unit cost is multiplied with cubic-feet of the building.

- ◆ It is generally used on industrial warehouses where structures have more than one floor, and the height of the floors varies.

$$\text{☞ } \text{Cubic feet} = \text{Length} \times \text{Width} \times \text{Height}.$$

Unit-in-Place Cost Method

It uses the construction cost for the various building components such as walls, foundations, floors, roof, plumbing, fireplace, heating units as installed, etc. These estimates include labor and overhead.

Appraisers rarely use this method since it requires specialized construction knowledge.

Quantity Survey Method (Most Accurate)

This method requires a thorough itemization of all construction costs, both direct (raw materials and labor) and indirect costs (such as permits, taxes, insurance) and other overheads including profits.

Every component involved for reproducing is estimated separately and the individual costs are totaled. It is very accurate but expensive and time consuming and can be used only by knowledgeable person who is familiar with the construction process.

Advantages of Quantity Survey Method

- ◆ It usually sets the highest limits on value.

Disadvantages of Quantity Survey Method

- ◆ The cost approach does not measure the individual amenities of the property, such as location, or outside influences like neighborhood.



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- ♦ It is difficult to convert depreciation into dollar figures especially on older properties.

Direct Costs

Direct costs are expenditures for labor and materials used in the construction of the improvement(s). A contractors overhead and profit are generally treated as direct costs.

Indirect Costs

Indirect costs are expenditures other than material and labor costs. Examples are administrative costs, professional fees, financing costs, insurance and taxes. Indirect costs are usually calculated separately from direct costs.

Estimate Site Value

The appraiser must estimate the value of land separately, as if there were no building on it. This is usually done by the market data approach.

The most common forms of site value are square foot value or front foot value. When one speaks of square foot value, one has divided the total value of the lot by the number of square feet in the lot. Square foot value is commonly used on industrial property. When one speaks of front foot value, one has divided the total value of the lot by its front footage. The deeper the lot, the greater the front foot value will be. A **commercial acre** is an acre minus streets, sidewalks, and alleys.

When comparing lots of different depth, appraisers sometimes use the “**4-3-2-1 rule**,” which states that the front 1/4 of the lot represents 40 percent of the total **value**; the second 1/4 of the lot represents 30 percent; the third 1/4 is worth 20 percent, and the back 1/4 is worth 10 percent.

The “**4-3-2-1 rule**” is best used by appraisers on commercial properties on which the lots vary in depth.

Figure 15-2: Site Appraisal 4-3-2-1 rule

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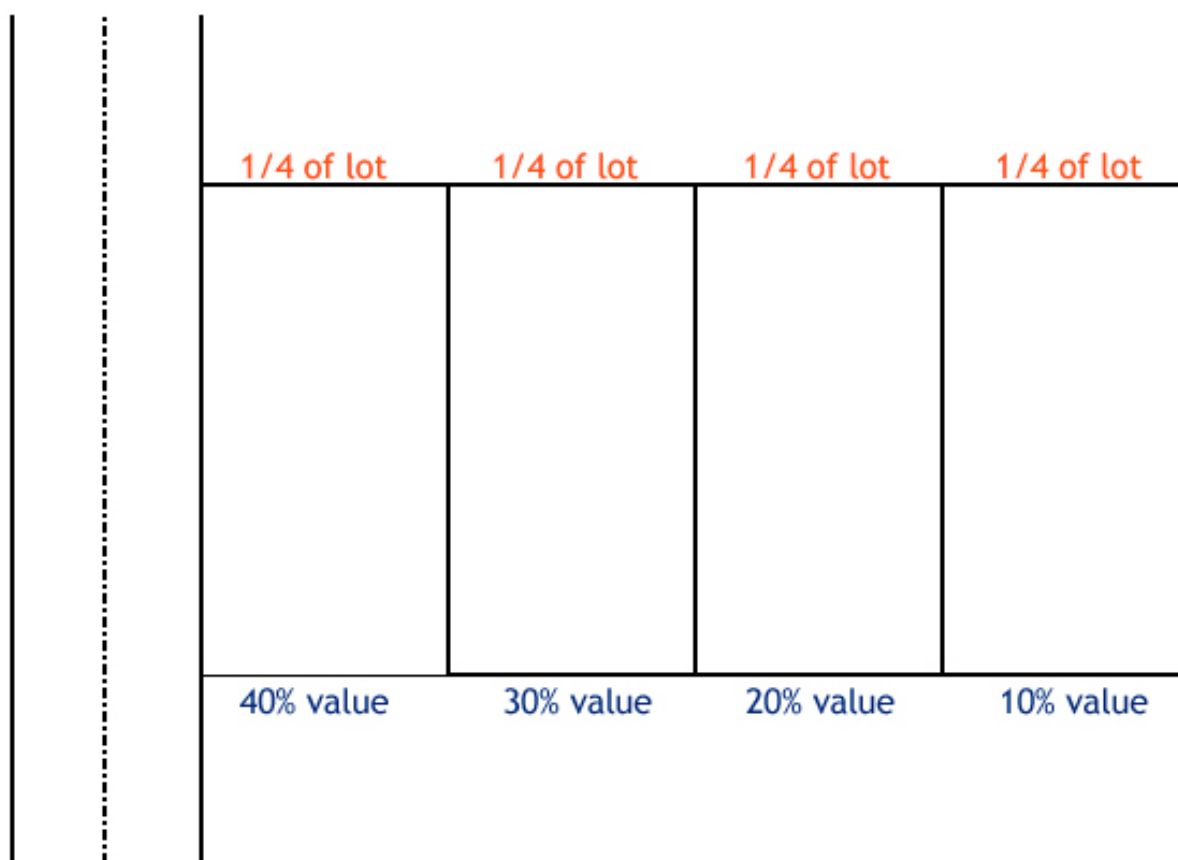


Figure 15-3: Cost Approach Steps

The next figure illustrates an example using replacement cost approach.

1. Replacement cost	\$208,000	\$2600 square feet @80/SF
2. Depreciation	-\$20,800	Building is 5 years old. Economic life estimated at 50 years. 2% per year, or 10% for 5 years.
	\$187,200	Depreciated value of improvements
3. Land value	+\$40,000	
4. Appraised Value	\$227,200	

INCOME (CAPITALIZATION) APPROACH

The **income approach** to value is based on the principle of what a property is worth depends on what income it can produce. It is a process of changing the net income projection from a property into its market value. In other words, it converts income into value, or “*present worth of future benefits*.” It is based on the concept of what an investor is willing to pay today for a property is directly related to what the investor expects to receive from the property.

Because of this, financial industries have developed a technique called **capitalization**, which mathematically computes the present value of the future income produced by the property.



Capitalization Rate

The **capitalization (cap) rate** is the ratio between the value and the net income. It is dependent upon the return which investors demand before they are attracted to an investment. By analyzing market prices and the interest rates demanded in the financial marketplace, capitalization rates can be approximated at any given time.

The capitalization rate is composed of two parts: the **“return on the investment”** (expected investors return) and **“return of the investment”** the rate of the asset that may be decreasing in value, but is rising in replacement cost. This is commonly referred to as the **rate of recapture**, or depreciation on the improvements.

Example: If a building cost \$100,000 to build and will last for 50 years, it is depreciating \$2,000 per year. Thus, the capitalization rate will be increased by 2 percent to compensate for depreciation (recapture of the investment in the improvements).

By analyzing market prices and the interest rates demanded in the financial marketplace, capitalization rates can be approximated.

Capitalization rate can be determined by these advanced methods (not discussed here):

1. Comparison,
2. Summation
3. Bands of Investment (discussed later).

To estimate the value, the appraiser first determines the **potential scheduled gross income** of the property - its maximum income from all sources. The appraiser next makes an allowance for *vacancy and collection losses* and subtracts those anticipated losses from gross income to derive **effective gross income**. By subtracting yearly *operating expenses* from effective gross income, the appraiser finally arrives at **net operating income**. By applying a capitalization rate to net operating income, the appraiser arrives at an estimate of market value.

The formula for the capitalization approach is:

$$\text{Value of income property} = \text{Net Operating Income} / \text{Capitalization Rate}$$

Steps in Income Appraising

Establish an appropriate capitalization rate.

This is the most difficult step.

Selection of a capitalization rate can be a delicate task. A one- percent change in the capitalization rate, for example, can alter the estimated value of a property by up to ten percent or more. The capitalization rate is composed of a return to the investor **“on”** his or her original investment and **“of”** the amount to replace the building later. For example, an investor may want an annual return of eight percent **“on”** his or her original investment, but two percent a

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year is needed to replace the building when its economic life is over. *Determination of the appropriate capitalization rate takes skill and training.*

Establish net operating income

The net operating income is derived with the following steps:

Find out the scheduled gross annual income.

Scheduled gross income is all of the rent the owner could possibly collect if he or she charges the market rent with no vacancies, or sometimes known as contract income. It is the highest income an owner can receive.

Calculate the effective gross income.

The **Effective gross income** is derived by subtracting vacancy factor and collection losses and rent concessions.

In the real situation, one inevitably will experience the vacancy loss. The vacancy factor is the loss in rents due to any cause. This is commonly expressed as a percentage. The vacancy factor increases while an owner trying to find a new tenant, or because of non-payment of rents, or cleaning, repairs and maintenance after one tenant moves out or being evicted. An above market rent will always yield a higher vacancy rate.

$$\Rightarrow \text{Effective Gross Income} = \text{Scheduled Gross Income} - \text{Vacancies}$$

Calculate the net operating income

The **Net operating income** or sometimes called Adjusted Gross Income is derived by subtracting the annual expenses from the Effective Gross Income.

$\text{Net Operating Income} = \text{Effective Gross Income} - \text{Operating Expenses}$

The operating expenses can be break down into the following categories (“TIMMUR”):

1. Taxes (Property Taxes not Income Taxes)
2. Insurance
3. Management
4. Maintenance & Services
5. Utilities
6. Replacement Reserves

Management fees and replacement reserves must always be included in the basic operating expenses.

The expenses listed in the operating statement should represent the actual cost of each item. Though costs may vary, it is the appraisers responsibility to determine what actual costs are on an annual basis.



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An item in the operating expenses needs explanation is the replacement reserve. A replacement reserve consists of funds set aside for the purpose of replacing items in the future. An example of a replacement reserve cost would be saying a \$2000 water heater with a life expectancy of five years. The replacement reserve for this item would be \$400 per year ($\$2000 / 5$)

The net income is divided by the capitalization rate to arrive at the property value.

☞ ***Do not deduct mortgage payments to derive Net Income.***

One may continue on the income ladder to derive the Net Spendable.

Pre-Tax Cash Flow = Net Operating Income - Annual Debt Service (loan expenses).

Do not subtract depreciation to arrive at cash flow, finally,

Net Spendable = Pre Tax Cash Flow - Income Tax.

Equity Dividend Rate = Pre-Tax Cash Flow / Down Payment.

- ◆ Loan expenses are not considered in establishing the annual net income.
- ◆ Management is the most often overlooked expense.
- ◆ Fixed expenses are like taxes and insurance, they remain constant during the year.
- ◆ Variable expenses are operating expenses that can vary such as repairs and utilities.
- ◆ Contract rent is rent specified in a contract; Income based on leases.
- ◆ Economic rent is the rent a property will reasonably produce. Established by comparison of rents being charged for similar properties.
- ◆ To accurately determine the rent schedule of an apartment building, a buyer should ask each tenant to verify the amount of his rent.
- ◆ A ***reconstructed operating statement*** is an estimate of income and expenses for use in the capitalization approach. It would include management costs.

Summary of income approach

- ◆ When interest rates increase, capitalization rates increase.
- ◆ As the capitalization rate increases, the value of the property decreases.
- ◆ If net income is constant, but interest rates increase, the value of the owners equity tends to decrease.
- ◆ Selecting a capitalization rate is most difficult part of the income approach.
- ◆ Require income and expense data on the subject and/or comparable properties.

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- ♦ Used on income producing property to establish the present worth (value) of future benefits (income). The income approach to value is based on the premise that, what an investor is willing to pay today for the property is directly related to what the investor expects to receive from the property in the future.

Gross Income Multiplier (GIM)

Gross income multiplier (GIM) is sometimes used in lieu of the capitalization rate. It is a rough and quick way of converting gross rent into market value.

In this method, the GIM is first selected for the subject property and is then multiplied by the actual or projected rental of the subject to find its market value. The appraiser should compare the GIM of at least 3 (or more) comparable properties to determine the multiplier most applicable to the subject property. It is not a very accurate method, but it is a quick good estimator because its easiness.

The formula for this method is:

$$\text{☞ } \text{Market Value} = \text{Gross Income (Rent)} \times \text{Gross Income Multiplier.}$$

- ♦ Annual GIMs are more likely to be used for industrial or commercial property, while monthly GIMs generally are used for residential properties.
- ♦ Provide a rough estimate of the value by multiplying the monthly or annual gross rent by a commonly accepted number (gross multiplier).
- ♦ An inspection of the property or site evaluation is unimportant.

☞ **Example: A new house renting for \$800, would sell for \$120,000.**

The Gross monthly multiplier = 150 (120,000 / 800).

Advantages of income approach

The advantage of income approach method is that no other method focuses solely on determining the present value of the future income stream from the subject property.

The present worth of future benefits is what the income approach is all about.

Methods of Establishing Capitalization Rate

The capitalization rate is the connecting link between an income estimate and a value estimate. Therefore, selecting the appropriate rate is a critical part of the income approach. Capitalization rate may be estimated by any of several methods. The direct comparison, band of investment, and summation methods are the most commonly used.

Comparison Method

The direct comparison method is generally the preferred method of deriving a capitalization rate and is also the easiest to understand. To use the direct comparison method, we simply analyze recent sales of similar properties and, adopt the capitalization rate used on that sales.



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Band of Investment Method

The real estate market is said to be made up of equity investors on the one hand and lenders on the other. Since both groups may be viewed as investors in income property, they combine to create what is referred to as the “**Band of Investment**”. The band of investment method produces a capitalization rate that is a *weighted average*. This means that is an average of two or more rates, adjusted for the percent of property value each source of money represents. The rate combines a rate for mortgage loan money and a rate for the investors equity. Figure below illustrates this method.

Figure 15-4: Band of Investment

Band of Investment		
<i>Investment Bands</i>	<i>% Property Value</i>	<i>x Interest Rates = Product</i>
1. 1st Trust Deed	50%	x 6% = 3%
2. 2nd Trust Deed	25%	x 8% = 2%
3. Equity	25%	x 10% = 2.5%
4. Overall Capitalization Rate		3%+2%+2.5%=7.5%

Summation Method

A capitalization rate can also be established by assigning a percentage factor to four theoretical components: *interest*, *risk*, *non-liquidity*, and *depreciation* that help determine the rate.. The total would be the capitalization rate. Such a rate is sometimes called a built-up rate.

Example:

Interest rate (safe rate)	6.25%
Investment risk	3.00%
Lack of Liquidity	1.25%
Total	11.5%

RECONCILIATION AND REPORT

The last and most important part of the appraisal process is the appraisers reconciliation of the value estimates reached by each of the approaches used - sales comparison, cost and/or income capitalization.

Correlation is the process of selecting the most appropriate approach for the particular appraisal job and giving it the most consideration in pinpointing the final value.

During this step, the appraiser weighs each of the estimates and chooses the value estimate most likely to be an accurate reflection of market value. The appraisers choice is explained in the report to the clients.

In general, the market comparison approach is best for residential properties; the cost approach is best for new, unique or unusual structures; and the income approach is best for properties that can be used to generate income.

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Narrative Report

The narrative report is the most comprehensive report with complete documentation of the entire appraisal process with all pertinent information, including computation, maps, photographs and detailed analysis. The estimate of value is included in the statement of purpose section.

Sample Appraisal Report

Form 15-1 illustrates a sample USAR appraisal report with typical attachments.

INTERNET WEB LINKS

www.aaro.net

www.aicanada.org

www.aicanada.org

Association of Appraiser Regulatory Officials

Appraisal Institute of Canada

Appraisal Institute of Canada, Winnipeg, Manitoba, Canada

Publisher of The Canadian Appraiser, a technical journal, and Appraisal Institute DIGEST, a newsletter.

Member designations: CRA (Canadian Residential Appraiser) and AACJ (Accredited Appraiser Canadian Institute)

www.appraisaldirectory.com

www.appraisalfoundation.org

www.appraisalinstitute.org

1111 Portage Avenue

Winnipeg, MB, Canada R3G05

Appraisal Directory (State Boards, Find an Appraiser, Education and Training)

The Appraisal Foundation

Appraisal Institute

Suite 2400

Chicago, IL 60611-1980

Appraisal Institute, Chicago, Ill.

Publisher of The Appraisal Journal and Valuation Insights and Perspectives, as well as a number of special reports and books

Member designations: MAI (Member of the Appraisal Institute) and SRA (Senior Residential Appraiser).

The Appraisal Institute was created in 1990 by the merger of the American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers. Appraisal Institute members who were members of one of the earlier organizations also may have one of the following designations, although these are no longer issued by the Appraisal Institute: RM (Residential Member), SRPA (Senior Real Property Appraiser), and SREA (Senior Real Estate Analyst).

www.appraisers.org

American Society of Appraisers (ASA)

P.O. Box 17265

Washington, D.C. 20041-0265



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www.arello.org
www.asfmra.org

www.frea.com
www.iaao.org

www.iami.org/narea.html
www.inman.com
www.instbusapp.org
www.ired.com
www.irwa.org

www.masterappraisers.com

www.nahb.com
www.naifa.com

www.orea.ca.gov
www.realtor.com
www.reea.org
www.uli.org

Association of Real Estate License Law Officials
American Society of Farm Managers and Rural Appraisers, Inc.

9505 Cherry Street, Suite 508
Denver, CO 80222
Foundation of Real Estate Appraisers
International Association of Assessing Officers (IAAO)
1313 East 60th Street
Chicago, IL 60637
National Association of Real Estate Appraisers
Inman News Features
Institute of Business Appraisers
International Real Estate Digest
International Right of Way Association, Inglewood, Calif.
Member designation: SR/WA (Senior-Right of Way Association)
National Association of Master Appraisers (NAMA)
303 West Cypress Street
P.O. Box 12617
San Antonio, TX 78212-0617

National Association of Home Builders
National Association of Independent Fee Appraisers (NAIFA)
7501 Murdoch Avenue
St. Louis, MO 63119
California Office of Real Estate Appraisers
National Association of Realtors®
Real Estate Educators Association
Urban Land Institute

CHAPTER QUIZ

1. The conditions of sale will affect the:
 - A. Price of the subject property;
 - B. Value of the subject property;
 - C. Utility of the subject property;
 - D. Basis of the subject property.
2. "Capitalization" is a process used to:
 - A. Find the interest rate;
 - B. Convert income into value;
 - C. Establish the market value;
 - D. Determine the net income.
3. The vacancy rate in an apartment building is basically the result of:
 - A. The cost of money;
 - B. The size of the apartment building;
 - C. Supply and demand;

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- D. The amount of money in deposits in savings and loan associations.
4. The fastest and easiest method of arriving at building cost estimates is the:
- A. Unit-in-place method;
 - B. Building permit record method;
 - C. Quantity survey method;
 - D. Comparative method.
5. Which of the following would be classified as economic obsolescence:
- A. Termite damage;
 - B. Negligent care;
 - C. Zoning changes;
 - D. Bad architectural design.
6. Which of the following methods of appraisal is based on the principle of substitution?
- A. Replacement cost approach;
 - B. Market comparison approach;
 - C. Reproduction cost approach;
 - D. Capitalization approach.
7. The ultimate test of functional utility is the:
- A. Maintenance costs;
 - B. Marketability;
 - C. Design;
 - D. Utility costs.
8. When using the cost approach to appraising, an appraiser would use:
- A. Separate methods for appraising the land and the improvements, and average the estimates into one overall estimate of value;
 - B. Separate methods for estimating the value of the land and the improvements, and combine the estimates into one overall estimate of value;
 - C. The same method for estimating the value of the land and the improvements, and arrive at a separate estimate for each;
 - D. A single method of appraising the value of the land and the improvements, and average both into an overall estimate of value.
9. Economic obsolescence most nearly means which of the following:
- A. Functional obsolescence;
 - B. Physical obsolescence;
 - C. Social obsolescence;
 - D. Outdated fixtures.
10. Sometimes appraisers refer to different principles of appraising. One of these principles states that a reasonable degree of homogeneity in such factors as social, political, economic, and physical aspects:
- A. Creates a lower value. This is the principle of regression;



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- B. Creates maximum value. This is the principle of conformity;
- C. Tends to destroy values because inharmonious elements infiltrate the neighborhood;
- D. Is not required in order to maintain maximum values.

Answers: 1-A, 2-B, 3-C, 4-D, 5-C, 6-B, 7-B, 8-B, 9-C, 10-B

Form 15-1: Uniform Residential Appraisal Report

15: REAL ESTATE APPRAISAL

File No. 1462Saska

APPRAISAL OF



LOCATED AT:

1462 Saskatchewan Dr.
Sunnyvale, CA 94087

FOR:

Chesapeake - EMail
30030 Mission Blvd. # 216
Hayward, CA 94544

BORROWER:

Chen Wen-Jei & Yu Ying L.

AS OF:

June 22, 2002

BY:

Dynasty Appraisal



Property Description		UNIFORM RESIDENTIAL APPRAISAL REPORT						File No. 1462KSA		
Legal Address		1462 Saskatchewan Dr.				City Sunnyvale		State CA Zip Code 94087		
Tract		3821, Lot 56				County Santa Clara				
Assessor's Parcel No.		323-29-071				Tax Year 2001 R.E. Taxes \$ 6,854.38		Special Assessments \$ N/A		
Borrower		Chen Wen-Jei & Yu Ying L.				Current Owner Same		Occupant: <input checked="" type="checkbox"/> Owner <input type="checkbox"/> Tenant <input type="checkbox"/> Vacant <input type="checkbox"/>		
Property rights appraised		<input checked="" type="checkbox"/> Fee Simple <input type="checkbox"/> Leasehold <input type="checkbox"/> Project Type <input type="checkbox"/> PUD <input type="checkbox"/> Condominium (HUD/VA only)				HOAS N/A		I/Mo.		
Neighborhood or Project Name		N/A				Map Reference 832-D4		Census Tract 5083.04		
Sale Price \$ Refinance		Date of Sale N/A				Description and \$ amount of loan charges/concessions to be paid by seller N/A				
Lender/Client Chesapeake - EMail		Address 30030 Mission Blvd. # 216, Hayward, CA 94544								
Appraiser Dynasty Appraisal		Address 4907 Colusa St., Union City, CA 94587								
Location		<input checked="" type="checkbox"/> Urban <input checked="" type="checkbox"/> Suburban <input type="checkbox"/> Rural		Predominant occupancy		Single family housing PRICE \$(000) AGE (yrs)		Present land use % Land use change		
Built up		<input checked="" type="checkbox"/> Over 75% <input type="checkbox"/> 25-75% <input type="checkbox"/> Under 25%		<input checked="" type="checkbox"/> Owner 95% <input type="checkbox"/> Tenant <input type="checkbox"/> Vacant (0-5%) <input type="checkbox"/> Vacant (over 5%)		400 Low 10 1100 High 60 Predominant		One family 95% 2-4 family 2% Multi-Family 1% Commercial 2%		
Growth rate		<input checked="" type="checkbox"/> Rapid <input checked="" type="checkbox"/> Stable <input type="checkbox"/> Slow						<input checked="" type="checkbox"/> Not likely <input type="checkbox"/> Likely		
Property values		<input checked="" type="checkbox"/> Increasing <input checked="" type="checkbox"/> Stable <input type="checkbox"/> Declining						To: <input type="checkbox"/> In process		
Demand/supply		<input type="checkbox"/> Shortage <input checked="" type="checkbox"/> In balance <input type="checkbox"/> Over supply								
Marketing time		<input checked="" type="checkbox"/> Under 3 mos. <input type="checkbox"/> 3-6 mos. <input type="checkbox"/> Over 6 mos.								
Note: Race and the racial composition of the neighborhood are not appraisal factors. Neighborhood boundaries and characteristics: The subject neighbourhood is bounded by El Camino Real to the north, Interstate 280 to the south, Highway 85 to the west, Wolfe Rd. to the east. Factors that affect the marketability of the properties in the neighborhood (proximity to employment and amenities, employment stability, appeal to market, etc.): At this time, there are no factors affecting the marketability of neighbourhood properties. The subject property is located in southern area of City of Sunnyvale. Homes in the area are of good to average quality/construction and are displaying typical care and maintenance. The subject property is located in close proximity to Fremont High School, Homestead Hospital and Homestead Square . Interstate 280 approximately 3/4 mile south, offers good access to the employment area of South Bay.										
Market conditions in the subject neighborhood (including support for the above conclusions related to the trend of property values, demand/supply, and marketing time -- such as data on competitive properties for sale in the neighborhood, description of the prevalence of sales and financing concessions, etc.): Concessions are not prevalent. Marketability for the area is good with reasonably priced listings selling within 1 to 3 months. Home values are stable over past couple months.										
Project Information for PUDs (if applicable) - Is the developer/builder in control of the Home Owners' Association (HOA)? <input type="checkbox"/> YES <input checked="" type="checkbox"/> NO Approximate total number of units in the subject project N/A Approximate total number of units for sale in the subject project N/A Describe common elements and recreational facilities: N/A										
Dimensions 94.78X85 Site area 8,056 Sq.Ft. Corner Lot <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No Specific zoning classification and description: R1 (Residential) Zoning compliance <input checked="" type="checkbox"/> Legal <input type="checkbox"/> Legal nonconforming (Grandfathered use) <input type="checkbox"/> Illegal <input type="checkbox"/> No zoning Highest & best use as improved: <input checked="" type="checkbox"/> Present use <input type="checkbox"/> Other use (explain)						Topography Basically Level Size Typical for area Shape Rectangular Drainage Appears adequate View None Landscaping Typical Driveway Surface Concrete Apparent easements None apparent FEMA Special Flood Hazard Area <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No FEMA Zone BX Map Date 12/19/1997 FEMA Map No. 0603520001D				
Utilities Public Other Off-site Improvements Type Public Private Electricity <input checked="" type="checkbox"/> Gas <input checked="" type="checkbox"/> Water <input checked="" type="checkbox"/> Sanitary sewer <input checked="" type="checkbox"/> Storm sewer <input checked="" type="checkbox"/> Street Asphalt <input checked="" type="checkbox"/> Curb/gutter Concrete <input checked="" type="checkbox"/> Sidewalk Concrete <input checked="" type="checkbox"/> Street lights Standard <input checked="" type="checkbox"/> Alley None Noted <input checked="" type="checkbox"/>						Comments (apparent adverse easements, encroachments, special assessments, side areas, illegal or legal nonconforming zoning, use, etc.): No apparent adverse easements, encroachment or conditions noted.				
GENERAL DESCRIPTION		EXTERIOR DESCRIPTION		FOUNDATION		BASEMENT		INSULATION		
No. of Units One	Foundation Concrete	Slab No	Area Sq.Ft. 0	Roof Cncl'd <input checked="" type="checkbox"/>						
No. of Stories One	Exterior Walls Stucco	Crawl Space Yes	% Finished N/A	Ceiling Cncl'd <input checked="" type="checkbox"/>						
Type (Det./Att.) Detached	Roof Surface Asph. Sh.	Basement N/A	Ceiling N/A	Walls Cncl'd <input checked="" type="checkbox"/>						
Design (Style) Ranch	Gutters & Dwnspnts. Gal Alum.	Sump Pump N/A	Walls N/A	Floor Cncl'd <input checked="" type="checkbox"/>						
Existing/Proposed Existing	Window Type Sld. Alum.	Dampness None noted	Floor N/A	None <input type="checkbox"/>						
Age (Yrs.) 37	Storm/Screens Thermo/Yes	Settlement None noted	Outside Entry N/A	Unknown <input type="checkbox"/>						
Effective Age (Yrs.) 25	Manufactured House No	Infestation None noted								
ROOMS Foyer Living Dining Kitchen Den Family Rm. Rec. Rm. Bedrooms # Baths Laundry Other Area Sq.Ft.										
Basement										
Level 1	1	1	1	1	1		1	1		1,265
Level 2							4	2		960
Finished area above grade contains: 9 Rooms; 5 Bedroom(s); 3 Bath(s); 2,225 Square Feet of Gross Living Area										
INTERIOR Materials/Condition		HEATING Type FWA		KITCHEN EQUIP. Refrigerator None <input type="checkbox"/>		AMENITIES Fireplace(s)# 1 <input checked="" type="checkbox"/>		CAR STORAGE: None <input type="checkbox"/>		
Floors Hd/Carpet/Good	Type Gas	Range/Oven <input checked="" type="checkbox"/>	Stairs <input type="checkbox"/>	Patio Concrete <input checked="" type="checkbox"/>	Garage 2 <input type="checkbox"/>		# of cars			
Walls Painted/Good	Fuel Gas	Disposal <input checked="" type="checkbox"/>	Drop Stair <input type="checkbox"/>	Deck Wood <input checked="" type="checkbox"/>	Attached 2 Cars					
Tnm/Finish Wood Trim/Good	Condition Avg.	Dishwasher <input checked="" type="checkbox"/>	Scuttle <input checked="" type="checkbox"/>	Porch Covered <input checked="" type="checkbox"/>	Detached					
Bath Floor Tile/Carpet/Good	COOLING Central None	Fan/Hood <input checked="" type="checkbox"/>	Floor <input type="checkbox"/>	Fence Wood <input checked="" type="checkbox"/>	Built-In					
Bath Wainscot Fiberglass	Other None	Microwave <input type="checkbox"/>	Heated <input type="checkbox"/>	Pool None <input type="checkbox"/>	Carport					
Doors Ext-Solid Wood	Condition	Washer/Dryer <input type="checkbox"/>	Finished <input type="checkbox"/>	Driveway 2Cars						
In-Hollow Wood										
Additional features (special energy efficient items, etc.): None										
Condition of the improvements, depreciation (physical, functional, and external), repairs needed, quality of construction remodeling/additions, etc.: The subject property is in average physical condition. No physical, external or functional inadequacies were noted at time of inspection.										
Adverse environmental conditions (such as, but not limited to, hazardous wastes, toxic substances, etc.) present in the improvements, on the site, or in the immediate vicinity of the subject property: There no adverse environmental condition were noted by the appraiser on the site, in the improvements, or the immediate vicinity at the time of inspection.										

15: REAL ESTATE APPRAISAL

Speedy Appraisal Services

UNIFORM RESIDENTIAL APPRAISAL REPORT

File No. 1462Saska

Valuation Section

ESTIMATED SITE VALUE		= \$ 600,000		Comments on Cost Approach (such as, source of cost estimate, site value, square foot calculation and for HUD, VA and FmHA, the estimated remaining economic life of the property): The high land to improvements ratio is typical of properties in this area. Costs were obtained from Marshall & Swift Handbook and local contractors. Land value is derived extraction. Depreciation determined by the overall condition of the unit as related to normal wear and tear and average condition of comparable residences in the area.
ESTIMATED REPRODUCTION COST-NEW OF IMPROVEMENTS:				
Dwelling	2,225 Sq. Ft. @ \$ 125.00	= \$	278,125	
Bsmt. 0	Sq. Ft. @ \$	=	0	
Patio		=	10,000	
Garage/Carport	489 Sq. Ft. @ \$ 20.00	=	9,780	
Total Estimated Cost New		= \$	297,905	
Less 25 Physical Functional External	Est. Remaining Econ. Life: 50			
Depreciation	\$83,466	= \$	83,466	
Depreciated Value of Improvements		= \$	214,439	
*As-is Value of Site Improvements		= \$	20,000	
INDICATED VALUE BY COST APPROACH		= \$ 834,400		

ITEM	SUBJECT	COMPARABLE NO. 1	COMPARABLE NO. 2	COMPARABLE NO. 3
1462 Saskatchewan Dr.	627 Oneida Dr.	650 Princeton Dr.	783 Steuben Dr.	
Address Sunnyvale, CA 94087	LP: \$ 869,000 DOM: 11	LP: \$ 850,000 DOM: 35	LP: \$ 869,000 DOM: 11	
Proximity to Subject	0.65 Mi	0.7 Mi	0.75 Mi	
Sales Price	\$ Refinance \$ 861,000	\$ 868,000	\$ 869,500	
Price/Gross Liv. Area	\$ 0.00 / 0 \$ 379.30 / 0	\$ 382.38 / 0	\$ 391.49 / 0	
Data and/or Verification Sources	Appraiser Inspection Win2Data/NDC/MLS# 214524 Doc # 16239853	Win2Data/NDC/MLS# 206562 Doc # 16152676	Win2Data/NDC/MLS# 207802 Doc # 16184304	
VALUE ADJUSTMENTS	DESCRIPTION	DESCRIPTION	DESCRIPTION	DESCRIPTION
Sales or Financing Concessions	N/A	Conventional None	Conventional None	Conventional None
Date of Sale/Time	N/A	04/30/2002 COE	03/13/2002 COE	03/29/2002 COE
Location	Suburban	Suburban	Suburban	Suburban
Leasehold/Fee Simple	Fee Simple	Fee Simple	Fee Simple	Fee Simple
Site	8,056 Sq. Ft.	6,000 Sq. Ft.	6,100 Sq. Ft.	7,954 Sq. Ft.
View	None	None	None	None
Design and Appeal	Ranch	Ranch	Ranch	Ranch
Quality of Construction	Average	Average	Average	Average
Age	37 Yrs.	37 Yrs.	36 Yrs.	26 Yrs.
Condition	Good	Average	Good/Average	Average
Above Grade	Total Bdrms Baths 9: 5: 3.00	Total Bdrms Baths 9: 5: 3.00	Total Bdrms Baths 10: 5: 3.00	Total Bdrms Baths 9: 4: 2.50
Gross Living Area	2,225 Sq. Ft.	2,270 Sq. Ft.	2,270 Sq. Ft.	2,221 Sq. Ft.
Basement & Finished Rooms Below Grade	0 Sq. Ft.	0 Sq. Ft.	0 Sq. Ft.	0 Sq. Ft.
Functional Utility	Standard	Standard	Standard	Standard
Heating/Cooling	Gas FWA	Gas FWA/No AC	Gas FWA/No AC	Gas FWA/No AC
Energy Efficient Items	Standard	Standard	Standard	Standard
Garage/Carport	2 Cars Att. Gar.	2 Cars Att. Gar.	2 Cars Att. Gar.	2 Cars Att. Gar.
Porch, Patio, Deck, Fireplace(s), etc.	Porch/Patio, Deck 1 Fireplace	Porch/Patio 1 Fireplace	Porch/Patio 1 Fireplace	Porch/Patio 1 Fireplace
Fence, Pool, etc.	Fence/No Pool	Fence/ Pool -10,000	Fence/No Pool	Fence/No Pool
APN #	323-29-071	201-28-001		
Net Adj. (total)	[X] + [] - \$ 20,000	[X] + [] - \$ 19,000	[X] + [] - \$ 17,500	
Adjusted Sales Price of Comparable	Gross: 4.6% Net: 2.3% \$ 881,000	Gross: 2.2% Net: 2.2% \$ 887,000	Gross: 4.3% Net: 2.0% \$ 887,000	

Comments on Sales Comparison (including the subject property's compatibility to the neighborhood, etc.): All comps are resales of similar design, age, quality, condition and appeal from subject's market area.
Most weight is given to comp # 1 with support from comp # 2, 3 and 4.

ITEM	SUBJECT	COMPARABLE NO. 1	COMPARABLE NO. 2	COMPARABLE NO. 3
Date, Price and Data Source for prior sales within year of appraisal	No prior sales within 12 months as per Win2Data	No prior sales other than above within 12 months as per Win2Data	No prior sales other than above within 12 months as per Win2Data	No prior sales other than above within 12 months as per Win2Data

Analysis of any current agreement of sale, option, or listing of the subject property and analysis of any prior sales of subject and comparables within one year of the date of appraisal:
The appraiser is not aware of any sale, option or listing on the subject property within last 12 months at all.

INDICATED VALUE BY SALES COMPARISON APPROACH \$ 881,000

INDICATED VALUE BY INCOME APPROACH (if Applicable) Estimated Market Rent \$ N/A Mo. x Gross Rent Multiplier N/A = \$ N/A

This appraisal is made [X] "as is" [] subject to the repairs, alterations, inspections or conditions listed below [] subject to completion per plans and specifications.
Conditions of Appraisal: No condition noted.

Final Reconciliation: Most emphasis is on the market comparison approach which considers area of similar properties within subject's neighbourhood. Cost approach is supportive. Income approach is not applicable.

The purpose of this appraisal is to estimate the market value of the real property that is the subject of this report, based on the above conditions and the certification, contingent and limiting conditions, and market value definition that are stated in the attached Freddie Mac Form 439/Fannie Mae Form 1004B (Revised 6/93).
I (WE) ESTIMATE THE MARKET VALUE, AS DEFINED, OF THE REAL PROPERTY THAT IS THE SUBJECT OF THIS REPORT, AS OF June 22, 2002
(WHICH IS THE DATE OF INSPECTION AND THE EFFECTIVE DATE OF THIS REPORT) TO BE \$ 881,000

APPRaiser:	SUPERVISORY APPRAISER (ONLY IF REQUIRED):
Signature	Signature
Name Dynasty Appraisal	Name Jerry Fung
Date Report Signed June 23, 2002	Date Report Signed June 23, 2002
State Certification #	State Certification # AR023677
Or State License # AT028604	Or State License #



REAL ESTATE PRACTICE

Speedy Appraisal Services

UNIFORM RESIDENTIAL APPRAISAL REPORT

File No. 1462Saska

Supplemental Valuation Section

ITEM	SUBJECT	COMPARABLE NO. 4	COMPARABLE NO. 5	COMPARABLE NO. 6			
1462 Saskatchewan Dr. Address Sunnyvale, CA 94087		617 Princeton Dr. LP: \$ 879,500 DOM: 12					
Proximity to Subject		0.65 Mi					
Sales Price	\$ Refinance	\$ 875,000	\$	\$			
Price/Gross Liv. Area	\$ 0.00	\$ 385.46	\$	\$			
Data and/or Verification Sources	Appraiser Inspection	Win2Data/NDC/MLS# 200915 Doc # 16109158					
VALUE ADJUSTMENTS	DESCRIPTION	DESCRIPTION	+ (-) \$ Adjustment	DESCRIPTION	+ (-) \$ Adjustment	DESCRIPTION	+ (-) \$ Adjustment
Sales or Financing Concessions	N/A	Conventional None					
Date of Sale/Time	N/A	COE 02/14/2002					
Location	Suburban	Suburban					
Leasehold/Fee Simple	Fee Simple	Fee Simple					
Site	8,056 Sq. Ft.	6,448 Sq. Ft.	+7,000				
View	None	None					
Design and Appeal	Ranch	Two Story					
Quality of Construction	Average	Average					
Age	37 Yrs.	36 Yrs.					
Condition	Good	Average/Good	+10,000				
Above Grade Room Count	Total: 9 Bdrms: 5 Baths: 3.00	Total: 10 Bdrms: 6 Baths: 3.00	-2,000				
Gross Living Area	2,225 Sq. Ft.	2,270 Sq. Ft.		Sq. Ft.		Sq. Ft.	
Basement & Finished Rooms Below Grade	0 Sq. Ft.	0 Sq. Ft.					
Functional Utility	Standard	Standard					
Heating/Cooling	Gas FWA	Gas FWA/No AC					
Energy Efficient Items	Standard	Standard					
Garage/Carport	2 Cars Att. Gar.	2 Cars Att. Gar.					
Porch, Patio, Deck, Fireplace(s), etc.	1 Fireplace	1 Fireplace					
Fence, Pool, etc.	Fence/No Pool	Fence/No Pool					
APN #	323-29-071	201-29-016					
Net Adj. (total)		[X] + - \$ 15,000		[X] + - \$		[X] + - \$	
Adjusted Sales Price of Comparable		Gross: 2.2% Net: 1.7% \$ 890,000		Gross: Net:		Gross: Net:	
Comments on Sales Comparison (including the subject property's compatibility to the neighborhood, etc.):							
Subject Property: Remodeled kitchen with marble counter top, eating island, custom wood patio windows. New hardwood, tile floor through out.							
Comp # 2: Partial hardwood and tile floor.							
Comp # 4: Wall to wall carpeting, partial hardwood floor, library, den or study in the living room.							
ITEM	SUBJECT	COMPARABLE NO. 4	COMPARABLE NO. 5	COMPARABLE NO. 6			
Date, Price and Data Source for prior sales within year of appraisal	No prior sales within 12 months as per Win2Data	No prior sales other than above within 12 months as per Win2Data					
Analysis of any current agreement of sale, option, or listing of the subject property and analysis of any prior sales of subject and comparables within one year of the date of appraisal:							
ADDITIONAL COMMENTS							

15: REAL ESTATE APPRAISAL

File No. 1462Saska

DEFINITION OF MARKET VALUE: The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby: (1) buyer and seller are typically motivated; (2) both parties are well informed or well advised, and each acting in what he considers his own best interest; (3) a reasonable time is allowed for exposure in the open market; (4) payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and (5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions* granted by anyone associated with the sale.

*Adjustments to the comparables must be made for special or creative financing or sales concessions. No adjustments are necessary for those costs which are normally paid by sellers as a result of tradition or law in a market area; these costs are readily identifiable since the seller pays these costs in virtually all sales transactions. Special or creative financing adjustments can be made to the comparable property by comparisons to financing terms offered by a third party institutional lender that is not already involved in the property or transaction. Any adjustment should not be calculated on a mechanical dollar for dollar cost of the financing or concession but the dollar amount of any adjustment should approximate the market's reaction to the financing or concessions based on the Appraiser's judgment.

STATEMENT OF LIMITING CONDITIONS AND APPRAISER'S CERTIFICATION

CONTINGENT AND LIMITING CONDITIONS: The appraiser's certification that appears in the appraisal report is subject to the following conditions:

1. The appraiser will not be responsible for matters of a legal nature that affect either the property being appraised or the title to it. The appraiser assumes that the title is good and marketable and, therefore, will not render any opinions about the title. The property is appraised on the basis of it being under responsible ownership.
2. The appraiser has provided a sketch in the appraisal report to show approximate dimensions of the improvements and the sketch is included only to assist the reader of the report in visualizing the property and understanding the appraiser's determination of its size.
3. The appraiser has examined the available flood maps that are provided by the Federal Emergency Management Agency (or other data sources) and has noted in the appraisal report whether the subject site is located in an identified Special Flood Hazard Area. Because the appraiser is not a surveyor, he or she makes no guarantees, express or implied, regarding this determination.
4. The appraiser will not give testimony or appear in court because he or she made an appraisal of the property in question, unless specific arrangements to do so have been made beforehand.
5. The appraiser has estimated the value of the land in the cost approach at its highest and best use and the improvements at their contributory value. These separate valuations of the land and improvements must not be used in conjunction with any other appraisal and are invalid if they are so used.
6. The appraiser has noted in the appraisal report any adverse conditions (such as, needed repairs, depreciation, the presence of hazardous wastes, toxic substances, etc.) observed during the inspection of the subject property or that he or she became aware of during the normal research involved in performing the appraisal. Unless otherwise stated in the appraisal report, the appraiser has no knowledge of any hidden or unapparent conditions of the property or adverse environmental conditions (including the presence of hazardous wastes, toxic substances, etc.) that would make the property more or less valuable, and has assumed that there are no such conditions and makes no guarantees or warranties, express or implied, regarding the condition of the property. The appraiser will not be responsible for any such conditions that do exist or for any engineering or testing that might be required to discover whether such conditions exist. Because the appraiser is not an expert in the field of environmental hazards, the appraisal report must not be considered as an environmental assessment of the property.
7. The appraiser obtained the information, estimates, and opinions that were expressed in the appraisal report from sources that he or she considers to be reliable and believes them to be true and correct. The appraiser does not assume responsibility for the accuracy of such items that were furnished by other parties.
8. The appraiser will not disclose the contents of the appraisal report except as provided for in the Uniform Standards of Professional Appraisal Practice.
9. The appraiser has based his or her appraisal report and valuation conclusion for an appraisal that is subject to satisfactory completion, repairs, or alterations on the assumption that completion of the improvements will be performed in a workmanlike manner.
10. The appraiser must provide his or her prior written consent before the lender/client specified in the appraisal report can distribute the appraisal report (including conclusions about the property value, the appraiser's identity and professional designations, and references to any professional appraisal organizations or the firm with which the appraiser is associated) to anyone other than the borrower; the mortgagee or its successors and assigns; the mortgage insurer; consultants; professional appraisal organizations; any state or federally approved financial institution; or any department, agency, or instrumentality of the United States or any state or the District of Columbia; except that the lender/client may distribute the property description section of the report only to data collection or reporting service(s) without having to obtain the appraiser's prior written consent. The appraiser's written consent and approval must also be obtained before the appraisal can be conveyed by anyone to the public through advertising, public relations, news, sales, or other media.



REAL ESTATE PRACTICE

File No. 1462Saska

APPRAISERS CERTIFICATION: The Appraiser certifies and agrees that:

1. I have researched the subject market area and have selected a minimum of three recent sales of properties most similar and proximate to the subject property for consideration in the sales comparison analysis and have made a dollar adjustment when appropriate to reflect the market reaction to those items of significant variation. If a significant item in a comparable property is superior to, or more favorable than, the subject property, I have made a negative adjustment to reduce the adjusted sales price of the comparable and, if a significant item in a comparable property is inferior to, or less favorable than the subject property, I have made a positive adjustment to increase the adjusted sales price of the comparable.
2. I have taken into consideration the factors that have an impact on value in my development of the estimate of market value in the appraisal report. I have not knowingly withheld any significant information from the appraisal report and I believe, to the best of my knowledge, that all statements and information in the appraisal report are true and correct.
3. I stated in the appraisal report only my own personal, unbiased, and professional analysis, opinions, and conclusions, which are subject only to the contingent and limiting conditions specified in this form.
4. I have no present or prospective interest in the property that is the subject to this report, and I have no present or prospective personal interest or bias with respect to the participants in the transaction. I did not base, either partially or completely, my analysis and/or the estimate of market value in the appraisal report on the race, color, religion, sex, handicap, familial status, or national origin of either the prospective owners or occupants of the subject property or of the present owners or occupants of the properties in the vicinity of the subject property.
5. I have no present or contemplated future interest in the subject property, and neither my current or future employment nor my compensation for performing this appraisal is contingent on the appraised value of the property.
6. I was not required to report a predetermined value or direction in value that favors the cause of the client or any related party, the amount of the value estimate, the attainment of a specific result, or the occurrence of a subsequent event in order to receive my compensation and/or employment for performing the appraisal. I did not base the appraisal report on a requested minimum valuation, a specific valuation, or the need to approve a specific mortgage loan.
7. I performed this appraisal in conformity with the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place as of the effective date of this appraisal, with the exception of the departure provision of those Standards, which does not apply. I acknowledge that an estimate of a reasonable time for exposure in the open market is a condition in the definition of market value and the estimate I developed is consistent with the marketing time noted in the neighborhood section of this report, unless I have otherwise stated in the reconciliation section.
8. I have personally inspected the interior and exterior areas of the subject property and the exterior of all properties listed as comparables in the appraisal report. I further certify that I have noted any apparent or known adverse conditions in the subject improvements, on the subject site, or on any site within the immediate vicinity of the subject property of which I am aware and have made adjustments for these adverse conditions in my analysis of the property value to the extent that I had market evidence to support them. I have also commented about the effect of the adverse conditions on the marketability of the subject property.
9. I personally prepared all conclusions and opinions about the real estate that were set forth in the appraisal report. If I relied on significant professional assistance from any individual or individuals in the performance of the appraisal or the preparation of the appraisal report, I have named such individual(s) and disclosed the specific tasks performed by them in the reconciliation section of this appraisal report. I certify that any individual so named is qualified to perform the tasks. I have not authorized anyone to make a change to any item in the report; therefore, if an unauthorized change is made to the appraisal report, I will take no responsibility for it.

SUPERVISORY APPRAISER'S CERTIFICATION: If a supervisory appraiser signed the appraisal report, he or she certifies and agrees that: I directly supervise the appraiser who prepared the appraisal report, have reviewed the appraisal report, agree with the statements and conclusions of the appraiser, agree to be bound by the appraiser's certifications numbered 4 through 7 above, and am taking full responsibility for the appraisal and the appraisal report.

ADDRESS OF PROPERTY APPRAISED: 1462 Saskatchewan Dr., Sunnyvale, CA 94087

APPRAISER:

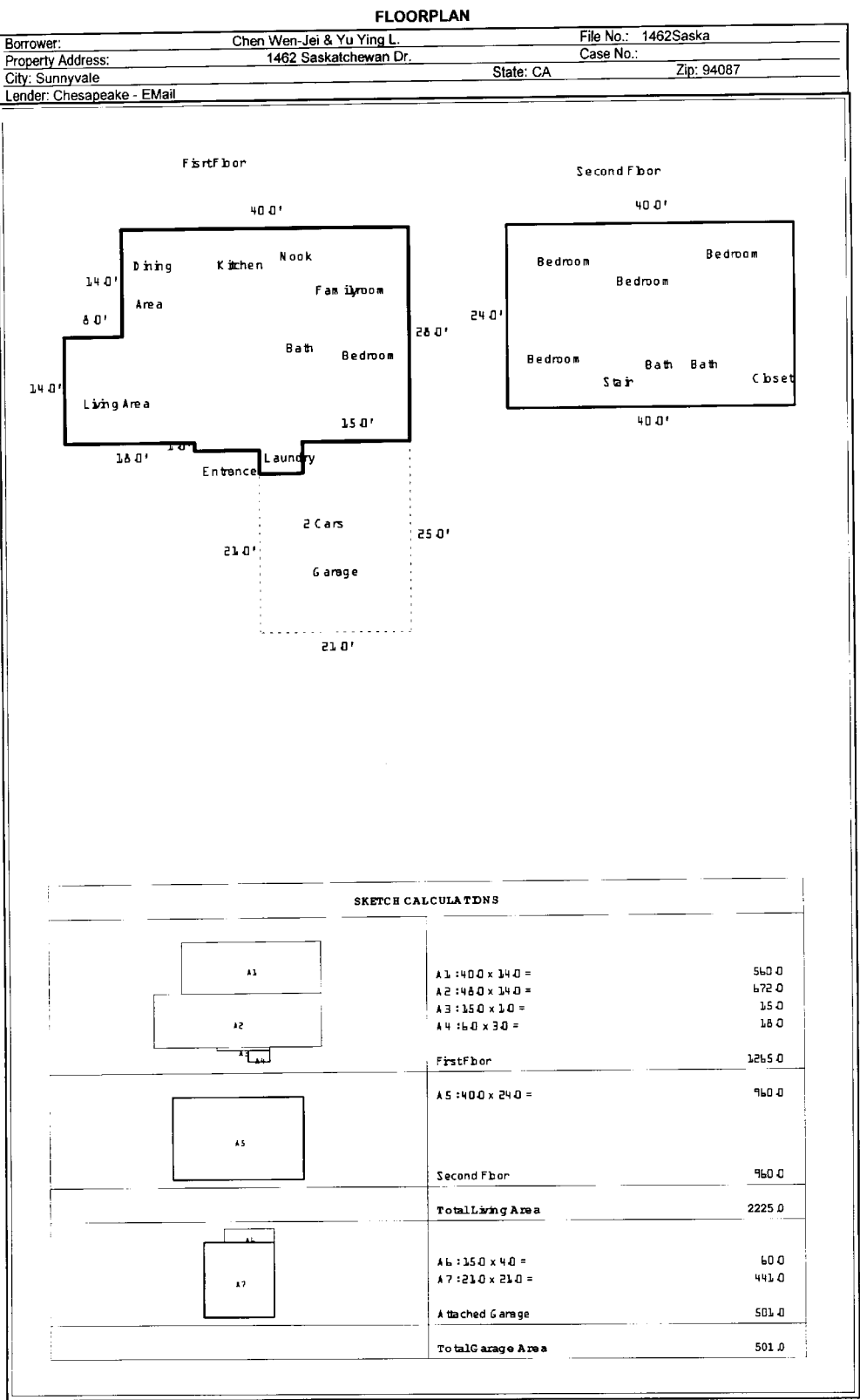
Signature: _____
Name: Dynasty Appraisal
Date Signed: June 23, 2002
State Certification #: _____
or State License #: AT028604
State: CA
Expiration Date of Certification or License: Jan 15, 2004

SUPERVISORY APPRAISER (only if required)

Signature: _____
Name: Jerry Fung
Date Signed: June 23, 2002
State Certification #: AR023677
or State License #: _____
State: CA
Expiration Date of Certification or License: Feb 26, 2003

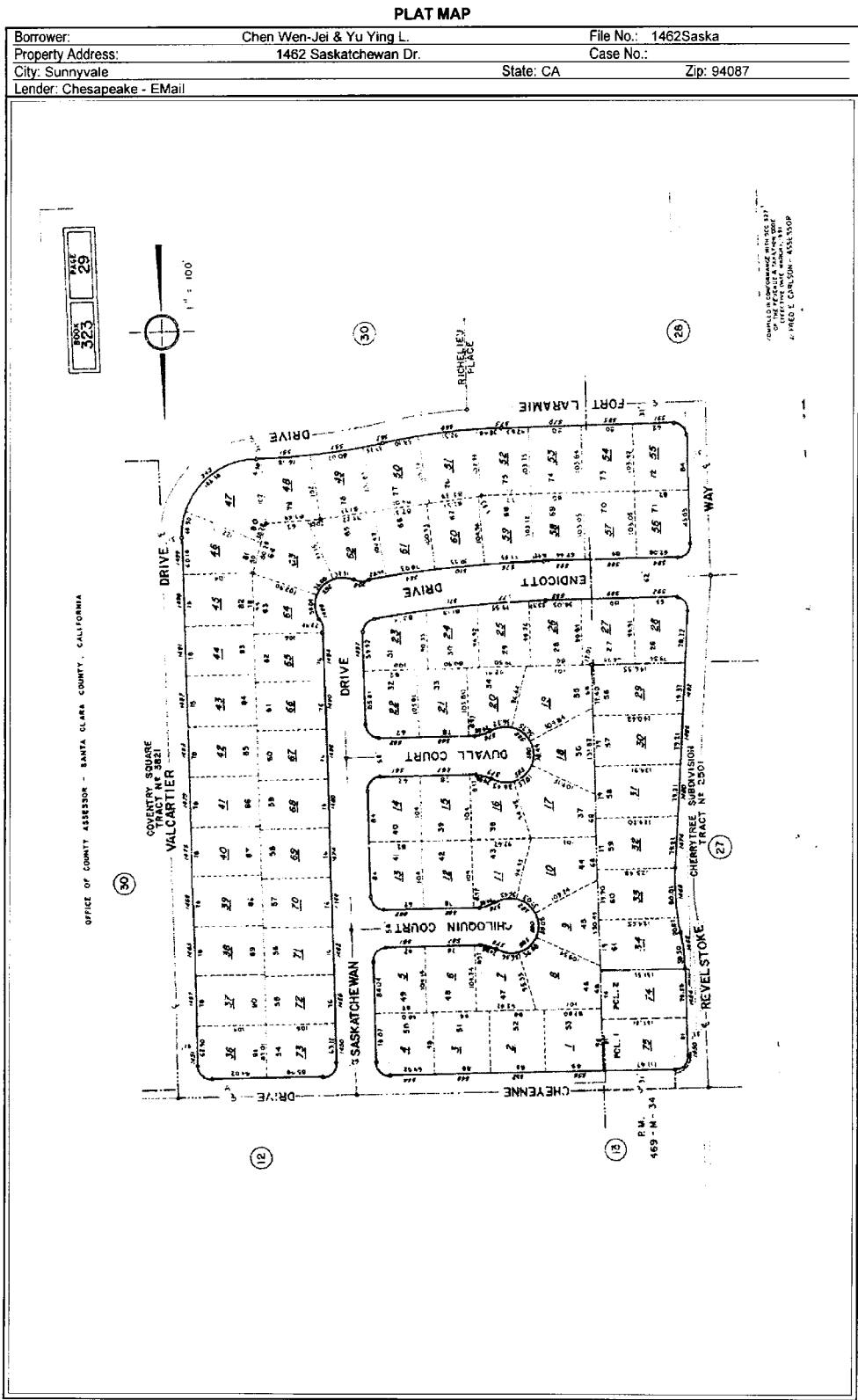
☐ Did ☒ Did Not Inspect Property

15: REAL ESTATE APPRAISAL



[illegible]

15: REAL ESTATE APPRAISAL

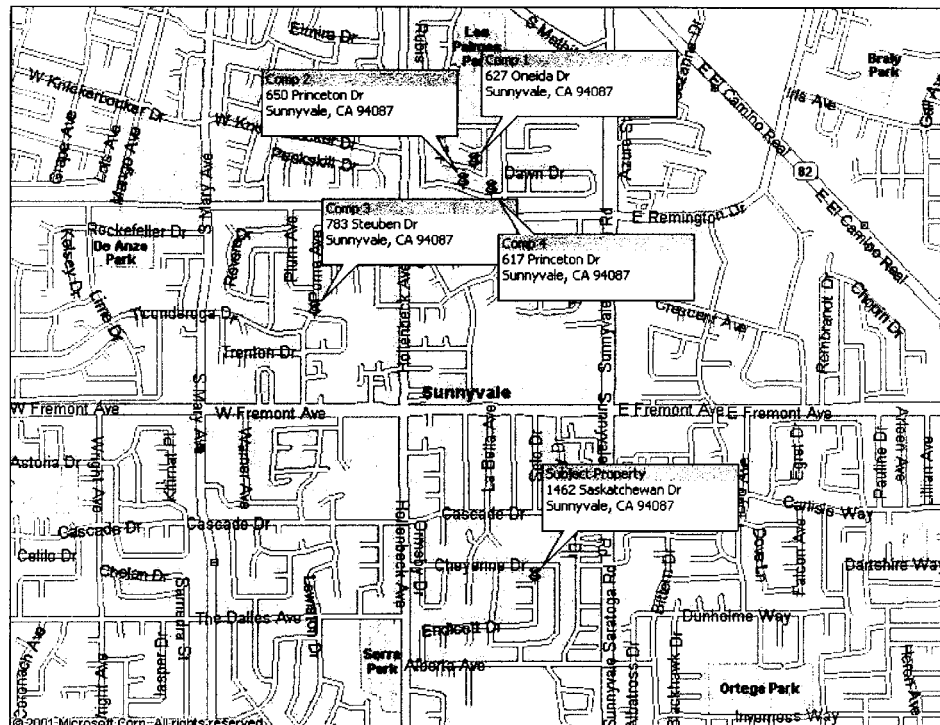




REAL ESTATE PRACTICE

LOCATION MAP

Borrower:	Chen Wen-Jei & Yu Ying L.	File No.:	1462Saska
Property Address:	1462 Saskatchewan Dr.	Case No.:	
City:	Sunnyvale	State:	CA
Lender:	Chesapeake - E-Mail	Zip:	94087



15: REAL ESTATE APPRAISAL

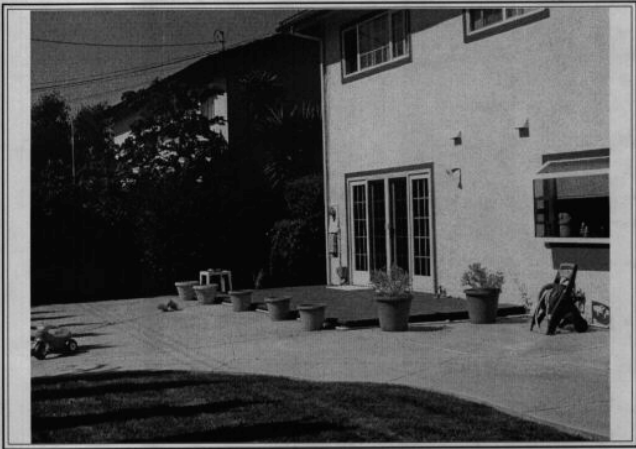
SUBJECT PROPERTY PHOTO ADDENDUM

Borrower:	Chen Wen-Jei & Yu Ying L.	File No.:	1462Saska
Property Address:	1462 Saskatchewan Dr.	Case No.:	
City: Sunnyvale		State: CA	Zip: 94087
Lender: Chesapeake - EMail			

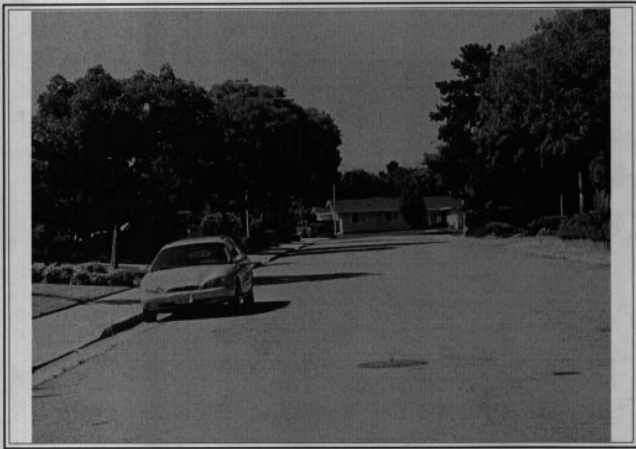


**FRONT VIEW OF
SUBJECT PROPERTY**

Appraised Date: June 22, 2002
Appraised Value: \$ 881,000



**REAR VIEW OF
SUBJECT PROPERTY**



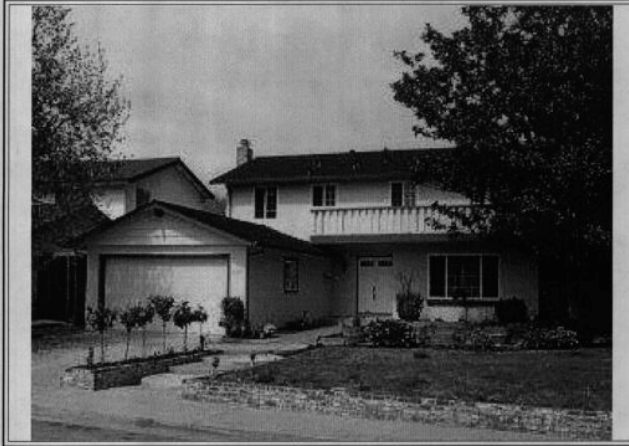
STREET SCENE



REAL ESTATE PRACTICE

COMPARABLE PROPERTY PHOTO ADDENDUM

Borrower:	Chen Wen-Jei & Yu Ying L.	File No.:	1462Saska
Property Address:	1462 Saskatchewan Dr.	Case No.:	
City: Sunnyvale		State: CA	Zip: 94087
Lender: Chesapeake - EMail			



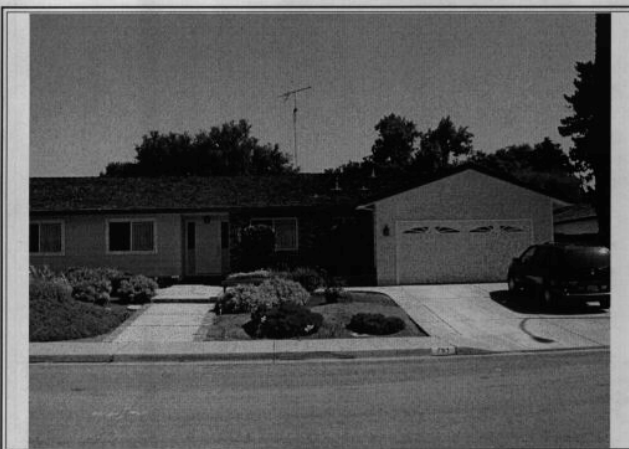
COMPARABLE SALE #1

627 Oneida Dr.
LP: \$ 869,000 DOM: 11
Sale Date: 04/30/2002 COE
Sale Price: \$ 861,000



COMPARABLE SALE #2

650 Princeton Dr.
LP: \$ 850,000 DOM: 35
Sale Date: 03/13/2002 COE
Sale Price: \$ 868,000



COMPARABLE SALE #3

783 Steuben Dr.
LP: \$ 869,000 DOM: 11
Sale Date: 03/29/2002 COE
Sale Price: \$ 869,500

APPENDIX

APPENDIX: STATE REAL ESTATE APPRAISER - REGULATORY BOARDS

Alabama Alabama Real Estate Appraiser Board	Tel: 334-242-8747 www.agencies.state.al.us	P. O. Box 304355 Montgomery, AL 36130-4355
Alaska Board Of Certified Real Estate Appraisers	Tel: 907-465-2542 www.state.ak.us	333 Willoughby Avenue P.O. Box 110806 Juneau, AK 99811-0806
Arizona Arizona Board Of Appraisal	Tel: 602-542-1539 www.appraisal.state.az.us	1400W. Washington, Suite 360 Phoenix, AZ 85007
Arkansas Arkansas Appraiser Licensing & Certification Board	Tel: 501-296-1843 http://ark.org/alcb	2725 Cantrell Road, Suite 202 Little Rock, AR 72202
California Office Of Real Estate Appraisers	Tel: 916-263-0722 www.orea.ca.gov	1755 Creekside Oaks Drive, Suite 190 Sacramento, CA 95833
Colorado State Of Colorado Board Of Real Estate Appraisers	Tel: 303-894-2166 www.state.co.us	1900 Grant Street, Suite 600 Denver, CO 80203
Connecticut Department Of Consumer Protection Real Estate Appraisal Division	Tel: 860-566-1568 www.state.ct.us/dcp	State Office Building, Room G-8A 165 Capitol Avenue Hartford, CT 06106
Delaware Delaware Council On Real Estate Appraisers Professional Regulation Division	Tel: 302-7394522 www.state.de.us	P. O. Box 1401 Cannon Bldg., Ste. 203 Dover, DE 19903
District Of Columbia	Tel: 202-727-7450 www.dcr.org	614 H. Street, NW, Room 921 Washington, DC 20013-7200
Florida Florida Department Of Business And Professional Regulation Div. Of Real Estate, Appraisal Section	Tel: 407-481-5631 www.state.fl.us	400 W. Robinson St. Hurst North Tower Orlando, FL 32801-1772
Georgia Georgia Real Estate Appraiser Board	Tel: 404-656-3916 www.state.ga.us	International Tower 229 Peachtree Street, NE, Suite 1000 Atlanta, GA 30303-1605
Hawaii Hawaii Real Estate Appraiser Program	Tel: 808-586-2693	1010 Richard Street Honolulu, HI 96813
Idaho Idaho Real Estate Appraiser Board Bureau Of Occupational	Tel: 208-334-3233 www.state.id.us	Owyhee Plaza 1109 Main Street, Suite 220 Boise, ID 83702-5642



REAL ESTATE PRACTICE

Licenses		
Illinois Illinois Real Estate Appraisal Administration	Tel: 217-785-9638 www.stat.il.us	500 E. Monroe Street, Suite 500 Springfield, IL 62701-1509
Indiana Indiana Professional Licensing Agency	Tel: 317-232-7209 www.state.in.us	302 W. Washington, Room E034 Indianapolis, IN 46204-2700
Iowa Iowa Real Estate Appraiser Examining Board	Tel: 515-281-7468 www.state.ia.us	1918 S.E. Hulsizer Avenue Ankeny, IA 50021-3941
Kansas Kansas Real Estate Commission	Tel: 913-296-0706 www.ink.org/public/kreab	820 S. Quincy, Suite 314 Topeka, KS 66612
Kentucky Kentucky Real Estate Appraisers Board	Tel: 502-573-0091 www.kyappraiserboard.com	1025 Capital Center Drive, Suite 100 Frankfort, KY 40601
Louisiana Louisiana Real Estate Commission	Tel: 504-925-4771 www.lrec.state.la.us	9071 Interline Avenue R.O. Box 14785 Baton Rouge, LA 70898
Maine Maine Board Of Real Estate Appraisers	Tel: 207-624-8603 www.state.me.us	35 State House Station 122 Northern Avenue Augusta, ME 04333
Maryland Maryland Dept. Of Licensing & Regulation Real Estate Appraisers Commission	Tel: 410-333-4620 www.state.md.us	501 St. Paul Place, Room 902 Baltimore, MD 21202
Massachusetts Commonwealth Of Massachusetts Division Of Registration	Tel: 617-727-3055 www.magnet.state.ma.us	100 Cambridge Street, Room 1512 Boston, MA 02202
Michigan Dept. Of Consumer & Industry Service Bureau Of Commercial Services	Tel: 517-335-1686 www.cls.state.mi.us	P.O. Box 30018 Lansing, MI 48909
Minnesota Minnesota Department Of Commerce	Tel: 612-296-6319 www.comm.rce.state.mn.us	133 E. 7th Street St. Paul, MN 55101
Mississippi Ms Real Estate Commission	Tel: 601-987-3969	5176 Keele St. P.O. Box 12685 Jackson, MS 39236-2665
Missouri Missouri Real Estate	Tel: 573-751-0038 www.ecodev.state.mo.us	P.O. Box 1335 Jefferson City, MO 65102

APPENDIX

Appraisers Commission		
Montana Board Of Real Estate Appraisers	Tel:406-444-3561 www.commerce.mt.gov	111 N.Jackson P.O. Box 200513 Helena, MT 59620-0513
Nebraska Nebraska Real Estate Appraiser Board	Tel:402-471-9015 http://dbdec.nrc.state.ne.us	301 Centennial Mall South State Office Bldg., 3rd Fl. P.O. Box 9496 Lincoln, NE 685094963
Nevada State Of Nevada, Real Estate Division	Tel: 702-687-6428 www.state.nv.us	Capitol Complex 1665 Hot Springs Road, Room 155 Carson City, NV 89710
New Hampshire NH Real Estate Appraiser Board	Tel: 603-271-6186 www.state.nh.us	State House Annex, Room 426 25 Capitol Street Concord, NH 03301-6312
New Jersey Board Of Real Estate Appraisers Division Of Consumer Affairs	Tel: 201-504-6480 www.state.nj.us	124 Halsey Street P. O. Box 45032 Newark, NJ 07101
New Mexico New Mexico Real Estate Appraisers Board	Tel: 505-827-7554 www.state.nm.us	1599 St. Francis Drive P.O. Box 25101 Santa Fe, NM 87504
Newyork Department Of State Division Of Licensing Services	Tel: 518-473-2728 www.dos.state.ny.us	84 Holland Avenue Albany, NY 12208-3490
North Carolina North Carolina Appraisal Board	Tel: 919-420-7920 www.ncab.state.nc.us/	P.O. Box 20500 Raleigh, NC 27619-0500
North Dakota North Dakota State Appraisal Board	Tel: 701-222-1051	P.O. Box 1336 Bismarck, NO 58502-1336
Ohio Ohio Division Of Real Estate	Tel: 216-787-3100 www.state.oh.us	615 Superior Avenue, N.W., Room 525 Cleveland, OH 44113
Oklahoma Oklahoma Real Estate Appraiser Board	Tel: 405-521-6636	2401 NW 23rd St, Ste 28 Oklahoma City, OK 73107
Oregon Appraiser Certification & Licensure Board Dept. Of Consumer & Business Services	Tel: 503-373-1505 www.cbs.state.or.us	350 Winter Street, NE, Room 21 Salem, OR 97310
Pennsylvania State Board Of Certified Real Estate Appraisers	Tel: 717-783-4866 www.dos.state.pa.us	124 Pine Street 1st Floor Harrisburg, PA 17101
Rhode Island Dept. Of Business Reg. Licensing Licensing & Regulation	Tel: 401-277-2262 www.dbr.state.ri.us	233 Richmond Street, Providence, RI 02903



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Real Estate Appraisal Section		
South Carolina South Carolina Real Estate Appraisal Board	Tel: 803-734-4283 www.leginfo.state.sc.us	3600 Forest Drive, Suite 100 P.O. Box 11329 Columbia, SC 29211-1329
South Dakota South Dakota Department Of Commerce And Regulation	Tel: 605-773-3178 www.state.sd.us	500 East Capitol Pierre, SD 57501
Tennessee Tennessee Real Estate Appraiser Com Mission	Tel: 615-741-1831 www.state.tn.us	500 James Robertson Pkwy. 2nd Floor Nashville, TN 37243
Texas Texas Appraiser Licensing & Certification Board	Tel: 512-465-3950 www.talcb.state.tx.us	P.O. Box 12188 Austin, TX 78711-2188
Utah Utah Division Of Real Estate Department Of Commerce	Tel: 801-530-6747 www.commerce.state.ut.us	Box 146711 Salt Lake City, UT 84145
Vermont Secretary Of States Office Vermont Board Of Real Estate Appraisers	Tel: 802-828-3256 www.sec.state.vt.us	P.O. Box 109 State Street Montpelier, VT 05609-1106
Virginia Department Of Professional & Occupational Regulation	Tel: 804-367-2039	3600 West Broad Street, 5th Floor Richmond, VA 23230-4817
Washington Business & Professions Division	Tel: 360-753-1062 www.wa.gov	P.O. Box 9015 Olympia, WA 98507-9015
West Virginia Licensing And Certification Board	Tel: 304-558-3919 www.state.wv.us	2110 Kanawha Blvd., East, Suite 101 Charleston, WV 25311
Wisconsin Wisconsin Department Of Regulation & Licensing Business & Design Professions	Tel: 608-266-1830 http://badger.state.wi.us	P.O. Box 8935 Madison, WI 53708
Wyoming Certified Real Estate Appraiser Board	Tel: 307-777-7141 www.realestate.wy.us	First Bank Building 2020 Carey Avenue, Suite 100 Cheyenne, WY 82002

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