Buying Homes in Foreclosure

first tuesday

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Buying Homes in Foreclosure

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Introduction

Buying Homes in Foreclosure is written for real estate licensees, equity purchase (EP) investors and attorneys. The course material is designed to be an educational tool for use in the classroom and in correspondence studies as well as a technical research and reference tool.

The objective of this study is to fully provide experienced licensees with complete knowledge of the statutory scheme governing home sales transactions between sellers-in-foreclosure and EP investors. Importantly, EP investors and their agents need to know and apply all the unique EP rules when negotiating and preparing purchase agreements and escrow instructions to acquire an owner-occupied residence in foreclosure. The material in this book is based on California law and controlling federal law existing on the date of this printing.

On completion of this study, agents and EP investors, whether they are licensed or unlicensed individuals acting as principals, will be prepared to handle all aspects of the sale and acquisition of owner-occupied, one-to-four unit residential property in foreclosure.

Included in each chapter is a summary of issues reviewed in the chapter with definitions of the key terms essential to the reader's comprehension of the topic. Unless a form cited in the book says, "See Form XXX accompanying this chapter" [emphasis added], it is not in the book. However, the reader has access to a fillable and savable version of all 400+ **first tuesday** forms online at *firsttuesdayjournal.com*.

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Future errata, supplemental material and recent developments specific to **Buying Homes in Foreclosure** are available for further research within the Online Reading section of the reader's Student Homepage at *firsttuesday.us*.

Chapter 1

Equity purchase investments

Learning Objectives

After reading this chapter, you will be able to:

- document an equity purchase (EP) transaction between an owner-occupant seller of a one-to-four unit residential property in foreclosure and an EP investor who acquires the property for dealer, investment or security purposes;
- apply the specific rules controlling an EP investor acquisition;
- advise on a seller-in-foreclosure's five-business-day right to cancel an EP transaction; and
- explain to EP investors a seller-in-foreclosure's two-year right to rescind a closed purchase transaction.

Key Terms

equity purchase investor
equity purchase transaction
five-business-day right to cancel

The equity purchase investor scheme

An **equity purchase (EP) transaction** takes place when the seller-occupant of a one-to-four unit residential property in foreclosure enters into an agreement and conveys title to the property, for any purpose, to any person who acquires title for:

- dealer purposes; or
- investment or security purposes.

The non-occupying person acquiring title to the residence of a seller-in-foreclosure is called an **EP investor**. Specific rules for rights and remedies apply to all EP transactions.

equity purchase transaction
A property transaction in which a one-to-four unit residential property in foreclosure, occupied by the owner as their principal residence, is acquired for dealer, investment or security purposes by an investor. [See **ft** Form 156]

Conversely, an EP transaction does not occur and the EP rules do not apply if:

- the buyer who acquires title to the property occupies it as their personal residence, such as the classic buyer-occupant of a home; or
- a lender originates a trust deed loan for the acquisition of the property.

The EP codes distinguish *principal residence* from *personal use* of a residence.

The seller of a **principal residence** comes under the protection of EP codes. Exempt buyers avoid application of the EP code. To be exempt from EP rules, the buyer only needs to meet the test of using the property as their personal residence.

Thus, a buyer's acquisition of a second home or vacation home for **personal use** is legislatively exempt from the EP laws, as is their use of the property acquired as their principal residence. All other uses are considered *investment purposes*.

equity purchase investor
A person who acquires title to a seller-occupied, one-to-four unit residential property in foreclosure for dealer, investment or security purposes.

Equity purchase rules and remedies apply to all buyers who are classified by conduct as *EP investors*, regardless of the number of EP transactions the buyer completes as an investor. A buyer, to be designated as an EP investor, is not limited to being in the business of buying homes in foreclosure for EP law to apply.[1]

Both the EP investor and their agent need to comply with EP law or be subject to penalties.

The Equity Purchase (EP) agreement

Initially, EP law controls the content of forms used to document an EP sale. The EP agreement signed by an EP investor will:

- be printed in **bold type**, ranging from 10-point to 14-point font size;
- contain EP right-to-cancel notices to the buyer; and
- be in the same language used during negotiations with the seller-in-foreclosure.[2] [See **first tuesday** Form 156]

Failure to use the correct forms subjects the EP investor and the transaction agents to liability for all losses incurred by the seller-in-foreclosure, plus further penalties.[3] [See Chapter 2]

*Editor's note — **first tuesday's** Equity Purchase Agreement, Form 156, complies with all statutory requirements imposed on an EP investor and sets forth the requisite notice to the seller-in-foreclosure of their right to cancel. [See **first tuesday** Form 156]*

Cancellation within five business days

After entering into an agreement to sell their principal residence while in foreclosure, the seller-in-foreclosure has a **five-business-day right to cancel** the agreement. This period commences on acceptance of an EP

1 **Segura** v. **McBride** (1992) 5 CA4th 102
2 Calif. Civil Code §§1695.2, 1695.3, 1695.5
3 Segura, *supra*

agreement containing the notice of the seller's cancellation rights. During this time period, the seller is permitted to cancel the sale, with or without cause.

five-business-day right to cancel
An owner-occupant seller of a one-to-four unit residential property in foreclosure on entering into a purchase agreement with an investor is entitled to cancel the agreement during a five-business-day period commencing on receipt of notice of the right to cancel. [See **ft** Form 156, page 6]

The *statutory right to cancel within five-business-days* after the seller accepts is set out in boilerplate language contained in equity purchase agreements. If the seller cancels before the period expires, the sale under the purchase agreement may not close. English language EP agreements include proper font throughout and notice to the seller of their five-business-day right to cancel, as they are designed to comply with all aspects of EP law.

The seller's *cancellation period* expires at:

- midnight (12:00 a.m.) of the *fifth business day* following the day the seller accepts an EP agreement submitted by an investor which contains the right to cancel notice; or
- 8:00 a.m. of the day scheduled for the *trustee's sale*, if it is to occur first.[4]

The seller-in-foreclosure's five-business-day period during which they have the right to cancel the transaction does not begin to run until proper notice of the cancellation period is given to the seller.[5]

Occasionally, a purchase agreement is used which fails to contain the requisite notice of right to cancel. Here, the seller may cancel the sales agreement and escrow at any time prior to service of proper notice and the passing of the five-business-days for cancellation.

Further, the seller is permitted to **rescind** the sale even after conveying title when the notice of right to cancel was not delivered more than five business days before the conveyance. The seller's right to rescind the closed sales transaction and recover ownership of the property remains until the running of five business days after notice is actually received by the seller.

Business days under EP law

A **business day** is any day except Sunday and the following business holidays:

- New Year's Day;
- Washington's Birthday;
- Memorial Day;
- Independence Day;
- Labor Day;
- Columbus Day;
- Veterans' Day;
- Thanksgiving Day; and
- Christmas Day.

4 CC §1695.4(a)
5 CC §1695.4(b)

Saturday is considered a business day under EP law, unless it falls on an enumerated holiday. Many state holidays are not included as holidays.[6]

Prohibited activities during the right to cancel period

Until expiration of the right of the seller-in-foreclosure to cancel the transaction, the EP investor may not:

- *accept or induce a conveyance* of any interest in the property from the seller;
- *record any document* with the county recorder regarding the residence signed by the seller;
- *transfer an interest* acquired in the property to a third party;
- *encumber any interest* acquired in the residence; or
- *hand the seller* a "good-faith" deposit or other consideration.[7]

However, escrow may be opened on acceptance of the EP investor's offer for deposit of deeds and funds with escrow. Escrow's involvement does not violate the right to cancel since the seller-in-foreclosure does not convey the property to the buyer and does not receive funds until the close of escrow.

Cancellation of the purchase agreement by the seller-in-foreclosure is *effective on delivery* of the signed written notice of cancellation to the EP investor's address in the EP agreement, part of the right to cancel notice.[8]

When the EP investor receives the seller-in-foreclosure's written notice of cancellation, the EP investor is to return all original documents to the seller within ten days of receipt. Returned documents include the original EP agreement bearing the seller's signature.[9]

When the cancellation period expires without the seller canceling, the purchase agreement becomes enforceable and escrow may close, unless other contingencies remain to be eliminated.

False representations prohibited

In negotiations with the seller-in-foreclosure, the EP investor is prohibited from misrepresenting or making misleading statements about:

- the value of the property in foreclosure;
- the net proceeds the seller receives on closing escrow [See **first tuesday** Form 310];
- the terms of the purchase agreement or any other document the EP investor uses to induce the seller to sign; or
- the rights of the seller in the EP transaction.[10]

These rules also apply to the EP investor's agent.

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6 CC §1695.1(d)
7 CC §1695.6(b)
8 CC §1695.4(b)
9 CC §1695.6(c)
10 CC §1695.6(d)

Sidebar

Locating properties in foreclosure

When an EP investor locates a property in foreclosure and begins an investigation of ownership, mortgage conditions and market value, their agent's due diligence effort includes gathering recorded data regarding:

- *Notice of Defaults (NODs);*
- *Notice of Trustee's Sales (NOTS);*
- *rescission of a NOD and trustee's deed; and*
- *the content of these documents.*

Services exist which gather and publish the daily recording of foreclosure-related documents, their contents, and ancillary information on the properties available from public records and title companies. The reporting is available primarily online, and is updated daily.

The foreclosure data is obtained directly from recorded documents or from providers of the data who collect and enter the data directly from the county recorder's records.

Companies that provide these online services are available at:

- *www.retran.net;*
- *www.countyrecordsresearch.com;*
- *www.foreclosureradar.com;*
- *www.foreclosures.com; and*

The buyer's agent is able to filter search results by factors such as:

- *address (ZIP code/city/county);*
- *type of property;*
- *recording dates of the trust deed/NOD/NOTS; or*
- *original loan amount or delinquency amount.*

Post-closing rescission rights, penalties

After escrow closes on a properly documented EP transaction, and while the EP investor remains the owner, the EP investor's title is subject to the seller-in-foreclosure's right of rescission for two years.

To be effective, the seller's rescission of a closed sales transaction needs to be based on evidence of **unconscionable conduct** the EP investor engaged in with regards to the transaction. Any attempt to get around this right to rescind by waiver of the seller's two-year right to rescind and recover the property is void and unenforceable.[11] [See Chapter 4]

Also, any provision in an EP agreement or escrow instructions that purports to limit the liability of the EP investor for money losses claimed by the seller due to misrepresentations of the EP investor or their broker is void. [See **first tuesday** Form 150 §10.8]

Further, the EP investor is liable for all losses incurred by the seller-in-foreclosure due to misrepresentations made by the EP investor or their agent.[12]

The EP investor is liable for any of the seller's money losses caused by failure of the EP investor or their agent to comply with EP law. The seller-in-foreclosure has four years from the date of the EP investor's violation to recover their money losses and penalties.

11 CC §§1695.10, 1965.14
12 CC §1695.15

Cancellation within five business days

If the EP investor acquires title and transfers or encumbers the property before the cancellation period expires after notice, the EP investor is further subject to:

- a statutory penalty of three times the amount of the seller's monetary losses; or
- a minimum $2,500 civil penalty.[13] [See Chapter 2]

An EP investor who violates the five-day cancellation period or takes unconscionable advantage of the seller-in-foreclosure is subject to imprisonment and a fine no greater than $25,000 or both for each violation.[14]

13 CC §1695.7
14 CC §1695.8

Chapter 1 Summary

An equity purchase (EP) transaction takes place when the seller-occupant of a one-to-four unit residential property in foreclosure enters into an agreement and conveys title to the property, for any purpose, to any person who acquires title for:

- dealer purposes; or
- investment or security purposes.

The non-occupying person acquiring title to the residence of a seller-in-foreclosure is called an EP investor. Specific rules for rights and remedies apply to all EP transactions.

Failure to use the correct forms subjects the EP investor and the transaction agents to liability for all losses incurred by the seller-in-foreclosure, plus further penalties.

After entering into an agreement to sell their principal residence while in foreclosure, the seller-in-foreclosure has a five-business-day right to cancel the agreement. This period commences on acceptance of an EP agreement containing the notice of the seller's cancellation rights. During this time period, the seller is permitted to cancel the sale, with or without cause.

After escrow closes on a properly documented EP transaction, and while the EP investor remains the owner, the EP investor's title is subject to the seller-in-foreclosure's right of rescission for two years. To be effective, the seller's rescission of a closed sales transaction needs to be based on evidence of unconscionable conduct the EP investor engaged in with regards to the transaction.

Further, the EP investor is liable for all losses incurred by the seller-in-foreclosure due to misrepresentations made by the EP investor or their broker.

Chapter 1 Key Terms

Chapter 2

The equity purchase agreement

Learning Objectives

After reading this chapter, you will be able to:

- apply the guidelines for an equity purchase (EP) investor's acquisition of a seller's principal residence in foreclosure;
- prepare an EP offer using an EP agreement; and
- advise on the penalties for an investor violating EP laws.

Key Terms

bona fide purchaser (BFP)
equity purchase transaction
two-year right of rescission

An EP investor's proper documentation

Consider a seller who defaults on a note secured by a trust deed lien on their principal residence, a one-to-four unit residential property. A **Notice of Default (NOD)** is recorded as agreed under the power-of-sale provision in the trust deed, placing the property in foreclosure. [See **first tuesday** Form 471]

An EP investor, having good credit and no knowledge of **equity purchase (EP)** laws, orally agrees to use their creditworthiness for the benefit of the seller-in-foreclosure. The EP investor agrees to refinance the property in exchange for a fee to be paid monthly by the seller, until fully paid. The seller conveys title to the investor for purposes of recording the refinancing and as security for the seller's deferred payment of the extension-of-credit fee due the EP investor.

It is additionally agreed the seller will remain in possession, pay all the costs of ownership and make monthly payments to the EP investor to cover payments on the refinancing and the fee due the EP investor. Title will be reconveyed to the seller when the fee due to the EP investor is fully paid and the seller assumes the refinancing debt.

No written agreement or escrow instructions are entered into to document the transfer of title or the terms of the extension-of-credit and refinancing. The seller conveys title to the investor by handing the EP investor a signed grant deed. The EP investor records the deed.

Concurrent with the delivery of the grant deed, the seller enters into a written lease agreement and option to purchase with the EP investor. The agreement calls for the payment of monthly rent and includes a *purchase option*. The option allows the seller to recover title to their property on payment of an unspecified sum of money. The lease option agreement to purchase also states the EP investor reserves the right to sell the property on the seller's default on the lease agreement.

The seller receives no funds for the conveyance of their equity to the EP investor.

Seller-in-foreclosure recovers value of lost equity

Continuing our example, the EP investor on taking title from the seller-in-foreclosure transfers title to themselves and their spouse as joint tenants. A first trust deed loan is originated which funds the payoff of the existing loan. The new loan is sufficient in amount for the EP investor to recover all the funds advanced to pay off the loan in foreclosure and the costs of the new loan, including:

- title insurance premiums;
- escrow fees; and
- loan charges.

Later, when interest rates drop, the investor again refinances the property. The refinancing reduces the EP investor's monthly loan payments, thus increasing their net cash flow from the rent they receive under the seller's leaseback. Prepayment penalties are incurred on the payoff, as well as origination costs for the new loan, all of which are covered by inclusion in the new loan amount.

The seller defaults on the lease agreement. A 3-day notice to pay rent or quit is served on the seller due to their default on the lease agreement. The seller does not pay and is evicted. [See **first tuesday** Form 575 and 575-1]

bona fide purchaser (BFP)
A buyer other than the mortgage holder who purchases a property for value at a trustee's sale without notice of title or trustee's sale defects.

The EP investor sells the property, conveying title to a buyer. The buyer is a **bona fide purchaser (BFP)**, unaware of the seller's unrecorded option rights to repurchase the property. No sales proceeds remain after the loan payoff due to a decline in the property's value after the investor first took title.

The seller now makes a demand on the EP investor for the dollar value of their lost equity in the property, claiming the transfer violated the state's EP laws. The amount demanded is based on the value of the seller's equity at the time the investor took title.[1]

1 **Boquilon** v. **Beckwith** (1996) 49 CA4th 1697

Is the seller who was in foreclosure at the time the EP investor acquired title entitled to recover the value of their equity from the EP investor?

Yes! The seller conveying title to their principal residence to an EP investor when in foreclosure is entitled to recover money losses equal to *four times* the sum of the fair market value (FMV) of their equity at the time they conveyed title to the EP investor, minus any funds they may have received from the EP investor.[2]

Recovery of the seller's lost equity is allowed since the EP investor violated EP law on each of the following events:

- failure to document in writing the terms for repayment of the funds the EP investor was owed[3];
- acquiring title to the seller's principal residence without first entering into a written purchase agreement that conforms to EP law[4]; and
- further transferring title to the property (to their spouse and again to the BFP) without the written consent of the seller.[5]

Editor's note — The EP investor in our facts was actually acting as a lender. All this chaos is avoided when the loan transaction is structured as a note and trust deed loan. As a loan, their advance of payoff funds is evidenced by a note signed by the seller in their favor and secured by a trust deed on the property. Then, if the EP investor/lender needs to recover their advance of funds, they either collaterally assign or sell the note and trust deed to another EP investor interested in holding a trust deed note. Note and trust deed documentation of the advance of funds complies with EP law and avoids penalties for failure to comply due to a transfer of title when the property is the seller's residence and a trust deed on it is in foreclosure.

Title to real estate is not transferred when a trust deed lien is created to encumber the property as security for the loan.[6]

equity purchase transaction
A property transaction in which a one-to-four unit residential property in foreclosure, occupied by the owner as their principal residence, is acquired for dealer, investment or security purposes by an EP investor. [See **ft** Form 156]

The EP transaction

An **EP transaction** occurs on the sale of a one-to-four unit residential property when a trust deed encumbrance on the property is in foreclosure and the property is occupied as the seller's principal residence, if the buyer acquires title for:

- dealer purposes (resale on a flip, whether or not rented in the interim); or
- investment (to hold as a rental income property) or security purposes.

Documenting EP sales transaction

Now consider the sale of a one-to-four unit residential property that is occupied by the seller as their principal residence. The property is in foreclosure under a trust deed. The seller's agent locates a buyer who does

2 **Segura** v. **McBride** (1992) 5 CA4th 1028
3 Calif. Civil Code §1695.3(d)
4 CC §1695.6(a)
5 Boquilon, *supra*; CC §1695.6(e)
6 **Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454

not intend to occupy the property as their principal residence. Thus, as an EP investor, the buyer is acquiring the property for either dealer or investment purposes. The EP investor is not represented by a broker.

A preprinted form EP agreement in compliance with EP law is used by the EP investor to document the sales transaction. [See Figure 1, **first tuesday** Form 156]

Escrow is immediately opened, conditioned on the expiration of the **five-business-day right** of the seller to cancel following acceptance. Escrow instructions are prepared and deeds are deposited in escrow, but the investor will not place any funds in escrow until escrow makes a demand for funds on closing. [See Chapter 1]

The seller-in-foreclosure's *five-business-day right* to cancel expires without the seller exercising the right. Thus, the EP agreement is now enforceable since no contingencies remain to be eliminated before escrow may use the seller's grant deed. The EP investor on a demand for funds from escrow deposits funds and the transaction closes.

Right of rescission, recovery of residence

However, once the period for the notice of right to cancel in the EP agreement runs and the transfer occurs, the EP investor has an additional EP risk to consider: their title is subject to the seller-in-foreclosure's **two-year right of rescission,** which commences upon closing.

The *two-year right of rescission* is based on the existence of any **unconscionable advantage** the EP investor may have introduced into the negotiations that brought about the sale. The two-year right of rescission cannot be *waived* by the seller in an effort by the EP investor to eliminate the EP risk imposed on an EP investor after closing.[7] [See Chapter 4]

two-year right of recission
A seller-in-foreclosure's right to rescind a closed equity purchase transaction when the equity purchase investor exploits an unconscionable advantage during negotiations to acquire the property.

However, the seller-in-foreclosure cannot rescind a closed sale and recover the property by exercising this right if the EP investor has:

- resold the property to a buyer who is classified as a *BFP*; or
- further encumbered the property with a loan originated by a lender classified as a BFP.

A buyer or lender's knowledge that the investor acquired the property from a seller-in-foreclosure does not affect their BFP status.

However, buyers and lenders acquiring their interest in the property from an EP investor do not qualify as a BFP if:

- a recorded **lis pendens** notifies them of the seller's claim; or
- the seller is still in possession of the property and, upon inquiry, they would have discovered their claim to recover title based on unconscionability or under some repurchase agreement.[8]

7 CC §§1695.10, 1695.14

8 CC §1695.14(c)

Instead of recovering title when the EP investor has resold the property to a BFP, the recovery by the seller-in-foreclosure is converted to a recovery of money loses.[9]

Money recovered on an EP law violation

Although the EP investor in the opening scenario violated three separate aspects of EP law, it is the date of the *first violation* that sets the valuation date of the seller's equity for recovery of money – lost value in the property's equity.[10]

Regardless of whether the EP investor still holds title to the property, the amount of money the seller-in-foreclosure can recover as their loss is:

- the FMV value of the property on the valuation date;

  less

- the unpaid principal and accrued interest on the existing loan at the time of the violation;

  less

- any money advances received by the seller-in-foreclosure from the EP investor.[11]

More importantly, the seller automatically recovers punitive money losses not less than three times their actual money losses for their equity, known as *treble damages*.[12]

The seller-in-foreclosure is also entitled to a statutory 10% annual rate of interest on the value of the equity they lost from the valuation date — the day they were separated from their equity by a transfer of title.[13]

Conversely, the EP investor is not entitled to any offsets against the dollar amount of the seller's equity.

Disallowed offsets

Disallowed offsets the EP investor cannot claim include:

- escrow costs;
- prepayment penalties;
- carrying costs of the property;
- maintenance and improvement costs; or
- any post-violation decline in the property's value due to adverse market conditions.[14]

However, the seller-in-foreclosure is not entitled to a refund of rental payments paid to the investor since they may not occupy property rent-free, regardless of the illegality of the circumstances.[15]

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9 Segura, *supra*
10 Segura, *supra*
11 Boquilon, *supra*
12 CC §1695.7
13 Segura, *supra;* CC §3288
14 Boquilon, *supra;* CC §1695.7
15 Boquilon, *supra*

Any recovery of money by the seller-in-foreclosure needs to be settled or an action filed within four years of the valuation date since a later filing of an action is barred.[16]

Further, the seller, due to the conveyance in violation of EP laws, has an alternative to seeking money during the four year statute of limitations period. Instead, the seller may seek **equitable relief**, such as **rescission and restoration** of their ownership if the investor still holds title — in addition to the two-year restoration of title based on unconscionable advantage claims.[17]

Structuring the EP agreement

An EP investor seeking an investment in single family residences (SFRs) contacts their real estate sales agent.

The agent locates a seller-occupied SFR encumbered by a trust deed lien which is in foreclosure since an *NOD* has been recorded. The EP investor is advised they need to comply with California's EP laws when preparing and submitting an offer to purchase the property. [See Figure 1, **first tuesday** Form 156]

Terms of the purchase

The EP investor is willing to purchase the SFR by:

- paying $10,000 cash to the seller-in-foreclosure for their equity in the property;
- taking over the existing loan with a total of $316,000 due to the lender in unpaid principal, delinquent installments of principal, interest, taxes and insurance (PITI), and foreclosure costs.

An EP agreement is then prepared, calling for a $10,000 cash down payment.

The EP investor will take title to the property subject to the existing first trust deed note with a 28-year amortization period remaining, in spite of the due-on clause in the lender's trust deed.

The conditions of the trust deed note are:

- $300,000 remaining principal on closing (after the delinquent payments have been brought current);
- 6.5% fixed rate of interest;
- $1,896 monthly principal and interest payments;
- $360 monthly taxes/insurance (TI) impounds payments;
- five months of delinquent payments on PITI of $12,280; and
- foreclosure costs of $2,900.

The first trust deed is a loan insured by the Federal Housing Administration (FHA) subject to the Department of Housing and Urban Development (HUD) due-on-sale rules controlling investor purchases.

16 CC §1695.7
17 CC §1695.7

However, only *HUD*, not the lender, has the right to call a HUD-insured loan. The likelihood of HUD calling any loan that is kept current is remote. Thus, the EP investor may take over the loan "subject to" the due-on-sale rules with minimal interference from the lender. In this way, assumption fees and a loan modification (to current higher interest rates) are avoided. [See Chapter 14]

The seller-in-foreclosure will not be carrying back a portion of the purchase price since this is a cash-to-loan transaction. As an alternative, negotiations might have arranged for the seller to carryback paper in the EP transaction.

Tax-wise, the payment of the delinquent principal and interest (PI) payments — not the taxes and impounds (TI) — is reported as part of the EP investor's original costs of acquisition. The interest paid by the investor that accrued before acquiring the property is an expense of the seller-in-foreclosure, not the investor. Thus, the payment of the seller's debts assumed/taken over by the investor must be *capitalized* as part of their cost basis in the property.[18]

Cost basis on acquisition

Continuing our previous example, the investor's *cost basis* on acquisition of the property will be the purchase price of approximately $325,000, which includes:

- the down payment;
- the seller's delinquent (PI) installments;
- foreclosure costs;
- the principal balance on the loan; and
- transactional costs, less the impound account balance assigned to the investor.

A prudent EP investor will determine the total cash funds needed to close escrow before making an offer. Cash expenditures of the EP investor on closing include:

- a down payment of $10,000;
- delinquent principal, interest, taxes, and impounds of $12,280;
- foreclosure costs of $2,900; and
- escrow fees and charges of $1,000.

Thus, the EP investor's total cash investment is $25,200. [See **first tuesday** Form 311]

Analyzing the EP agreement

The Equity Purchase Agreement, **first tuesday** Form 156, is used by an agent to prepare a written offer to be entered into by an investor or dealer to purchase a one-to-four unit residential property which is occupied by the seller as their principal residence and is in foreclosure.

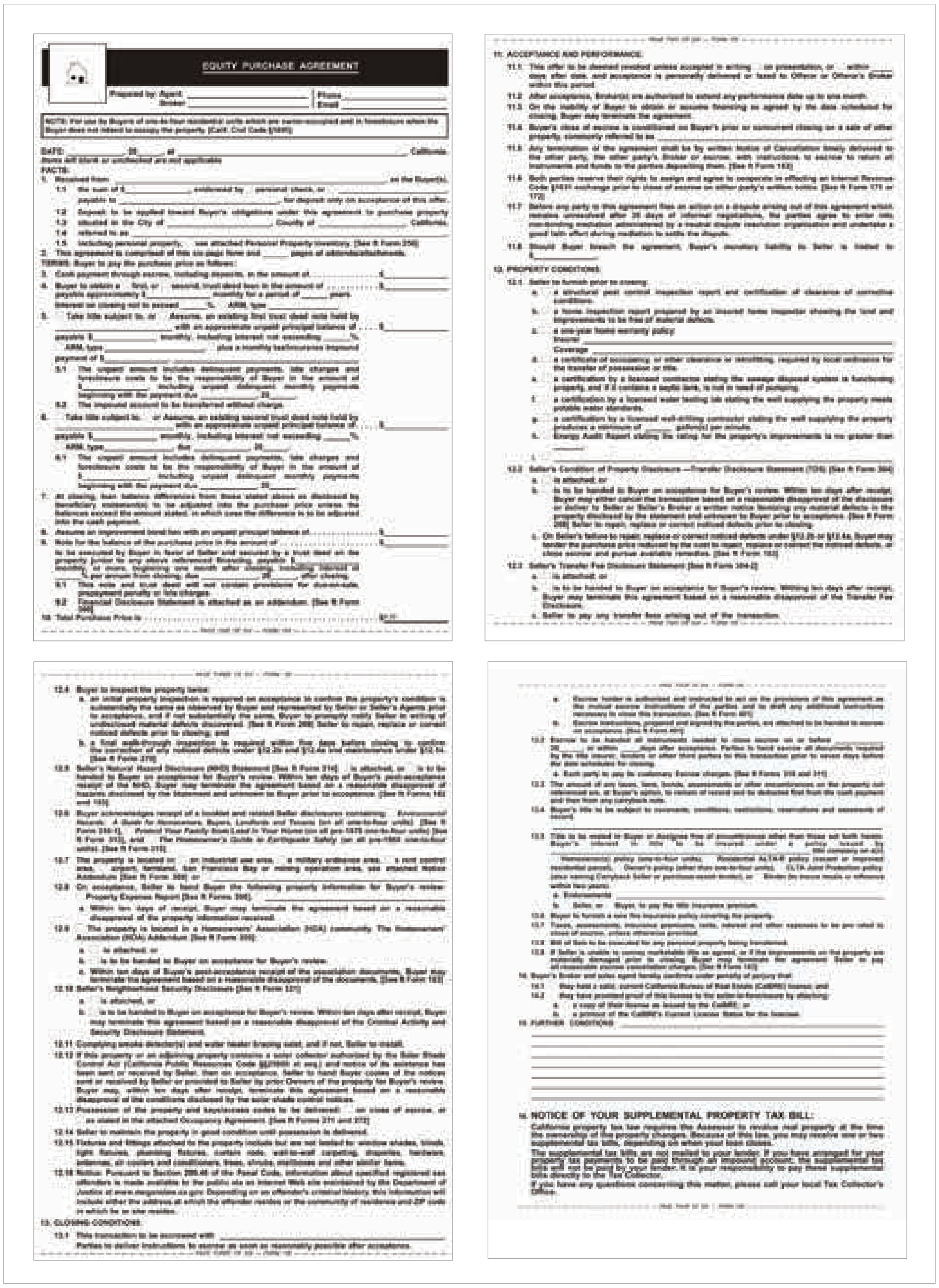
18 Internal Revenue Code §1012

Figure 1

Form 156

Equity Purchase Agreement

Page 1 - 4


EQUITY PURCHASE AGREEMENT

As required by EP law, the form contains bold print, minimum size type and the statutory notice of the five-business-day right of cancellation, as well as the actual *Notice of Cancellation* for use by the seller who chooses to cancel the agreement.

A purchase of the seller-occupied residence in foreclosure by a buyer who will occupy the property as their residence does not require the use of an EP agreement since the purchase is not subject to EP law.

NOTICE REQUIRED BY CALIFORNIA LAW:

Until your right to cancel this contract has ended,

______________________________(Buyer)

or anyone working for

______________________________(Buyer)

CANNOT ask you to sign or have you sign any deed or any other document.

You may cancel this contract for the sale of your house, without any penalty or obligation at any time before ____:____ ____m. on ____________, 20____.

See attached Notice of Cancellation form for an explanation of this right.
(To be filled out by Buyer)

NOTICE OF CANCELLATION

NOTICE OF CANCELLATION

Figure 1

Form 156

Equity Purchase Agreement

Page 5 - 6

However, an EP transaction requiring the use of an EP agreement does occur when a buyer acquires the seller-occupant's one-to-four unit property for:

- dealer resale purposes, being a business; or
- rental, a buy-to-let investment program.

Components of the EP agreement

The terms for payment of the price are structured to include a **lump sum** amount of cash to be paid to the seller for their equity in the property. Thus, the seller will receive this lump sum amount unchanged by any adjustments, prorations, credits and offsets. The EP investor will pay all closing costs and delinquencies based on the seller's representations of sums owing on encumbrances affecting title to the property.

Each section in Form 156 has a separate purpose and need for enforcement. The sections include:

1. *Identification:* The date of preparation, the real estate and any personal property to be purchased, and the number of pages comprising the entire agreement including addenda are set forth in Sections 1 and 2.
2. *Price and terms of payment:* All the typical variations for payment of the price are set out in Sections 3 through 10 as a "checklist of provisions." The EP investor selects the terms of purchase by checking boxes and filling blanks in the desired provisions. While the subject matter of the various provisions is typical, the terms each contains are not. All financial aspects are biased in favor of the buyer, such as prorates and adjustments, since EP transactions are structured as the payment of a lump sum for the conveyance.

3. *Acceptance and performance:* Aspects of the formation of a contract, justification for nonperformance and termination of the agreement are provided for in Section 11, such as the time period for acceptance of the offer, the broker's authorization to extend performance deadlines, the financing of the price as a closing contingency, procedures for cancellation of the agreement, a sale of other property as a closing contingency, cooperation to effect a §1031 transaction and limitations on monetary liability for breach of contract.
4. *Property conditions:* The EP investor's confirmation of the physical condition of the property as disclosed prior to acceptance is provided for in Section 12. This is accomplished by the seller's delivery of:
   - reports;
   - warranty policies;
   - certifications;
   - disclosures statements;
   - an environmental lead-based paint and earthquake safety booklet;
   - any operating cost and income statements; and
   - any homeowners' association (HOA) documents not handed to the EP investor prior to entry into the purchase agreement, as well as by the EP investor's initial inspection, personally or by a home inspector, and final inspection at closing to confirm the seller has eliminated defects known, but not disclosed, prior to acceptance.
5. *Closing conditions:* The escrow holder, escrow instruction arrangements and the date of closing are established in Section 13, as are title conditions, title insurance, hazard insurance, prorates and loan adjustments.
6. *Brokerage and agency:* The release of sales data on the transaction to trade associations is authorized, the brokerage fee is set, and the delivery of the agency law disclosure to both the EP investor and seller and the disclosure of compliance with proof of licensure and any future bonding requirements is provided for as set forth in Sections 14 and 18, as well as the confirmation of the agency undertaken by the brokers and their agents on behalf of one or both parties to the agreement.
7. *Notice of supplemental property tax:* Notifies the EP investor they will receive one or two supplemental property tax bills they are to pay when the county assessor revalues the property after a change in ownership, as set forth in Section 16.
8. *Seller's right to cancel:* A requisite by EP rules and remedies, the notice to the seller-occupant whose home is in foreclosure is set forth in Section 19, disclosing the seller' right to cancel the entire transaction within five business days after they enter into this agreement. The notice is one of two major additions imposed on standard purchase agreements by EP law. The other is the Notice of Cancellation used by the seller to implement the right to cancel during the five-business-day period following the seller's acceptance.

9. *Notice of Hazardous Liquid Pipelines:* Notifies buyer that the locations of gas and hazardous liquid transmission pipelines are available to the public via the Department of Transportation website, as set forth in Section 17.
10. *Signatures:* The seller and EP investor bind each other to perform as agreed in the purchase agreement by signing and dating their signatures to establish the date of offer and acceptance.
11. *Cancellation notice:* Separate from the actual EP purchase agreement is the form completed by the EP investor, in duplicate, that the seller will use if they choose to cancel the agreement. By signing and delivering one of the easily detachable cancellation forms to the EP investor at any time before midnight of the fifth business day after the date the seller signs the agreement, the seller effectively cancels the entire EP purchase agreement, with or without reason.

Preparing the EP agreement

The following instructions are for the preparation and use of the EP Agreement, **first tuesday** Form 156. Form 156 is designed to comply with EP law when prepared for use by an investor as an offer to purchase a one-to-four unit, seller-occupied residential property in foreclosure.

*Editor's note — See **first tuesday** Form 156-1 for an EP Agreement with short sale provisions.*

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the offer is prepared. This date is used when referring to this purchase agreement.

Facts:

1. *Buyer, deposit and property:* **Enter** the name of each buyer/EP investor who will sign the offer.

   1.1 **Enter** the dollar amount of any good-faith, earnest money deposit. Check the appropriate box to indicate the form of the good-faith deposit. Enter the name of the payee (escrow, title company, or broker).

   1.3 **Enter** the name of the city and county in which the property is located.

   1.4 **Enter** the legal description or common address of the property, or the assessor's parcel number (APN).

   1.5 **Check** the box to indicate personal property will be included in the sale. The seller's trade fixtures to be purchased by the buyer must be listed as inventory if they are to be acquired by the buyer. [See **first tuesday** Form 256]

2. *Entire agreement:* **Enter** the number of pages comprising all of the addenda, disclosures, etc., which are attached to the purchase agreement.

Terms for payment of the purchase price:

3. *Cash down payment:* **Enter** the dollar amount of the buyer's cash down payment toward the purchase price. The down payment represents the amount of cash the seller-in-foreclosure will receive on closing, less any adjustments, escrow charges and fees.
4. *New trust deed loan:* **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed loan. **Enter** the amount of the loan, the monthly PI payment, the term of the loan and the rate of interest. **Check** the box to indicate whether the interest will be adjustable (ARM), and if so, **enter** the index name. **Enter** any limitations on loan points.
5. *First trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing first trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly principal and interest (PI) payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment. **Enter** any due date or other terms unique to the loan.

   5.1 *Delinquencies:* **Enter** the dollar amount required to cure all defaults on the loan. **Enter** the date the loan payments became delinquent.

   5.2 *Impound balances:* **Authorizes** the impound account to be transferred without charge to the EP investor.

6. *Second trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing second trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name.

   6.1 *Delinquencies:* **Enter** the dollar amount required to cure all defaults on the loan. **Enter** the date the loan payments became delinquent.

7. *Loan balance adjustments:* **Authorizes** any adjustments due to differences between the loan balances stated in the agreement and actually existing at the time of closing to be made into the purchase price. However, if the balance on the loans exceeds the amount stated in the purchase agreement, the difference is subtracted from the cash down payment.

8. *Improvement bond lien:* **Enter** the amount of the principal balance remaining unpaid on improvement bond liens which will remain unpaid and become the responsibility of the buyer on closing.

*Editor's note — Improvement bonds are obligations of the seller which may be assumed by the EP investor in lieu of their payoff by the seller. If assumed, the bonded indebtedness becomes part of the consideration paid for the property. Some purchase agreements erroneously place these bonds under "property tax" as though they were **ad valorem taxes**, and then fail to prorate and charge the unpaid amount to the seller.*

9. *Seller carryback note:* **Enter** the amount of the carryback note to be executed by the EP investor as partial payment of the price. **Enter** the amount of the note's monthly PI payment, the interest rate and the due date for the final/balloon payment.
   - 9.1 *Special carryback provisions:* No transfer restrictions or charges for early payoff or late payment will be included in the carryback note and trust deed.
   - 9.2 *Financial Disclosure:* **Fill out** and **attach** a Financial Disclosure Statement as an addendum. [See **first tuesday** Form 300]

Editor's note — Further approval of the disclosure statement in escrow creates by statute a buyer's contingency allowing for cancellation until time of closing on any purchase of one-to-four unit residential property.

10. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 4, 5, 6, 8 and 9.

Acceptance and performance periods

11.1 *Delivery of acceptance:* **Check** the appropriate box to indicate the time period for acceptance of the offer. If applicable, **enter** the number of days in which the seller may accept this offer and form a binding contract.

Editor's note — If "on presentation" is used, the seller still has a statutory period of five business days to cancel the agreement after the seller's acceptance.

11.2 *Extension of performance dates:* **Authorizes** the brokers to extend the performance dates up to one month to meet the objectives of the agreement — time being of a reasonable duration and not the essence of this agreement as a matter of policy. This extension authority does not extend to the acceptance period.

11.3 *Loan contingency:* **Authorizes** the EP investor to cancel the transaction at the time scheduled for closing if the financing for payment of the price is not obtainable or assumable.

11.4 *Sale of other property:* If the closing of this transaction is to be contingent on the EP investor's receipt of net proceeds from a sale of other property, **enter** the address of the property to be sold by the EP investor.

11.5 *Cancellation procedures:* **Provides** the method of cancellation required to terminate the agreement when the right to cancel is triggered by other provisions in the agreement, such as contingency or performance provisions.

11.6 *Exchange cooperation:* **Requires** the parties to cooperate in an IRS §1031 transaction on further written notice by either party. **Provides** for the parties to assign their interests in this agreement.

11.7 *Mediation provision*: **Provides** for the parties to enter into non-binding mediations to resolve a dispute remaining unsolved after 30 days of informal settlement negotiations.

11.8 *Liability limitations:* **Provides** for a dollar limit on the EP investor's liability for the EP investor's breach of the agreement. **Enter** the maximum dollar amount of money losses the seller may recover from the EP investor for breach of the EP agreement.

Editor's note — Liability limitation provisions avoid the misleading and unenforceable forfeiture called for under liquidated damage clauses included in most purchase agreement forms provided by other publishers of forms.

Property conditions

12.1 *Seller to furnish:* **Check** the appropriate box(es) within the following subsections to indicate the items the seller is to furnish prior to closing.

a. *Pest control:* **Check** the box to indicate the seller is to furnish a structural pest control report and clearance.

b. *Home inspection report:* **Check** the box to indicate the seller is to employ a home inspection company and furnish the buyer with the company's home inspection report.

c. *Home warranty:* **Check** the box to indicate the seller is to furnish an insurance policy for home repairs. **Enter** the name of the insurer and the type of coverage, such as for the air conditioning unit, etc.

d. *Local ordinance compliance:* **Check** the box to indicate the seller is to furnish a certificate of occupancy or other clearance required by local ordinance.

e. *Sewer or septic certificate:* **Check** the box to indicate the seller is to furnish a certificate of the condition of the sewage disposal system stating it is functioning properly.

f. *Potable well water:* **Check** the box to indicate the seller is to furnish a certificate stating the well supply meets water standards.

g. *Well water capacities:* **Check** the box to indicate the seller is to furnish a certificate stating the amount of water the well supplies. **Enter** the number of gallons per minute the well is expected to produce.

h. *Energy Audit Report:* Stating maximum rating for the property's improvements.

i. *Other terms:* **Check** the box and **enter** any other report, certification or clearance the seller is to furnish.

12.2 *Property condition(s):* **Check** the appropriate box within the following subsections to indicate the status of the Transfer Disclosure Statement (TDS).

a. *Attached TDS:* **Check** the box to indicate the seller's TDS has been prepared and handed to the buyer, and if so, **attach** it to this agreement. Thus, the property's condition is accepted by the EP investor upon entering into the purchase agreement offer.

*Editor's note — Use of the TDS form is mandated on one-to-four unit residential property. [See **first tuesday** Form 304]*

b. *Later delivered TDS:* **Check** the box to indicate the TDS is to be **delivered later** to the EP investor to confirm the condition of the property is as disclosed prior to entry into the purchase agreement. On receipt of the TDS, the EP investor may either cancel the transaction for failure of the seller or the seller's agent to disclose known property defects prior to acceptance of the purchase agreement (or counteroffer), or give notice to the seller of the defects known and not disclosed prior to acceptance and make a demand on the seller to correct them prior to closing.

c. *Repair of defects:* **Authorizes** the EP investor to either cancel the transaction or adjust the price if the seller fails to correct the defects noticed under Sections 12.2b or 12.4a.

12.3 *Transfer Fee Disclosure Statemen*t: **Check** the appropriate box within the following subsections to indicate the status of the seller's Transfer Fee Disclosure Statement (TFDS). [See **first tuesday** Form 304-2]

a. *Attached TFDS:* **Check** the box to indicate the seller's Transfer Fee Disclosure Statement has been prepared and handed to the buyer, and if so, **attach** it to this agreement.

b. *Later delivered TFDS:* **Check** the box to indicate the TFDS is to be **delivered later** to the buyer to confirm the existence of a transfer fee as disclosed prior to entry into the purchase agreement. On receipt of the TFDS, the buyer may terminate this agreement based on a reasonable disapproval of the TFDS.

c. Transfer fee: Requires the seller to pay any transfer fees arising out of this transaction.

12.4 *EP investor's inspection:* **Authorizes** the EP investor to inspect the property twice during the escrow period to verify its condition is as disclosed by the seller prior to the time of acceptance.

a. *Initial property inspection:* **Requires** the EP investor to inspect the property immediately after acceptance to put the seller on notice of material defects to be corrected by the seller prior to closing. [See **first tuesday** Form 269]

b. *Final walk-through inspection:* **Requires** the EP investor to inspect the property again within five days before closing to confirm repairs and maintenance of the property have occurred. [See **first tuesday** Form 270]

12.5 *Seller's Natural Hazard Disclosure (NHD) Statement:* **Check** the appropriate box to indicate whether the NHD statement disclosing the seller's knowledge about the hazards listed on the form has been prepared and handed to the EP investor. If it has been received by the EP investor, **attach** a copy to the purchase agreement. If the NHD will be handed to the EP investor after acceptance, the EP investor has ten days after the EP investor's receipt of the NHD statement in which to approve it or cancel.

Editor's note — Disclosure by the seller is mandated on one-to-four unit residential property.[19]

12.6 *Hazard disclosure booklets:* **Check** the appropriate box(es) to indicate which hazard booklets have been received by the EP investor, together with the seller's prepared and signed disclosures accompanying each booklet. [See **first tuesday** Form 316-1]

12.7 *Other property disclosures:* **Check** the appropriate box(es) to indicate other disclosures made by the seller regarding the location of the property. **Enter** a reference to any local (option) ordinance disclosure statement attached as an addendum to the purchase agreement and **attach** it. [See **first tuesday** Form 307]

12.8 *Property Expense Report*: **Check** the appropriate box(es) to indicate the information the seller is to disclose regarding the operating expenses of ownership. [See **first tuesday** Form 306]

a. *Disclosure approval*: **Authorizes** the EP investor to cancel the purchase agreement and escrow if the operating expense disclosure is unacceptable within 10 days of receipt.

12.9 *The Homeowners' Association (HOA) Addendum*: **Check** the appropriate box to indicate whether the HOA Addendum is attached or will be delivered on acceptance to the EP investor for their review. [See **first tuesday** Form 309]

a. *Attached disclosure*: **Check** the box to indicate the HOA Addendum has been prepared and handed to the buyer, and if so, **attach** it to this agreement.

b. *Later delivered disclosure:* **Check** the box to indicate the HOA Addendum is to be **delivered later** to the buyer.

c. *Disapproval of HOA documents*: **Authorizes** the EP investor to terminate this purchase agreement within ten days after their receipt of HOA documents based on reasonable disapproval of the documents.

12.10 *Seller's Neighborhood Security Disclosure*: **Check** the appropriate box within the following subsections to indicate the status of the seller's Criminal Activity and Security Disclosure Statement. [See **first tuesday** Form 321]

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19 CC *§1103*

a. *Attached disclosure*: **Check** the box to indicate the seller's Criminal Activity and Security Disclosure Statement has been prepared and handed to the buyer, and if so, **attach** it to this agreement.

b. *Later delivered disclosure:* **Check** the box to indicate the Criminal Activity and Security Disclosure Statement is to be **delivered later** to the buyer. On receipt of the disclosure, the buyer may terminate this agreement based on a reasonable disapproval.

12.11 *Safety compliance:* **Requires** smoke detectors and water heater bracing to exist or be installed by the seller.

12.12 *Solar Collector Notice:* **States** the seller will hand a copy of the notice received from any neighbor to the buyer. If the seller sent neighbors a notice, a list of everyone who was sent a notice is to be handed to the buyer. The buyer is authorized to terminate this purchase agreement for cause within ten days after receipt.

12.13 *Buyer's possession:* **Check** the appropriate box to indicate when possession of the property will be delivered to the EP investor, whether at closing or under an **attached** buyer's interim occupancy or seller's holdover agreement. [See **first tuesday** Forms 271 and 272]

12.14 *Property maintenance:* **Requires** the seller to maintain the present condition of the property until the close of escrow.

Editor's note — See Section 12.4b for the buyer's final inspection to confirm maintenance at closing.

12.15 *Fixtures and fittings:* **Confirms** this agreement includes real estate fixtures and fittings as part of the property purchased.

*Editor's note — Trade fixtures are personal property to be listed as items on an attached inventory. [See **first tuesday** Form 256]*

12.16 *Sex offender disclosure:* **Complies** with requirements that the seller disclose the existence of a sex offender database on the sale (or lease) of one-to-four residential units.

Editor's note — By the existence of the disclosure in the form, the seller and brokers are relieved of any duty to make further disclosures regarding registered sex offenders.

Closing conditions

13.1 *Escrow closing agent:* **Enter** the name of the escrow company handling the closing.

a. *Purchase agreement as escrow instructions*: **Check** the box to indicate the purchase agreement is to also serve as the mutual instructions to escrow from the parties. The escrow company will typically prepare supplemental instructions they will need to handle and close the transaction.

b. *Separate escrow instructions*: Check the box to indicate signed escrow instructions are attached and are to be handed to escrow on closing. [See **first tuesday** Form 401]

13.2 *Closing date:* **Check** the appropriate box to indicate the method to be used to set the date on which escrow is scheduled to close. Following the checked box, **enter** the specific date for closing or the number of days anticipated as necessary for the parties to perform and close escrow. Also, prior to seven days before closing, the parties are to deliver all documents needed by third parties to perform their services by the date scheduled for closing.

a. *Escrow charges*: **Requires** each party to pay their customary escrow closing charges, amounts any competent escrow officer can provide on inquiry.

13.3 *Undisclosed lien adjustments:* At the EP investor's option, adjustments for liens not disclosed in the agreement will be made first into the down payment and then into any carryback note for any amounts remaining.

13.4 *Title conditions:* **Enter** wording for any further-approval contingency provision the EP investor may need to confirm that title conditions set forth in the preliminary title report will not interfere with the EP investor's intended use of the property, such as "closing contingent on EP investor's approval of preliminary title report."

13.5 *Title insurance:* **Provides** for title to be vested in the name of the EP investor or their assignee. **Enter** the name of the title insurance company which is to provide a preliminary title report in anticipation of issuing title insurance. **Check** the appropriate box to indicate the type of title insurance policy to be issued on closing.

a. *Policy endorsements*: **Enter** any endorsements to be issued with the policy.

b. *Payment of premium*: **Check** the appropriate box to indicate whether the EP investor or seller is to pay the title insurance premium.

13.6 *Fire insurance:* **Requires** the EP investor to provide a new policy of hazard insurance.

13.7 *Prorates and adjustments:* **Authorizes** prorations and adjustments on the close of escrow for taxes, insurance premiums, rents, interest, loan balances, service contracts and other property operating expenses, prepaid or accrued.

13.8 *Personal property:* **Requires** the seller to execute a bill of sale for any personal property being transferred in this transaction at Section 1.

13.9 *Property destruction:* **Provides** for the seller to bear the *risk of loss* for any casualty losses suffered by the property prior to the close of escrow. Thus, the EP investor may terminate the agreement if the seller is unable to provide a marketable title or if the property improvements suffer major damage.

14. *Licensing disclosure:* **Check** the boxes to indicate the EP investor is represented by a BRE licensed broker, exclusively or as a dual agent, and the broker has provided proof of their licensure to the seller-in-foreclosure.

15. *Other terms:* **Enter** any special provision to be included in the purchase agreement.

16. *Supplemental property tax bill:* **Notifies** the buyer they will receive one or two supplemental property tax bills they are to pay when the county assessor revalues the property after a change in ownership.

17. *Gas and Hazardous Liquid Pipelines:* **Notifies** the buyer they may use the Department of Transportation website or contact their local gas utility or pipeline operators to obtain information about the general location of gas and hazardous liquid transmission pipelines.

Brokerage fee

18.1 *Fee amount:* **Enter** the total amount of the fee due all brokers to be paid by the seller. The amount may be stated as a fixed dollar amount or a percentage of the price.

Editor's note — The defaulting party pays all brokerage fees and the brokerage fee can only be altered or cancelled by mutual instructions from the EP investor and seller.

18.2 *Fee sharing:* **Enter** the percentage share of the fee each broker is to receive.

Editor's note — The percentage share may be set based on an oral agreement between the brokers, by acceptance of the seller's broker's MLS offer to a selling office to share a fee, or unilaterally by an agent when preparing the buyer's offer.

18.3 *Agency law disclosures:* **Attach** a copy of the Agency Law Disclosure addendum for all parties to sign. The disclosure is mandated to be acknowledged by the EP investor with the offer and acknowledged by the seller on acceptance as a prerequisite to the brokers enforcing collection of the fee on the sale of any type of real estate. [See **first tuesday** Form 305]

18.4 *Disclosure of sales data:* **Authorizes** the brokers to report the transaction to trade associations or listing services.

Cancellation period

19.1 *Statutory cancellation period:* The seller has the **right to cancel** the EP agreement until midnight (12 a.m.) of the fifth business day (Monday through Saturday, excluding specified holidays) following the day the EP agreement is accepted or until 8 a.m. on the day scheduled for a trustee's foreclosure sale of the property, whichever occurs first.[20]

Notice of right to cancel

Enter the EP investor's name and the appropriate time and date for the expiration of the seller's cancellation period of five business days after acceptance.

Editor's note — See explanations for time and date given in Section 19.1 above.

Agency confirmation:

Buyer's broker identification: **Enter** the name of the buyer's broker and their Bureau of Real Estate (BRE) license number. **Enter** the name of the broker's buyer's agent and their BRE license number. **Obtain** the signature of the buyer's broker or the selling agent acting on behalf of the buyer's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and their agents') conduct with the parties. **Enter** the broker's address, phone, cell, fax and email information.

Seller's broker identification: **Enter** the name of the seller's broker and their BRE license number. **Enter** the name of the seller's agent and their BRE license number. **Obtain** the signature of the seller's broker or the seller's agent acting on behalf of the seller's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and their agents') conduct with the parties. **Enter** the broker's address, phone, cell, fax and email information.

Signatures:

Buyer's signature: **Enter** the date the buyer signs the purchase agreement and each buyer's name. **Obtain** each buyer's signature on the purchase agreement and on each attachment which requires their signature. **Enter** the buyer's address, telephone and fax numbers, and email address.

Seller's signature: **Enter** the date the seller signs the purchase agreement and each seller's name. **Obtain** each seller's signature on the purchase agreement and on each attachment which requires their signature. **Enter** the seller's address, telephone and fax numbers, and email address.

Notice of Cancellation:

Editor's note — The Notice of Cancellation is not part of the actual EP agreement. It is the notice the seller-in-foreclosure signs and delivers to cancel the transaction. It must be filled out, ***in duplicate,*** *by the buyer and handed to the seller with the EP agreement.*

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20 CC §1695.4(a)

Enter the date the seller signs their acceptance of the EP agreement. **Enter** the time (12 a.m. or 8 a.m.) and the date on or before which the seller may cancel the agreement (five business days after acceptance or the date set for the trustee's sale, if earlier).

Enter the EP investor's name and the address where the Notice of Cancellation is to be delivered if the seller-in-foreclosure chooses to cancel the EP agreement by signing it. **Enter** the time (12 a.m. or 8 a.m.) and the date by which the seller may cancel the agreement (five business days after acceptance or the date set for the trustee's sale, if earlier).

The EP investor is to also **complete** the second, duplicate Notice of Cancellation which follows.

Editor's note — The Notices of Cancellation at the end of the EP agreement are not dated or signed by the seller on acceptance. The seller will later sign and deliver a Notice of Cancellation to the EP investor only when the seller decides to cancel the transaction.

Observations

As a policy of the publisher, this EP agreement does not contain clauses which tend to increase the risk of litigation or work against generally accepted best interests of the buyer, seller and broker. Excluded provisions include:

- an *attorney fee provision*, which tends to promote litigation and inhibit resolution;
- a *time-essence clause*, since future performance dates are, at best, estimates by the broker and their agents of the time needed to close and are too often improperly used by sellers in rising markets to cancel the transaction before the buyer or broker can reasonably comply with the terms of the purchase agreement;
- a *liquidated damages provision*, since they create wrongful expectations of windfall profits for sellers and are nearly always forfeitures and unenforceable; and
- an *arbitration provision*, since arbitration decisions are final and unappealable, without any judicial oversight to assure the arbitrator's award will be fair and correct.

Chapter 2 Summary

An equity purchase (EP) transaction occurs on the sale of a one-to-four unit residential property when a trust deed encumbrance on the property is in foreclosure and the property is occupied as the seller's principal residence, if the buyer acquires title for:

- dealer purposes (resale on a flip, whether or not rented in the interim); or
- investment (to hold as a rental income property) or security purposes.

The Equity Purchase Agreement, **first tuesday** Form 156, is used by an agent to prepare a written offer to be entered into by an investor or dealer to purchase a one-to-four unit residential property which is occupied by the seller as their principal residence and is in foreclosure.

As required by EP law, the form contains bold print, minimum size type and the statutory notice of the five-business-day right of cancellation, as well as the actual Notice of Cancellation for use by the seller who chooses to cancel the agreement.

Chapter 2 Key Terms

Chapter 3

The EP investor operates with or without an agent

Learning Objectives

After reading this chapter, you will be able to:

- analyze the risks involved for a real estate broker to represent a seller-in-foreclosure;
- discern the role of a foreclosure consultant and determine when a California Bureau of Real Estate (CalBRE) licensee is considered a foreclosure consultant; and
- understand the prohibition against collecting advance fees from a seller-in-foreclosure.

Key Terms

foreclosure consultant

Home Equity Sales Contract Act (HESCA)

put option

The evolution of EP law

Equity purchase (EP) law in California regulates all parties in an **equity purchase transaction**. Collectively, equity purchase laws are known as the **Home Equity Sales Contract Act (HESCA).** Brokers and agents licensed by the Bureau of Real Estate (CalBRE) who take part in EP transactions are also bound by *HESCA*.

Home Equity Sales Contract Act (HESCA)
An equity purchase (EP) scheme established to protect homeowners whose residence is in foreclosure from deception and unfair dealing by investors.

An *EP transaction* occurs when an EP investor, whether or not represented by a real estate broker, enters negotiations to acquire a one-to-four unit residential property which is in foreclosure and occupied in whole or in part by the seller as their principal residence.

Until 2007, brokers were largely prevented from representing EP investors in EP transactions due to vague and suppressive surety bond legislation. To participate in an EP transaction, legislation previously enforced required a broker to be bonded by a surety insurer to guarantee fulfillment of their employment if the broker failed to fulfill their duties.

Brokers who chose to negotiate EP transactions were left to guess at how to comply with the vague language or to ignore it, leaving them open to liability.

Consider a buyer's broker representing an EP investor prior to 2007. The broker is not bonded, and makes no disclosure to the seller-in-foreclosure regarding bonding.

After the sale closes, the seller-in-foreclosure claims the purchase agreement is void and demands the EP investor return the property to the seller since the buyer's broker representing the EP investor did not provide proof they were bonded — as required by legislation.[1]

However, the legislation requiring the surety bond is void due to its lack of certainty – vagueness. As a result, the seller-in-foreclosure may not rescind the sale based on a void code and the EP investor retains ownership of the property.

Today, a broker representing an investor on purchases controlled by EP laws no long needs to obtain a surety bond.[2]

The EP law otherwise remains enforceable

While a buyer's broker or their agent representing an investor in an EP transaction is no longer concerned with a bond, they do need to:

- hand the seller-in-foreclosure evidence they have a valid, CalBRE license; and
- provide a statement to all the parties, that:
  - they have a valid California CalBRE license; and
  - they have provided proof of licensing to the seller-in-foreclosure.[3] [See Chapter 2; see **first tuesday** Form 156 §14]

The license disclosure code does not state what evidence constitutes proof of licensure. However, a print-out from the CalBRE's License Lookup at **http://www2.dre.ca.gov/PublicASP/pplinfo.asp** will suffice. A photocopy of the official license issued to the licensee, both front and back, will also work.

If the seller-in-foreclosure wants something more official looking, the CalBRE's Current License Status Request Form RE 291 may be filled out and submitted to the CalBRE. The CalBRE will then send an official print-out to the seller-in-foreclosure via mail.

Failing to provide both the evidence of licensure and the written licensing declaration may result in the seller-in-foreclosure voiding the EP agreement and leave the EP investor liable for all losses caused by their broker's failure to provide proof of their licensure.[4]

However, the EP investor may not be at fault for the broker's failure to comply with the EP disclosures, but they are liable to pay for the seller-in-foreclosure's

1 Calif. Civil Code §1695.17(a)
2 **Schweitzer** v. **Westminster Investments** (2007) 157 CA4th 1195; CC **§§1695 et seq.**
3 CC §1695.17; CC §1695.15(b)
4 CC §1695.17(b)

losses created by their broker's nondisclosure. Thus the EP investor is entitled to indemnity from their broker for any judgment against them resulting from licensure disclosure failures, plus attorney fees.[5]

A licensee as the EP investor

A licensed real estate broker or agent may themselves be the EP investor. A licensee, when acting solely as a principal purchasing property for their own account in an EP transaction, eliminates the use of the agency law addenda and licensee disclosure provisions in the EP agreement. When acting as a principal, the licensee is not acting as an agent for anyone in the transaction.

The licensee acting solely as an EP investor is a buyer who merely happens to hold a real estate license – a coincidental set of circumstances. This is an unrelated fact and it need not be disclosed to the seller-in-foreclosure as no **conflict of interest** exists with others.

Conversely, a CalBRE licensee, while employed as the seller's broker by a seller-in-foreclosure to locate a buyer, may decide to directly or indirectly buy their client's property. This is not prohibited for brokers in any type of market. However, a broker needs to disclose to their seller-client that the broker is also acting as a principal in the transaction, in addition to being, or having been, the seller's agent.[6] [See Form 527 accompanying this chapter]

Representing the seller

Brokers who consider the risks of litigation are less inclined to solicit and accept a listing from a seller-in-foreclosure than from a seller of comparable property not in foreclosure. However, short sales reentered the sales volume in 2008 becoming by 2011 a significant part of the sales transactions handled by agents working in single family residence (SFR) sales. More germane to the EP laws, by 2013 investors had become predominate as short sale buyers of SFRs in foreclosure.

The 2008 recession left one-half of mortgaged homes in California with price drops to below the mortgage amounts. Short sales with lenders discounting the mortgage balance for a payoff before the foreclosure sale became the norm for EP investor acquisitions. But EP transactions they were, even though the owner occupant had no equity to sell and thus no EP losses for recovery if EP law violations occurred.

The recovery will eventually bring permanent price increases from the rebalanced post-boom prices of 2008 returning to historical trendline prices. With a sufficient price increase and time for amortization of principle mortgage debt to work its magic, seller-in-foreclosure sales will again have positive equity positions and generate net sales proceeds for the seller if not lost due to EP violations.

The broker's reluctance to list a home in foreclosure arises from the fact a home with a positive equity, unless sold and escrow closed before the date of the trustee's foreclosure sale, will be lost by their client to foreclosure. Without

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5 **Francisco Examiner Division, Hearst Publishing Company** v. **Sweat** (1967) 248 CA2d 493

6 Calif. Business and Professions Code §§10176(d), 10176(g) and 10176(h)

locating a buyer – one who will occupy or is an investor – and closing a sale, the broker has failed to meet their seller's expectations under the listing, i.e., to salvage their equity before it is lost to foreclosure.

The difficulty for the seller's agent is that foreclosure periods are roughly four months in length following the recording of an NOD. Some sell quickly if aggressively priced; others go to foreclosure sales.

Further, the seller has known *solvency issues*. Their home will be sold at a trustee's sale under a recorded NOD unless the delinquent loan is either:

- brought current (or a forbearance agreement/loan modification is entered into) prior to five business days before the trustee's sale, called **reinstatement**; or
- paid in full before the trustee's sales, called **redemption**.

The typical seller-in-foreclosure can do neither unless a buyer comes to the rescue with cash.

Also at issue is the seller's lack of funds to maintain the property to provide the necessary "curb appeal" to draw homebuyers (rather than investors).[7]

If the insolvent seller loses their property by foreclosure, the seller might make a demand on the broker for the amount of the seller's lost equity. Their claim: a lack of *due diligence* or *unprofessional conduct* on the part of the broker — a risk brokers do not lightly undertake when listing any property.

EP agents in MLS submissions

A seller of their residence which is in foreclosure first lists the home in one or many **Multiple Listing Services (MLS)** to publically announce it is for sale. To alert interested agents and investors of the EP exposure, the published MLS information provided by the seller's agent needs to note the property is a seller-occupied residence in foreclosure. It is most helpful for prospective investors when mortgage information is included. This tactic also avoids agent liability for nondisclosure of material facts.[8]

With information on the seller's occupancy and the foreclosure status on the property, buyers who are investors and buyer's agents representing investors know they need to use an EP-compliant purchase agreement form to submit an offer to buy.

While buyers who intend to occupy the property are exempt from EP law, they often have no interest in the property, since it is:

- improperly encumbered — a buyer-occupant may not want to assume the existing loan, or the property cannot be financed for an amount sufficient to pay off the existing loan requiring loan discount negotiations with the lender to avoid foreclosure; and
- physically unattractive — due to deferred maintenance by a financially impaired seller.

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7 CC §§2903

8 **Holmes** v. **Summer** (2010) 188 CA4th 1510

Thus, a property in foreclosure is attractive primarily to **investors**. *Investors* are willing to buy property and take risks presented by delinquencies and maintenance requirements during what is usually a recessionary sales market, prior to a price resurgence. Further for investors, the price is calculated to be sufficiently "back-of-market" to cover the market risks of a resale on a flip at a profit.

The property needs to be rehabilitated, and financing and operating costs carried until the property is resold or rented — at a profit or a loss.

To further complicate the seller-in-foreclosure's plight, the legislature set up marketplace restrictions on the sale of a residence-in-foreclosure. The legislation reduced the flexibility of the seller's broker to locate a buyer through advanced fee restrictions and foreclosure consultant rules controlling the conduct of brokers and agents.[9]

Foreclosure consultants for sellers

Typically, a seller-in-foreclosure will do everything in their power to prevent their residence from being lost to a foreclosure sale.

Faced with foreclosure, sellers-in-foreclosure often prudently seek the services of a financial advisor or investment counselor, called a **foreclosure consultant**.

foreclosure consultant
A person who, for a fee from a seller-in-foreclosure, agrees to stop or postpone the foreclosure sale, prevent lienholders from enforcing or accelerating their note, help the seller reinstate the loan or negotiate an extension of the reinstatement period, advance funds to the seller or arrange a loan for the seller.

Editor's note — While this discussion deals with the paid foreclosure consultants, free foreclosure consulting services are available through the Department of Housing and Urban Development's HOPE NOW alliance.

A *foreclosure consultant* is any person who, for a fee from the seller-in-foreclosure, agrees to:

- stop or postpone the foreclosure sale;
- prevent lienholders from enforcing or accelerating their note;
- help the seller reinstate the loan or negotiate an extension of the *reinstatement* period;
- advance funds to the seller; or
- arrange a loan for the seller.[10]

The dramatic increase in foreclosures during the *Great Recession of 2008* provoked additional legislation regulating foreclosure consultants. To be a foreclosure consultant an individual needs to:

- obtain a surety bond of $100,000 in favor of the state of California for the benefit of homeowners for damages caused by the foreclosure consultant's violation of any applicable laws. One copy needs to be filed with the Secretary of State, and a second copy needs to be provided to the Department of Justice (DOJ); and,
- register with the DOJ by submitting the required fees and a completed registration form, which includes:

9 CC §2945.4(a)
10 CC §2945.1(a)

- all names, addresses, telephone numbers, web sites, and email addresses which will be used in connection with foreclosure consultant activities;
- a statement that the person has not been convicted of any crime, or subject to a criminal judgment for misrepresentation, dishonesty, or a violation of the requirements;
- copies of all print and electronic advertising material and scripts of all telephone or broadcast advertising to be used in connection foreclosure consultant activities; and
- a copy of the required surety bond.

DOJ authority

The DOJ has the power to deny or revoke a certificate of registration if:

- there is any misstatement on the registration form;
- the consultant has violated any state laws; or
- the consultant has failed to maintain the required bond.

Any individual who acts as a foreclosure consultant without meeting the above requirements will be punished for each violation by:

- a fine between $1,000 and $25,000;
- imprisonment in the county jail for up to a year; or
- both the fine and imprisonment.[11]

Contracts entered into by a seller-in-foreclosure and foreclosure consultant are to be translated into the language used in negotiation between the two parties.[12]

Additionally, the seller-in-foreclosure is given five days after the date of signing the contract to cancel the contract with the foreclosure consultant. The seller-in-foreclosure may cancel the contract by mailing, faxing, or emailing their cancellation request to the foreclosure consultant.[13]

The licensee exemption

A CalBRE licensed broker or agent acting on behalf of an owner-in-foreclosure avoids being labeled a *foreclosure consultant* when they:

- receive only a *contingency fee* (paid on closing) from the owner for negotiating the sale of their residence in foreclosure;
- receive no *advance fees or costs* from the owner, an activity which will convert the broker into a foreclosure consultant;
- make a Reg Z consumer mortgage as a principal for an amount sufficient to cure defaults, or arrange a Reg Z consumer mortgage as an mortgage loan originator (MLO)-endorsed broker employed by the owner; and
- receive no ownership interest in the property from the owner, except a security interest under a trust deed when acting solely as a principal (lender) making a MLO loan.[14]

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11 CC §2945.45

12 CC §2945.45(c)

13 CC §§2945.3, 2945.2

14 CC §2945.1(b)(3)

Duties breached

Consider a CalBRE licensed broker (MLO endorsed) who arranges a consumer mortgage for an owner-occupant of a one-to-four unit residential property in foreclosure. The loan is funded by a trust deed investor and secured by a trust deed lien on the owner's residence – all in compliance with the MLO licensing and consumer mortgage rules.

The broker discloses to the owner they are the spouse of the trust deed investor, and that the money lent is the spouse's sole and separate property. The loan's closing statement notes the broker is acting solely as a CalBRE licensee arranging the loan transaction for a fee.

Later, the trust deed investor forecloses on the trust deed by a trustee's sale. The successful bidder at the trustee's sale is the investor under a credit bid. However, the trustee's deed vests title jointly, as spouses, in the names of the trust deed investor and the broker. Thus, the trustee's deed conveys title to both the broker and the trust deed investor.

The owner-in-foreclosure claims the broker's actions constituted those of a *foreclosure consultant* since the broker took title at the trustee's foreclosure sale on the mortgage arranged by the broker, which constitutes a breach of their fiduciary duties as a foreclosure consultant.

The broker claims they are exempt from being classified as a foreclosure consultant since:

- the broker was acting in the capacity of a CalBRE licensed broker when the mortgage was arranged for the owner; and
- the trustee's sale was a public auction at which anyone may bid and buy the property.

Did the broker breach their fiduciary duties to the owner?

Yes! The broker breached their duties both as a foreclosure consultant and as a CalBRE licensee when they acquired an ownership interest at the trustee's sale on a loan they arranged for an owner-in-foreclose of a one-to-four unit residential property. Here, the broker participated only to arrange the mortgage; they were not the foreclosing lender.

To properly acquire ownership of the property at a trustee's sale, the broker needs to lend their own funds and be named as the beneficiary in the trust deed when the loan is made.

The broker arranged a mortgage for which a CalBRE license was required. However, the broker became a foreclosure consultant and violated that law the instant they acquired an ownership interest at the foreclosure sale on the loan they arranged for a fee.[15]

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15 **Onofrio** v. **Rice** (1997) 55 CA4th 413

Form 527

Conflict of Interest

Page 1 of 2

CONFLICT OF INTEREST

Kinship, Position or Undue Influence

Prepared by: Agent ______________ Phone ______________
Broker ______________ Email ______________

NOTE: Licensed Brokers and Sales Agents when acting on behalf of a client may not act in a manner which might cause the client to conclude that others, or a position held by the Broker or his Agents, can improperly influence or cause the Broker or his Agents to fail to properly act in their fiduciary capacity as an agent without first disclosing to the client the facts which might otherwise lead to that conclusion and obtaining their consent.

DATE: ____________, 20______, at ______________________________, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This disclosure is made in connection with the following agreement:
   - ☐ Listing (Employment) Agreement ☐ Purchase Agreement
   - ☐ Escrow Instructions ☐ ______________

   1.1 ☐ of the same date, or dated ____________, 20______, at ______________________, California.

   1.2 entered into by ______________________________, as the ______________, and

   1.3 ______________________________, as the ______________.

   1.4 regarding real estate referred to as ______________________________.

2. The client(s) represented by the undersigned Broker with regard to the above referenced agreement is/are identified as the ______________________________.

DISCLOSURE OF CONFLICT OF INTEREST:

3. Broker provides the following information as a disclosure to the client of relationships or positions held by Broker or his Agents, and their family members, in investments, business activities or real estate interests which present circumstances that might, if not disclosed, appear to be in conflict with the agency duty owed the client to care for and protect the interests of the client.

Check the following items and enter information on facts which are believed might create a conflict of interest for Broker or his Agents in performing their agency duties on behalf of the client.

3.1 ☐ Real estate
Property type: ______________________________
Address: ______________________________
Interest held: ______________________________
Activity creating conflict: ______________________________

3.2 ☐ Government agency
Agency name: ______________________________
Position held: ______________________________
Activity creating conflict: ______________________________

3.3 ☐ Business position
Business name: ______________________________
Goods or services provided: ______________________________
Position held: ______________________________
Activity creating conflict: ______________________________

3.4 ☐ Business investment
Company name: ______________________________
Type of trade or business: ______________________________
Interest held: ______________________________
Activity creating conflict: ______________________________

---------------- PAGE ONE OF TWO — FORM 527 ----------------

put option
A provision in all trust deeds which, in tandem with anti-deficiency laws, grants the owner of mortgaged real estate the right to default and force the mortgage holder to first sell the property through foreclosure.

Risky business

Normally, a broker may bid and acquire property at a foreclosure sale. Brokers often do so when the lender is a client. However, the broker may not acquire the property at the foreclosure sale if they were paid to arrange the mortgage on the residence of an owner-in-foreclosure.

Such cases make doing EP business risky for brokers and reduce the available buyers at the trustee's sale — a voluntary sale contracted for in the trust deed and initiated by the owner by defaulting, called a **put option**.

Form 527

Conflict of Interest

Page 2 of 2

— — — — PAGE TWO OF TWO — FORM 527 — — — —

3.5 ☐ Representation of others in transaction

Name of person also owed agency duties: ____________________

Activity creating conflict: ____________________

3.6 ☐ Kinship and employee relationships

Name of individual(s): ____________________

Relationship with Broker or employee: ____________________

Activity creating conflict: ____________________

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for additional compensation and controlled business arrangements. [See ft Forms 119 and 519]

BROKER:

5. I certify that the above information is true and correct.

Date: ____________, 20____ Broker's Name : ____________________

By: ____________________

Agent's Name: ____________________

CLIENT: I have received a copy of this disclosure and consent to continue the relationship with the broker as my agent.

☐ See attached Signature Page Addendum [ft Form 251]

Date: ____________, 20____

Name: ____________________ Name: ____________________

Signature: ____________________ Signature: ____________________

FORM 527 03-11 ©2011 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Advance fees

When a broker collects a fee or any marketing costs in advance from an owner-in-foreclosure, the broker is considered a **foreclosure consultant**. Thus, the broker becomes subject to statutory foreclosure consultant restrictions, in addition to broker licensing laws already in place.

Advance costs include:

- appraisal fees;
- credit report charges; and
- property inspection report fee.

However, a foreclosure consultant may never collect an advance fee. This legal "catch-22" affects the loan broker attempting to be paid a fee or collect loan costs up front as is typical of a loan broker's arrangement with borrowers.

If, as a broker, they accept an advance of costs, they are at once classified as a consultant and violator of that law. Also, a foreclosure consultant may not secure their contingent fee by a lien on the property.[16]

16 CC §§2945.4(a), 2945.4(c)

Further, a CalBRE licensee is forbidden by the CalBRE from collecting advance fees for offering loan forbearance or loan modification services. They may not demand a lien on property or any other type of security to guarantee compensation.[17]

Compounded risks

A broker taking a listing from a seller-in-foreclosure without an advance fee arrangement assumes the risk the uncreditworthy seller will be unable to pay the fee if they refuse a full listing offer (and keep the property), or are unable or unwilling to close if they enter into a purchase agreement.

EP law overlooks the fact the broker who takes a permitted advance fee is already heavily regulated by the CalBRE (and outright forbidden when offering loan forbearance or modifications service). To receive an advance fee, the broker needs to:

- place any permitted advance fees in a trust account;
- provide accounting to the client before withdrawing funds; and
- use a fee agreement approved by the CalBRE.[18]

However, to collect an advance fee as authorized by the CalBRE violates a different law when the homeowner is in foreclosure — the broker, due to the recorded NOD on an SFR, becomes a foreclosure consultant controlled by more stringent rules of conduct.

By prohibiting advance fee arrangements, EP law works to the detriment of the seller-in-foreclosure by barring access to one segment of the broker community.

Broker for a foreclosure consultant

When a broker arranges for an owner-in-foreclosure to employ a foreclosure consultant, or pay a fee or transfer title to a foreclosure consultant, the broker is considered the agent of the foreclosure consultant. Thus, the broker becomes a sort of *agent-once-removed* of the owner who has retained the foreclosure consultant.[19]

Further, a foreclosure consultant retained by an owner-in-foreclosure is barred from acquiring any interest in a residence in foreclosure — even if they hire a broker to represent them to buy the property.[20]

A foreclosure consultant's agent or employee may only be a CalBRE licensee who:

- provides the owner-in-foreclosure with a written statement they are a CalBRE licensed broker; and
- is bonded by a surety insurer for an amount equal to twice the value of the residence in foreclosure.[21]

17 Business and Professions Code §10085.6
18 Bus & P C §10085
19 CC §2945.9(b)
20 CC §2945.4(e)
21 CC §2945.11(a)

Failure of the foreclosure consultant's broker to provide the broker's statement to the owner-in-foreclosure will, at the owner's option, void the advisory agreement with the foreclosure consultant.[22]

Further, an agreement between the foreclosure consultant and the owner-in-foreclosure may not contain provisions attempting to limit the liability of the foreclosure consultant for money damages caused by the foreclosure consultant's broker.[23]

22 CC §2945.11(b)

23 CC §2945.10

Chapter 3 Summary

Equity purchase (EP) law in California regulates all parties in an equity purchase transaction. Collectively, equity purchase laws are known as the Home Equity Sales Contract Act (HESCA). Brokers and agents licensed by the Bureau of Real Estate (CalBRE) who take part in EP transactions are also bound by HESCA.

An EP transaction occurs when an EP investor, whether or not represented by a real estate broker, enters negotiations to acquire a one-to-four unit residential property which is in foreclosure and occupied in whole or in part by the seller as their principal residence.

Brokers are less inclined to solicit and accept a listing from a seller-in-foreclosure than from a seller of comparable property not in foreclosure. The broker's reluctance arises from the fact that the property must be sold and escrow closed before the date of the trustee's foreclosure sale. For anything less, the broker has failed to fully perform the employment by meeting the seller's expectations under the listing.

Further, the seller has known solvency issues. The typical seller-in-foreclosure cannot exercise reinstatement or redemption unless a buyer comes to the rescue with cash.

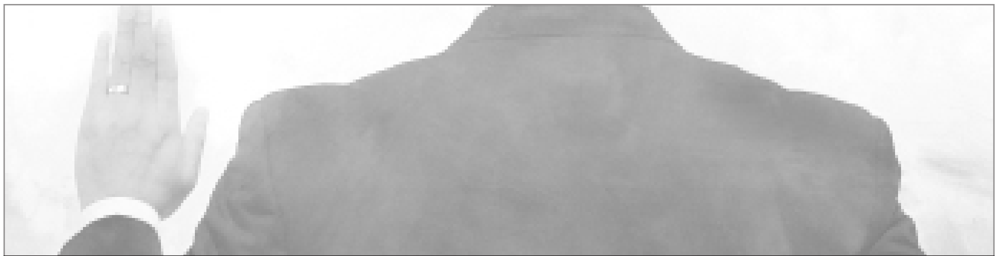
A foreclosure consultant is any person who, for a fee from the seller-in-foreclosure, agrees to:

- stop or postpone the foreclosure sale;
- prevent lienholders from enforcing or accelerating their note;
- help the seller reinstate the loan or negotiate an extension of the reinstatement period;
- advance funds to the seller; or
- arrange a loan for the seller.

A CalBRE licensed broker or agent acting on behalf of an owner-in-foreclosure avoids being labeled a foreclosure consultant when they:

- receive only a contingency fee (paid on closing) from the owner for negotiating the sale of their residence in foreclosure;
- receive no advance fees or costs from the owner, an activity which will convert the broker into a foreclosure consultant;
- make a Reg Z consumer mortgage as a principal for an amount sufficient to cure defaults, or arrange a Reg Z consumer mortgage as an mortgage loan originator (MLO)-endorsed broker employed by the owner; and
- receive no ownership interest in the property from the owner, except a security interest under a trust deed when acting solely as a principal (lender) making a MLO loan.

Chapter 3 Key Terms



Chapter 4

The unconscionable advantage some investors create

Learning Objectives

After reading this chapter, you will be able to:

- advise investors on a seller-in-foreclosure's right to rescind a sale within two years after closing when an equity purchase (EP) investor takes unconscionable advantage of the seller;
- instruct an EP investor how to avoid exploiting an element of oppression or surprise to exact unreasonably favorable terms from the seller; and
- understand the remedies a seller-in-foreclosure has to rescind a closed EP transaction.

Key Terms

bona fide purchaser (BFP)

comparable market analysis (CMA)

notice of rescission

oppression

post-closing surprise

unconscionable advantage

Suppression of the seller's continued marketing

Consider an EP investor who begins acquisition efforts by seeking out a suitable property in a distressed seller-in-foreclosure market. The investor senses owners do not have much ability to maneuver to avoid loss of their property to foreclosure.

In a **recessionary economic climate** preceding a rise in prices, EP investors with cash seize the opportunity to acquire real estate with low-ball offers submitted to financially down-and-out homeowners. By providing an owner with cash – liquidity – the EP investor has the ability to suppress an owner's effort to further market their property and locate a better match for themselves than the one offered by the EP investor.

In this market's emotional environment of colliding fear and greed, the EP investor is buoyed by their negotiations for setting prices. Conversely, the seller-in-foreclosure is often mentally impaired by the *emotions* generated by their financial failure to retain homeownership for their family. These conditions occasionally drive dominating EP investors to suppress any further or competitive marketing of the property by the seller-in-foreclosure – shopping the EP investor's offer – as a condition of entering into a purchase agreement with the EP investor.

Risky friskiness of an EP investor

Consider an EP investor who views a cash EP transaction as providing instant liquidity for the financially strapped seller-in-foreclosure. The EP investor delivers cash to an anxious seller in exchange for their property. This activity usually occurs in a cash-starved market suffering from a liquidity failure of no sufficient demand by end users of property, tight credit conditions and high interest rates.

On taking the risk of investing, the EP investor believes they have an opportunity to profit on their cash investment by:

- a short-term resale of the real estate as a speculator pursuing a quick profit – a one-time *flip*; or
- long-term ownership of the real estate as a rental, a store of the investor's net worth which generates cash flow known as *spendable income*.

Purchasing a single family residence (SFR) from a seller-in-foreclosure places a heavier burden on the EP investor to protect the seller's interests than when purchasing an SFR from a seller who is not in foreclosure. The burden is imposed by the risk of claims made by the seller simply because their residence is in foreclosure and is the subject matter of negotiations.

The liability exposure of an EP investor for EP violations is reduced greatly when the seller-in-foreclosure has a **negative equity** rather than a positive equity. With a negative equity, a discounted short payoff of the mortgage is involved to buy the property. On a short sale, the seller has no equity in the property to lose and thus no claim for money lost if the EP investor acts in violation of EP laws.

The seller-in-foreclosure needs to suffer a loss of a positive equity before there is a monetary recovery in the equity purchase environment. However, the right to rescind is unaffected by the lack of a monetary loss.

When the lender is discounting the payoff of their mortgage, it is the lender who ultimately approves (read: sets) a price as the fair market value (FMV) of the property supporting their mortgage. The seller is under burden to be concerned abiut the property's value and the EP investor takes advantage of the void.

The value of the mortgage holder's security interest in the real estate under negative equity conditions is tantamount to its price. With a negative equity property, the owner has no economic interest in the property – essentially they are a tenant in a home they hold title to – since they receive none of the benefits of ownership until the mortgage balance drops (or the price rises) to a *loan-to-value ratio (LTV)* of 94% or less.

The EP investor's risk lies in a seller-in-foreclosure's **two-year right of rescission**. This right gives the seller-in-foreclosure the ability to rescind the sale and recover the property for the price the investor paid within two years after closing based on a claim of **unconscionable advantage.**

unconscionable advantage
When an equity purchase investor or a mortgage holder exploits an element of oppression, helplessness or surprise to exact unreasonably favorable terms from a property owner or tenant.

To prove an EP investor took *unconscionable advantage*, the seller needs to provide evidence of both:

- the purchase price or method of payment was unreasonably favorable to the EP investor, legally called **substantive unconscionability**; and
- the lack of a meaningful choice of action for the seller-in-foreclosure when negotiating to sell to the EP investor, legally called **procedural unconscionability**.

It is critical for both elements to be present in order to prove unconscionable advantage.

Unreasonable pricing and payment

To protect themselves from an unconscionable advantage claim, the EP investor purchases the property of a seller-in-foreclosure using *reasonable* pricing and payment. To this end, the investor's agent has a duty to advise and assist in meeting this objective.

The price paid, like any other component of a sale, may later be challenged by the seller as being unconscionable. When determining the unconscionability of the purchase price, justification for the price at the time of the sale and the terms of payment of that price are examined.

A fair price calls for an analysis of:

- the property's condition;
- the price trend in the resale market for like property;
- the costs of carrying the ownership; and
- a discount on FMV to cover a reasonable profit for the risk taken to provide liquidity for the seller by investing cash then flipping it at a profit.

To set a purchase price for a property, the EP investor is best served by their agent's completion of a valuation spread sheet, called a **comparable market analysis (CMA).** Using the *CMA*, the EP investor and their agent evaluate the amenities of nearby, comparable properties which have sold within the past six months. When a short sale is involved, it is the lender who approves, if not sets the price to be paid by an investor.

comparable market analysis (CMA)
A worksheet used by an agent to prepare an estimate for review with an equity purchase (EP) investor of the value of property for sale based on the price recently paid for similar properties.

Form 318

Comparable Market Analysis For Setting Values

Page 1 of 2

COMPARABLE MARKET ANALYSIS FOR SETTING VALUES

Addendum

Prepared by: Agent ______________________ | **Phone** ______________________

Broker ______________________ | **Email** ______________________

This Comparable Market Analysis (CMA) worksheet is prepared by the seller of a property, or his agent, to provide an estimate of the value of the seller's property based on the sales price of other similar properties sold within the past few months, each adjusted in price to reflect the dollar valuation of their distinctions from the seller's property. On locating recent sales through the County Records and completing a visual inspection of the comparable sales, note in the column for each comparable property, at any itemized features which is distinguishable from the seller's property, the dollar amount of the adjustment to the comparable property's price by, 1) deducting the dollar value of the feature the comparable property has which the seller's property does not, or, 2) adding the dollar value of the feature the comparable property does not have which the seller's property has.

Date prepared ____________, 20_____, by ______________________, Application/order # ____________

Features:	Subject property	Comparable No. 1	Comparable No. 2	Comparable No. 3
Address:				
Proximity to Subject				
Sale Price	$	$	$	$
Sale Price/Gross Living Area	$ per sq. ft	$ per sq. ft	$ per sq. ft	$ per sq. ft
Data Source				
Verification Source				
1. Sales Information:				
1.1 Date of sale				
1.2 Concessions (sales/financing)				
1.3 Fee simple/ leasehold				
1.4 Age of improvements				
1.5 Special HOA assessments				
1.6 Bonded assessments				

2. VALUE ADJUSTMENT:	DESCRIPTION	DESCRIPTION	+(-)$	DESCRIPTION	+(-)$	DESCRIPTION	+(-)$
2.1 Zoning Compliance (nonconforming/ illegal)							
2.2 Easement/ encroachment							
2.3 Use restrictions (CC&Rs)							
2.4 Retrofitting/water conservation							
3. Location/area:							
3.1 Neighborhood trend							
3.2 Street amenities							
3.3 Lot size/shape							
3.4 Vehicle access							
3.5 Schools/churches /institutions							
3.7 Inside/corner lot							
3.8 Utilities available							
3.9 Environmental hazards/ nuisances							

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From the value determined using the CMA, the price the EP investor will offer to pay is calculated based on the lump-sum profit or annual rate of return the EP investor seeks from their investment on resale or rental. [See Form 318 accompanying this chapter]

Unconscionable methods of payment include:

- carryback paper with an interest below the applicable federal rate rate (AFR) when the price is low and a long amortization or remote due date bears no relationship to current market conditions;

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VALUE ADJUSTMENT	DESCRIPTION	DESCRIPTION	+(-)$	DESCRIPTION	+(-)$	DESCRIPTION	+(-)$
4. Landscaping:							
4.1 Quality							
4.2 Maintenance							
4.3 Soil condition/ drainage							
4.4 Topography							
5. Improvements:							
5.1 Age of improvement							
5.2 Construction type							
5.3 Highest and best use							
5.4 Design/style							
5.5 Energy efficiency							
5.6 Maintenance/ obsolescence							
5.7 Exterior conditions							
5.8 Interior conditions							
5.9 Garage/carport							
5.10 Central AC/heating							
5.11 Gutters and downspouts							
5.12 Windows/ screens							
6. Livable Space:							
6.1 Gross livable sq. ft.							
6.2 No. of bedrooms							
6.3 No. of baths							
6.4 Kitchen/ appliances							
6.5 Living room							
6.6 Dining room							
6.7 Family room							
6.8 Basement/ storage							
6.9 Attic/access							
7. Amenities:							
7.1 Fireplace/ woodstove							
7.2 Pool							
7.3 Fences							
7.4 Patio/porch/deck							
8. TOTAL Price Adjustment:		+ -	$0.00	+ -	$0.00	+ -	$0.00
9. Adjusted Price of Each Comparable:		%	$	%	$	%	$
10 Value of Subject Property:	$						

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Comparable Market Analysis For Setting Values

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- an equity exchange of overpriced land, stock, gems, metals, annuity policies or zero coupon bonds with a long maturity; or
- any form of payment which is uncollectible, unredeemable or having little present worth.

However, the existence of unreasonable pricing and payment is only the first component of two the seller-in-foreclosure needs to present to support an unconscionable advantage claim. Pricing alone is not enough to show the unconscionable advantage needed to rescind a closed sales transaction.

Un-American activity coupled with a low price

The second component of the *unconscionable advantage* arises when the investor deprives the seller of a reasonable choice of action. Conditions of unconscionable advantage exist when the EP investor exercises **oppression** or **post-closing surprise**, while at the same time exacting an unreasonably low purchase price or onerous terms for payment.

oppression
When negotiations between an equity purchase (EP) investor and a seller-in-foreclosure are not realistic due to a "take it or leave it" environment created by the EP investor's abuse of inequality in bargaining power.

post-closing surprise
The post-closing discovery of detrimental conditions hidden in the wording of an equity purchase (EP) agreement or escrow instructions.

To deprive the seller-in-foreclosure of a meaningful choice between the EP investor's offer and offers from other buyers, a misrepresentation or fraudulent activity from threats, undue influence or deceit needs to exist.

Oppression by the EP investor exists when the inequality in bargaining power results in no genuine negotiations — a "take it or leave it" environment. A foreclosure in progress in an illiquid market environment presents a one-sided bargaining advantage for an aggressive EP investor to exploit. This power is improperly used by the EP investor when they insist that their offer is not "shopped around" in a marketing effort by the seller or the seller's agent to solicit a better deal during the five-business-day cancellation period.

Post-closing surprise is the post-closing discovery of terms which are essentially hidden in the lengthy provisions of the agreement or escrow instructions. Typically the price and how it is to be paid is not the surprise as it is well known to the seller-in-foreclosure. However, on a later rescission, it is the price that is likely the only provision in the agreement contested by the seller.

The greater the marketplace oppression or post-closing surprise in the transaction, the less an unreasonably favorable price paid by an EP investor is tolerated.[1]

Prudent investor conduct

Thus, to mitigate the risk of the seller having evidence an unconscionable advantage existed in the EP investor's conduct, the EP investor begins negotiations by entering into an EP agreement on a form that meets all statutory requirements. [See **first tuesday** Form 156; see Chapter 2]

The EP investor may be called upon to further defend their actions by demonstrating the EP agreement was not entered into through:

- *misrepresentation* of facts or law in deceitful conduct by the investor or the investor's agent;
- *undue influence* arising out of a prior or special relationship with the seller; or
- *duress* applied in the negotiations by the investor to obtain the seller's acceptance and close the transaction.

The EP investor's defense against any future attempt by the seller to show an unconscionable advantage is enhanced by:

- representation of the seller-in-foreclosure by a seller's broker; and
- evidence a counteroffer was prepared and submitted by the seller-in-foreclosure.

1 **Carboni** v. **Arrospide** (1991) 2 CA4th 76

The seller's broker is a middle man whose presence signifies the seller was represented by a knowledgeable gatekeeper. The counteroffer is proof the EP investor and seller (or seller's broker) actually competitively negotiated.

Two-year right of rescission

To understand the role of the *two-year right of rescission* period, consider a **Notice of Default (NOD)** recorded on a homeowner's personal residence after several months of delinquencies.

The homeowner, now in foreclosure on recording the NOD, is willing to sell on almost any terms to salvage their remaining equity in the property from loss to a foreclosure sale. The property is listed and the seller's broker markets the property primarily to buyers who desire to occupy the property as their personal residence.

Avoiding the seller's broker, an offer is submitted directly to the seller-in-foreclosure by an EP investor. The EP investor is not represented by a broker. Under the EP offer, the seller-in-foreclosure is to receive cash for their equity. Additionally, the EP investor is to cure the seller's loan delinquencies and take over the loan, a classic EP arrangement except in short sale conditions.

On review of the offer, the seller's broker recommends the seller accept the EP investor's offer. The broker further recommends that if an acceptable backup offer is received within the five-business-day cancellation period, the seller is to accept the backup offer and cancel the EP agreement.

The seller-in-foreclosure accepts the EP investor's offer. The five-day cancellation period expires without receiving a backup offer. The EP transaction is later closed and the property conveyed.

Does the EP investor receive good title when they accept the grant deed?

No! The EP investor's title remains subject to the seller-in-foreclosure's right of rescission for two years after closing. If at any time during the two years following the close of escrow and the recording of the grant deed the seller believes the EP investor's **conduct and the price** paid gave the EP investor an unconscionable advantage, the seller has the option to attempt to rescind the transaction and recover the property they sold, called **restoration**. [2]

These rescission risks for an investor are more prevalent during periods of swift upward price movement. The market conditions which favor speculator activity are precisely the same conditions that cause a seller of a property to demand their home be returned. A profit has come about within two years which is now sought by both the investor, who speculated and gained by a flip, and the seller, who believes they were ripped off of the profit taken by the investor.

2 Calif. Civil Code §1695.14

Seller's steps to exercise rescission rights

notice of rescission
Notice given by a seller-in-foreclosure to an equity purchase (EP) investor to exercise the seller's two-year right to rescind the sale and be restored to title of the property sold.

bona fide purchaser (BFP)
A buyer other than the mortgage holder who purchases a property for value at a trustee's sale without notice of title or trustee's sale defects.

The seller-in-foreclosure rescinds the completed EP transaction by:

- notifying the EP investor of their decision to rescind the transaction, called a **notice of rescission**[3]; and
- returning all funds and items of value received from the EP investor under the EP agreement (*restoration*).[4]

To perfect their claim for restoration of the property to their ownership, the seller-in-foreclosure also records the *notice of rescission* in the county in which the real estate is located.

The notice of rescission describes the real estate and contains the names of the:

- rescinding seller;
- EP investor; and
- any successor-in-interest of the investor who is not a **bona fide purchaser (BFP)**.

Once served with a notice of rescission, the EP investor (or their non-bona fide successor) has 20 days to reconvey title to the rescinding seller, free of any encumbrances the EP investor or their non-bona fide successor placed on title after acquiring the property.[5]

Often an investor on acquiring ownership to a homeowner's residence further invests money and effort rehabilitating and carrying the expenses of property ownership. However, a rescinding seller has no obligation under EP law to reimburse the investor for these expenditures. The EP investor's improvements during the two-year rescission period are not considered good faith improvements. The expenditures are made while the investor holds a voidable ownership interest in the property.

The EP investor's conduct, which created the unconscionable advantage over the seller-in-foreclosure, charges them with knowledge of their defective title. EP law then acts to sanction the EP investor, if the seller establishes an unconscionable advantage in conduct and pricing.

If the EP investor fails to timely reconvey title to the seller on notice of rescission, the seller is allowed to sue the investor to enforce the rescission and recover the residence.

The prevailing party in the rescission action is entitled to attorney fees. Here, the seller-in-foreclosure is basically insolvent, but has reason to believe the return of the property will be financially rewarding.[6]

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3 CC §§1695.14(b)
4 CC §§1691
5 CC §§1695.14(b)
6 CC §§1695.14(d)

The burden of proving unconscionable advantage

Showing the existence of and defending against the components of an *unconscionable advantage*, evidenced by the investor's conduct and pricing, is problematic for both the seller-in-foreclosure and the EP investor.

The legislature has not clearly defined what exactly constitutes an act of unconscionable advantage by an EP investor. It is difficult for the seller-in-foreclosure to prove — and for the EP investor to refute.

A reasonable sales price under the circumstances at the time the EP transaction was entered into may possibly appear to be unconscionable to the seller in the future. Thus, an EP investor assumes not only the risk that a rising economy may provide a profit on a flip, but that it will provoke the seller into attempting to rescind the sale to capture that profit as part of their original sale.

However, the test of unconscionable advantage is not based on events occurring after the seller-in-foreclosure enters into the purchase agreement. Thus, any increase in the value of the property after acceptance of the EP investor's offer is not considered. It is the FMV of the property at the time of the EP investor's acquisition that is critical.

The evaluation of a seller's assertion of unconscionable advantage is based on market circumstances existing at the time negotiations were conducted, or when the parties entered into the EP agreement.

Title insurance

Title insurance companies have few qualms about insuring property purchased during the foreclosure period. The reason: title insurance does not defend or cover the insured EP investor against the seller's rescission claims. By definition, the seller's claim is based on the conduct of the buyer, which is an exclusion from coverage.

Some title companies insist the seller-in-foreclosure sign an *estoppel affidavit* declaring the seller:

- fully understands the nature of the EP transaction;
- appreciates the finality of the consequences of the sale;
- agrees the purchase price is reasonable and fair under the circumstances; and
- the transaction is not merely financing that allows the seller to reacquire title to the property.

The signed affidavit makes it more difficult for the seller-in-foreclosure to later decide to rescind the transaction and recover their property, since it increases the seller's burden of proving unconscionable advantage.

However, the affidavit does not and cannot waive the seller-in-foreclosure's two-year right of rescission if unconscionable pricing and an oppressive negotiating environment on the part of the buyer actually existed. Any waiver of the seller's rescission rights is void as a violation of the home equity sales law.[7]

The BFP on a flip of the property

Consider an investor who acquires ownership in an EP transaction. The investor then resells (flips) the property for a fair market price to a BFP before the seller-in-foreclosure's two-year right of rescission expires and before the seller records a notice of rescission.

The seller seeks to recover title to the residence and follows the necessary steps to rescind the transaction.

However, rescission is not available to the seller-in-foreclosure against the BFP if the property is purchased or encumbered prior to the seller recording a notice of rescission.[8]

Despite the BFP status preventing the seller from recovering the property, the seller is permitted to recover money from the EP investor. The dollar amount of the recovery is based on the value of the lost equity at the time of the sale to EP investor, not the resale value. The money recovery claim is to be filed within four years of the investor's violation of the EP statutes.

Further, and more menacing for the EP investor, is the automatic entitlement of the seller to additionally recover three times their actual loss as punitive damages mandated by statute, known as **treble damages.**[9]

The BFP's title insurance

Obtaining title insurance poses no problem for the BFP. A title insurance company is to insure over the seller-in-foreclosure's two-year right of rescission, unless a notice of rescission has been recorded (or the title company has other knowledge of the seller's claim).

Title insurance only insures against what is not known by the buyer at the time the insurance is obtained or not listed as an exclusion from coverage.

Yet, the title insurance company has a duty to defend the BFP against any later rescission claim made by the seller-in-foreclosure against the BFP.

What if the insured buyer is not a BFP, but a successor-in-interest involved in a title flipping scheme with the EP investor for the purpose of avoiding the seller-in-foreclosure's right of rescission? Here, the title insurance company may refuse to defend the insured buyer against the seller's enforcement of their right of rescission.[10]

7 CC §1695.10
8 CC §1695.14(c)
9 CC §1695.7
10 Calif. Insurance Code §330 et seq.

Sale-leaseback to the insolvent seller

A buyer who chooses to acquire a property from an EP investor is obligated to inquire about the property rights of any person in possession of the property before they can qualify as a BFP.[11]

Consider an EP transaction in which the seller-in-foreclosure occupies the property under a sale-leaseback arrangement. Here, the buyer is charged with inquiring of the occupant as to their rights in the property (as also is the title company to inquire when issuing a American Land Title Association ALTA policy).

If the seller-in-foreclosure holds an *option to purchase* under the sale-leaseback, the sale-leaseback is in law a **mortgage**, not a sale as structured. Further, the investor is a lender, not a buyer; the seller is still the owner.

Thus, the lender vested as the title holder has nothing to sell beyond their right to receive money as holder of a lien on the property for repayment of a debt since the grant deed is a mortgage-in-fact.[12] [See Chapter 21]

Possession of property by any person other than the current vested owner of record imparts **constructive notice** to a potential buyer to inquire as to the right, title, and interest of the person in possession.[13]

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11 CC §1695.14(c)
12 CC §1695.12
13 **Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356

Chapter 4 Summary

Purchasing a single family residence (SFR) from a seller-in-foreclosure places a heavier burden on the equity purchase (EP) investor to protect the seller's interests than when purchasing an SFR from a seller who is not in foreclosure. The EP investor's risk lies in a seller-in-foreclosure's two-year right of rescission. This right gives the seller-in-foreclosure the ability to rescind the sale and recover the property for the price the investor paid within two years after closing based on a claim of unconscionable advantage.

To prove an EP investor took unconscionable advantage, the seller needs to provide evidence of both:

- the purchase price or method of payment was unreasonably favorable to the EP investor, legally called substantive unconscionability; and
- the lack of a meaningful choice of action for the seller-in-foreclosure when negotiating to sell to the EP investor, legally called procedural unconscionability.

Both components need to be present to show unconscionability existed.

To protect themselves from an unconscionable advantage claim, the EP investor purchases the property of a seller-in-foreclosure using reasonable pricing and payment. To this end, the investor's agent has a duty to advise and assist in meeting this objective.

The legislature has not clearly defined what exactly constitutes an act of unconscionable advantage by an EP investor. It is difficult for the seller-in-foreclosure to prove — and for the EP investor to refute. The test of unconscionable advantage is not based on events occurring after the seller-in-foreclosure enters into the purchase agreement. It is the fair market value (FMV) of the property at the time of the EP investor's acquisition and the investor's oppressive conduct that is critical.

Chapter 4 Key Terms

Chapter 5

Reinstatement and redemption periods during foreclosure

Learning Objectives

After reading this chapter, you will be able to:

- identify the boilerplate power-of-sale and acceleration provisions in trust deeds;
- understand how a property owner or junior lienholder terminates foreclosure proceedings by reinstating or redeeming a mortgage;
- distinguish the timeframes an owner has to cure a default and reinstate the mortgage from periods for trustee's notices, postings and advertising periods;
- advise a client on their financial options when faced with foreclosure; and
- recognize defaults curable only by redemption.

Key Terms

acceleration
future advances clause
power-of-sale provision
redeem
reinstatement

Nullifying the lender's call during foreclosure

Trust deeds securing a debt obligation contain a boilerplate provision authorizing lenders to call all amounts remaining unpaid due and payable on a material default under the trust deed, called an **acceleration clause**. Similarly, the trust deed **power-of-sale provision** authorizes the trustee to initiate a non-judicial foreclosure sale of the property on a declaration of default and instructions to foreclose from the *mortgage holder*.

Exercising the *power-of-sale provision,* the trustee records a *notice of default* (NOD), initiating the trustee's foreclosure procedures when instructed by the

acceleration
A demand on an owner of property by a mortgage holder for immediate payment of all amounts remaining unpaid on a mortgage. Also known as a call.

mortgage holder to do so. As a result of the tandem effect of the *acceleration clause* when an NOD is recorded, all sums remaining to be paid on the note and trust deed become due and immediately payable, subject to the owner's and junior lienholder's reinstatement rights.

Consider a homeowner who defaults on a trust deed lien on their property (which includes any default on the note). To enforce collection of all sums owed, the mortgage holder by a declaration handed to the trustee causes an NOD to be recorded commencing foreclosure.

power-of-sale provision
A provision contained in a trust deed or other security device granting the holder the ability to nonjudicially foreclose by a trustee's sale of the secured real estate.

An EP investor's agent, aware of the NOD, submits an EP agreement offer to the homeowner. The homeowner accepts. The terms include the transfer of ownership to the EP investor, taking title subject to the existing mortgage in foreclosure. The homeowner is to pay all delinquencies and foreclosure charges through escrow on closing using funds received on the price paid by the EP investor.

Escrow is opened on the running of the seller's right to cancel the EP transaction within five business days of acceptance. The escrow agent sends a request for a *beneficiary statement* to the holder of the note and trust deed, called the **beneficiary**. The mortgage holder responds to escrow's request for a beneficiary statement by sending a **payoff demand**, not a beneficiary statement. The mortgage holder claims they are enforcing the acceleration clause in the trust deed and will only accept payment in full now that the NOD has been recorded.

Itemization of delinquencies and charges

The NOD itemizes the amount of all delinquencies and related charges separately from the balance due. Thus, escrow is able to determine the amount due to cure the default. The trustee is contacted and the total of the foreclosure fees and charges incurred by the date scheduled for close of escrow are established.

The EP investor deposits closing funds with escrow on escrow's call for funds. Escrow is closed, title is conveyed to the EP investor and the delinquencies and foreclosure costs sufficient to reinstate the mortgage are forwarded to the trustee, payable to the mortgage holder from funds accruing to the homeowner on closing.

The mortgage holder rejects the sales proceeds, claiming the entire amount of their note is due as agreed in the trust deed provisions. Further, the mortgage holder claims the **due-on clause** in the trust deed has now been triggered by the buyer's failure to obtain the beneficiary's consent to the sales transaction. Thus, the mortgage holder now further justifies a full payoff of the debt based on a violation of the due-on clause.

Does escrow, on tendering only the amount of the delinquencies and foreclosure costs necessary to cure the default, cause the mortgage to be reinstated as though a default had never occurred?

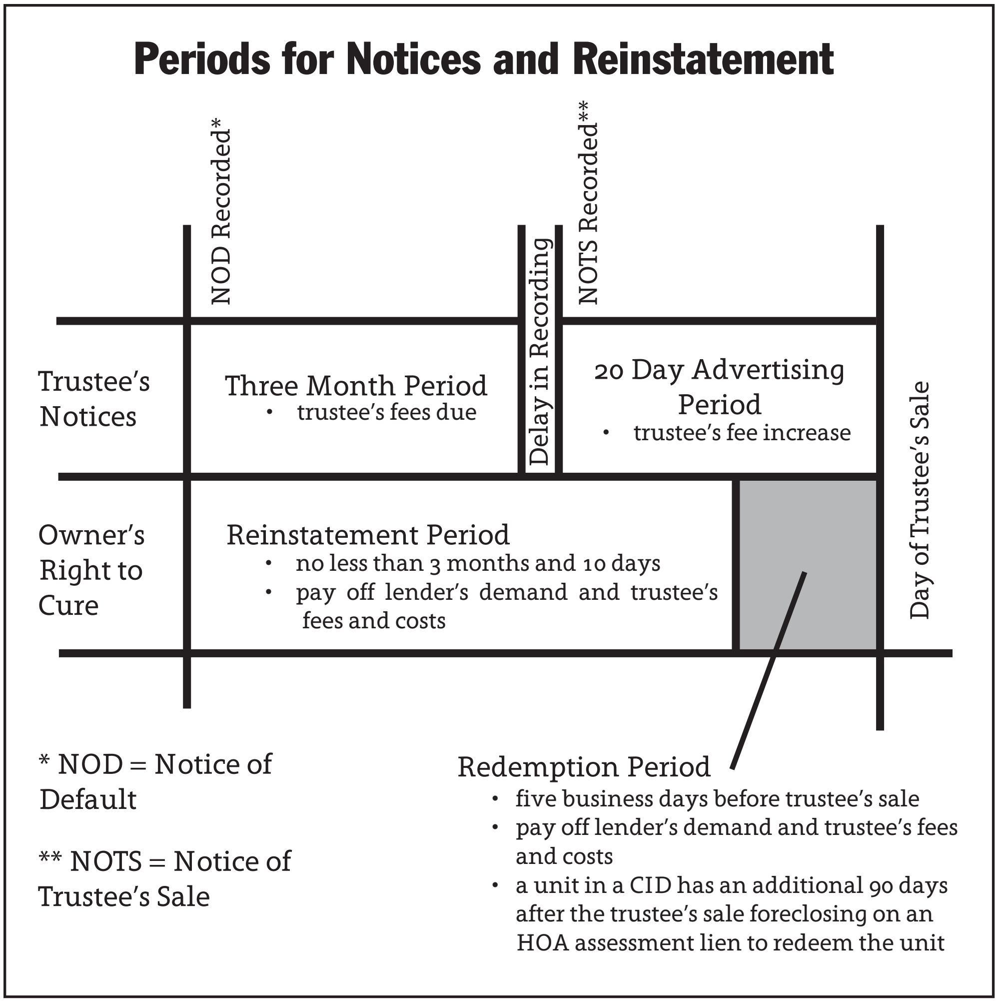

Figure 1

Periods for Notice and Reinstatement

Yes! After an NOD is recorded and prior to five business days before the trustee's sale, the owner is able to terminate the foreclosure proceedings by paying:

- the *delinquent amounts* due on the note and trust deed as described in the NOD and foreclosure charges, called **reinstatement**;[1] or
- the *entire amount* due on the note and trust deed, plus foreclosure charges, called **redemption**.[2]

In this instance, the call triggered by a violation of the due-on clause based on the unconsented-to transfer to the EP investor took place after the recording of the NOD. The default in payment due on the call is not stated as a default in the NOD. Thus, the due-on call cannot be enforced under this NOD. Here, the mortgage holder needs to call the loan due if they do not intend to accept monthly payments from the new owner, and if not paid in full, proceed anew to foreclose under a later recorded NOD.

reinstatement
The curing of monetary defaults and terminating the foreclosure process on a mortgage by a property owner or junior lienholder prior to expiration of the reinstatement period applicable to the trustee's or judicial foreclosure by paying the delinquent amounts and foreclosure charges.

redeem
The clearing of title to a parcel of real estate of a monetary lien, such as a mortgage, through payment of the debt in full as is required during a redemption period to avoid loss of the property either at a trustee's foreclosure sale or following a judicial foreclosure sale.

1 Calif. Civil Code §2924c
2 CC §2903

Monetary defaults and reinstatement

A trust deed on which a foreclosure has been initiated is *reinstated* when the mortgage holder receives:

- all amounts referenced as delinquent in the NOD, including principal, interest, taxes and insurance (collectively known as PITI), assessments, and advances;
- installments that become due and remain unpaid after the recording of the NOD;
- any future advances made by the mortgage holder after the recording of the NOD to pay taxes, senior liens, assessments, insurance premiums, and to eliminate any other impairment of the security; and
- costs and expenses incurred by the mortgage holder to enforce the trust deed, including statutorily limited trustees fee's or attorney fees.[3]

After the NOD is recorded

After an NOD is recorded, an owner or junior lienholder may bring current any curable monetary default stated in the NOD prior to five business days before the trustee's sale, called the **reinstatement period**. If the sale is postponed, the *reinstatement period* is extended, ending the day before the fifth business day prior to the postponed sale date.[4] [See Figure 1]

Until the NOD is recorded by a trustee, the mortgage holder is compelled to accept the tender of all delinquent amounts noticed in the NOD.

After recording the NOD, the trustee needs to allow three months to pass before advertising and posting notice of the date of the trustee's sale.[5] [See Figure 1]

The trustee needs to begin advertising and post a **Notice of Trustee's Sale (NOTS)** at least 20 days before the date of the sale. The property may be sold by the trustee no sooner than the twenty-first day after advertising begins and the posting of notice occurs.[6] [See Figure 1]

Additionally, if the billing address for the owner is different than the address of the *residential property* in foreclosure, the NOTS needs to be accompanied by a notice to the occupants regarding their tenant rights during and after foreclosure.[7] [See **first tuesday** Form 573]

The owner in foreclosure is no longer allowed to delay the trustee's sale by requesting a postponement.[8]

Thus, the owner or junior lienholder has approximately 105 days after recording the NOD to cure the default and reinstate the note and trust deed. Doing so avoids a full payoff or foreclosure of the property.

3 CC §2924c(a)(1)
4 CC §2924c(e)
5 CC §2924
6 CC §2924f(b)
7 CC §2924.8
8 CC §2924g

Reinstatement of the note and trust deed

To determine the last day for reinstatement of the mortgage, consider a trustee's sale scheduled for a Friday. Count back five business days beginning with the first business day prior to the scheduled Friday sale. Since weekends are not business days, the fifth day counting backward from the scheduled trustee's sale is the previous Friday (if no holidays exist).

Thus, the very last day to reinstate the mortgage is on the Thursday eight calendar days before the trustee's sale.

The mortgage holder's failure to identify or include the dollar amount of all known defaults in the NOD does not invalidate the NOTS. Further, the mortgage holder may enforce payment of any omitted defaults by recording another, separate NOD.[9]

On reinstatement of the mortgage, the NOD is rescinded by the trustee, removing the recorded default from the title to the property.[10]

Any call due to a default is eliminated when the mortgage have been reinstated. Upon reinstatement, the owner continues their ownership of the property as though the mortgage had never been in default.

Redemption to clear title

Failure to cure a default before the reinstatement period expires allows a mortgage holder to require the owner to *redeem* the property prior to completion of the trustee's sale by:

- paying all sums due under the note and trust deed; and
- reimbursing the costs of foreclosure.

The owner's right of redemption runs until the trustee completes the bidding and announces the property has been sold. Any owner, junior lienholder, or other person with an interest in the property may satisfy the debt and redeem the property prior to the completion of the trustee's sale.[11]

To redeem the property, the owner or junior lienholder is required to pay:

- the principal and all interest charges accrued on the principal;
- permissible penalties;
- foreclosure costs; and
- any future advances made by the foreclosing mortgage holder to protect its security interest in the property.

Unless all amounts due on the note and trust deed resulting from the owner's default are paid in full during the redemption period, the owner loses ownership of the property at the trustee's foreclosure sale.

Lender remedies on a default

An owner's default on a trust deed encumbering their property may arise under a provision in either the note or trust deed.

9 CC §2924
10 CC §2924c(a)(2)
11 CC §2903

Sidebar

The owner's alternatives

Aside from reinstatement and redemption, an owner of property has several other options when faced with losing their property through foreclosure. These options include:

1. ***Refinance*** *— The owner obtains a new loan to pay off the one in default.*
2. ***Foreclosure consultant*** *— The owner seeks the services of a financial advisor or investment counselor, called a foreclosure consultant. For a fee, a foreclosure consultant will:*
   - *prevent a lender from enforcing or accelerating the note;*
   - *help the owner reinstate the loan or receive an extension of the reinstatement period; or*
   - *arrange a loan or an advance of funds for the owner. [CC §2945.1(a)]*

   However, a property owner grappling with foreclosure can obtain similar services at no cost from a mortgage counselor subsidized by the federal government.
3. ***Deed-in-lieu*** *— The owner deeds the property directly to the mortgage holder in exchange for cancelling the secured debt.*
4. ***Litigate*** *— The owner disputes the validity of the foreclosure by filing an action, restraining and enjoining the foreclosure.*
5. ***Bankruptcy*** *— The owner files a petition in bankruptcy for protection. The petition automatically stays the foreclosure until a release of the stay is obtained by the mortgage holder from the court. [11 United States Code §362(a)]*

   Unless the owner can make up the default or have the loan amount "crammed down" as part of any reorganization plan, bankruptcy only delays the inevitable foreclosure. Once the automatic stay is lifted, the foreclosure sale may take place no sooner than seven calendar days later. [CC §2924g(d)]
6. ***Sale*** *— The owner sells the property to a buyer before the trustee's sale. A recorded NOD states the owner has the right to sell their property while in foreclosure. [CC §2924c(b)]*

   In an effort to protect owners from being unlawfully deprived of the equity in their property, special requirements exist for purchase agreements between owners and ***equity purchase investors*** *on owner-occupied, one-to-four unit residential property in foreclosure. [CC §1695 et seq.]*

   However, selling property in foreclosure is difficult for the owner. Time constraints imposed by reinstatement and redemption periods and the difficulty of locating a buyer-occupant or investor able to meet the financing needs to assume or pay off existing loans, cure defaults and correct the deferred maintenance on the property exacerbate any sales effort .
7. ***Walk away*** *— The owner on a default decides to vacate the property when the lender completes foreclosure. This is also known as a strategic default.*

   A strategic default is an economically viable alternative for an owner with little or no equity remaining in the property. The strategy is particularly useful if payments saved during continued occupancy (nine months on average from default) exceed the value of the equity in the property, and specifically when the mortgage balance exceeds the property's value.

A default on the note triggers a default on the trust deed, permitting foreclosure. For example, when the owner fails to pay installments as they become due under the terms of the note, the owner is in default on the note. Thus, a default also exists on the trust deed.

The owner's default prompts the mortgage holder to immediately call the loan due under the *acceleration clause* in the trust deed by the act of recording an NOD.

Additionally, when the owner fails to meet their obligations regarding the care, use and maintenance of the secured real estate, the owner is in default under the **waste provision** in the trust deed. The default on the trust deed exists even though the owner may be current on all payments called for in the note.

Other activities are considered a default on the trust deed, such as the owner's failure to pay:

- property taxes;
- hazard insurance premiums;
- assessments; and
- amounts due on senior trust deed liens.

A mortgage holder may advance funds to cure a default on the trust deed or preserve the value of the property. The amount of the advance is then added to the debt owed by authority of the trust deed's **future advances** provision. The mortgage holder may then demand the immediate repayment of the advance from the owner.

Trust deed defaults and reinstatement

A property owner's ability to **reinstate** a loan by curing a default depends on the trust deed provision in default.

For example, an owner of real estate encumbered by a mortgage fails to pay property taxes. The mortgage holder records an NOD, specifying the delinquent property taxes as the owner's default.

Is the property owner able to reinstate the loan and retain the property by eliminating the default?

Yes! The default is monetary, entitling the owner to reinstate the loan by simply paying the delinquent property taxes, and the trustee's fees and charges incurred in the foreclosure proceeding. Monthly payments on the note, payment of insurance premiums and payments on senior encumbrances are also curable defaults allowing reinstatement of the mortgage.

Defaults cured only by redemption

Some trust deed defaults do not allow debt to be reinstated. Reinstatement of the note on those defaults is only available if agreed to by the mortgage holder. Defaults triggering a call and requiring redemption of the property by a payoff of the entire debt without the ability to reinstate the mortgage include:

- a breach of a due-on clause;
- a waste provision; or
- a violation of law provision in the use of the property.

Consider real estate that is encumbered by a trust deed requiring the owner to maintain their property in good condition and repair. The owner fails to maintain the property, and the roof needs replacement.

The mortgage holder becomes concerned as the owner's activities have decreased the value of the mortgage holder's security, called **impairment**. Due to the owner's failure to maintain the property in good condition, the mortgage holder calls the loan, and on the owner's failure to fully satisfy the remaining debt, records an NOD against the property.

In this instance, the owner cannot cure the default in the trust deed (waste) by tendering less than the entire remaining balance of the debt. Thus, the owner is unable to reinstate the mortgage. As a result, the entire foreclosure period becomes the redemption period.

future advances clause
A trust deed provision authorizing a mortgage holder to advance funds for payment of conditions impairing the mortgage holder's security interest in the mortgaged property, such as delinquent property taxes, assessments, improvement bonds, mortgage insurance premiums or elimination of waste. [See **ft** Form 450 §2.5]

To retain ownership of the property, the owner needs to *redeem* the property by tendering full payment of all sums due, including foreclosure costs, prior to the trustee's sale.

Alternatively, a trust deed provision gives the holder the authority to cure the waste and add that cost to the principal balance of the debt under the **future advances clause**.

However, when waste by the owner is committed in *bad faith*, the foreclosing mortgage holder needs to consider an underbid at the trustee's sale in an amount equal to the property's reduced fair market value attributable to the waste. With an underbid, the mortgage holder may sue the owner to recover the deficient property value below the amount due on the debt caused by the bad faith waste.[12]

12 **Cornelison** v. **Kornbluth** (1975) 15 C3d 590

Chapter 5 Summary

Trust deeds securing debt obligations contain a boilerplate provision authorizing mortgage holder to call all amounts remaining unpaid due and payable on a material default under the trust deed, called an acceleration clause. Similarly, the trust deed power-of-sale provision authorizes the trustee to initiate a non-judicial foreclosure sale of the property on a declaration of default and instructions to foreclose from the mortgage holder.

After a notice of default (NOD) has been recorded and prior to five business days before the trustee's sale, the owner may terminate the foreclosure proceedings by paying:

- the delinquent amounts due on the note and trust deed, plus foreclosure charges, called reinstatement; or
- the entire amount due on the note and trust deed, plus foreclosure charges, called redemption.

The owner or junior lienholder has approximately 105 days after recording the NOD to cure the default and reinstate the note and trust deed. Doing so avoids a full payoff or foreclosure sale of the property.

On reinstatement of the note and trust deed, the NOD is rescinded by the trustee, removing the recorded default from the title of the property. The owner continues their ownership of the property as though the trust deed had never been in default.

A property owner's ability to reinstate a trust deed by curing a default depends on the trust deed provision in default.

Failure to cure a default before the reinstatement period expires allows a trust deed holder to require the owner to redeem the property and avoid the trustee's sale by:

- paying all sums due under the note and trust deed; and
- reimbursing the costs of foreclosure prior to completion of the trustee's sale.

The owner's right of redemption exists until the trustee completes the bidding and announces the property has been sold.

Other activities are considered a default on the trust deed, such as the owner's failure to maintain the property, called waste, or failure to pay:

- property taxes;
- hazard insurance premiums;
- assessments; or
- amounts due on senior trust deed liens.

A trust deed holder may advance funds to cure a default on the trust deed and then add the advance to the debt owed. The trust deed holder may then demand the immediate repayment of the advance from the owner.

Chapter 5 Key Terms


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Chapter 6

Condition of property: disclosure by the seller-in foreclosure

Learning Objectives

In this chapter, you will learn about:

- the affirmative duty a seller-in-foreclosure and their agent have to visually inspect and disclose their observations and knowledge about the property's condition to equity purchase (EP) investors as prospective buyers;
- the mandated obligation of the seller-in-foreclosure and their agent owed to prospective EP investors to prepare and deliver a Transfer Disclosure Statement (TDS) presenting known conditions of improvements which might adversely affect the price and terms of an offer a prospective EP investor might submit; and
- the role of a home inspection report (HIR) to identify and warrant property conditions as an important risk mitigation activity for the seller and seller's agent in the preparation of a TDS.

Key Terms

"as-is" clause

home inspection report

transfer disclosure statement (TDS)

Mandated on one-to-four residential units

The seller of a one-to-four unit residential property completes and delivers to a prospective equity purchase (EP) investor a statutory form called a **Transfer Disclosure Statement (TDS)**, more generically called a **Condition of Property Transfer Disclosure Statement**.[1] [See Figure 1, **first tuesday** Form 304]

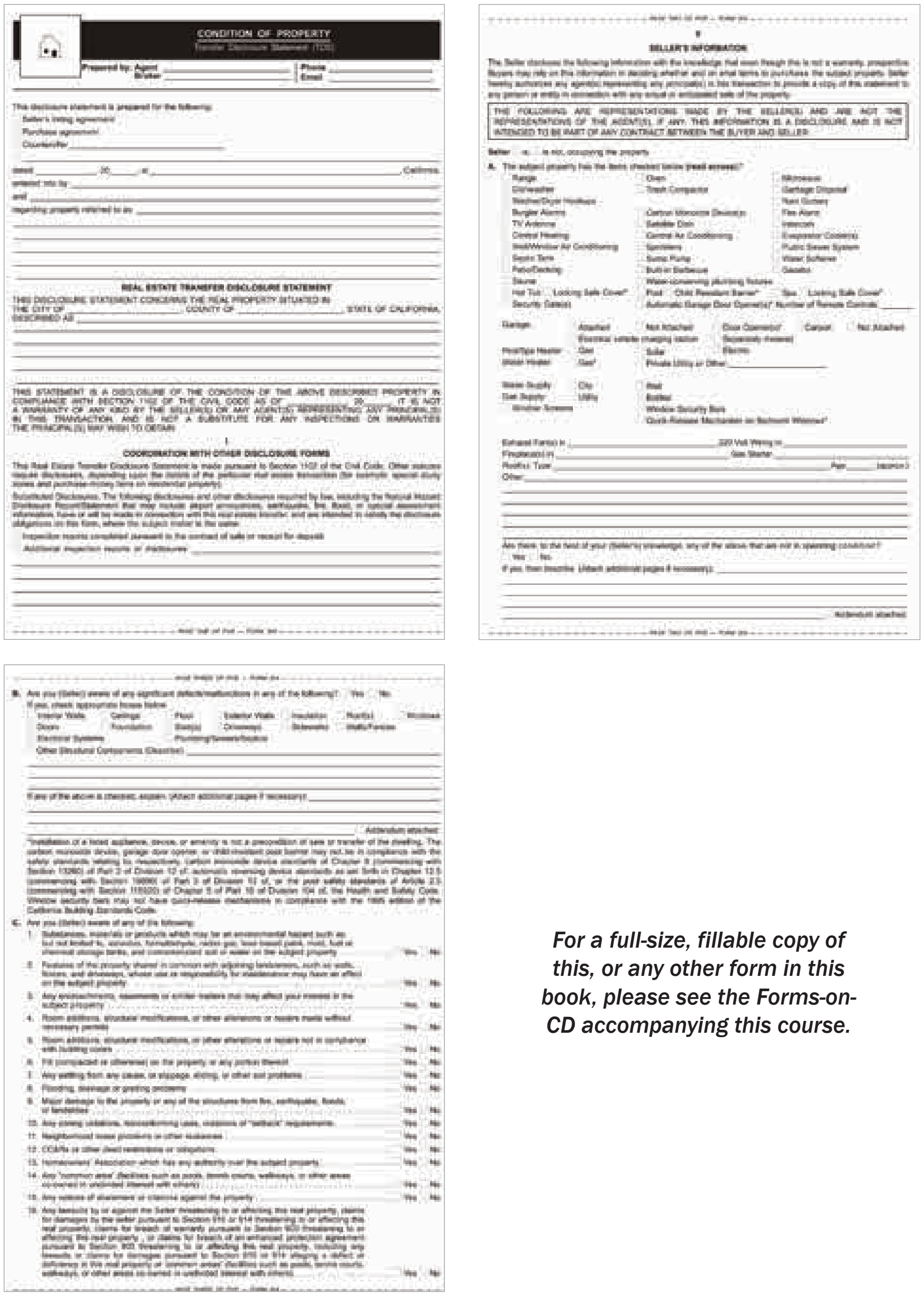
1 Calif. Civil Code §§1102(a), 1102.3

Figure 1

Form 304

Condition of Property Disclosure

Pages 1-3



CONDITION OF PROPERTY

REAL ESTATE TRANSFER DISCLOSURE STATEMENT

COORDINATION WITH OTHER DISCLOSURE FORMS

SELLER'S INFORMATION

For a full-size, fillable copy of this, or any other form in this book, please see the Forms-on-CD accompanying this course.

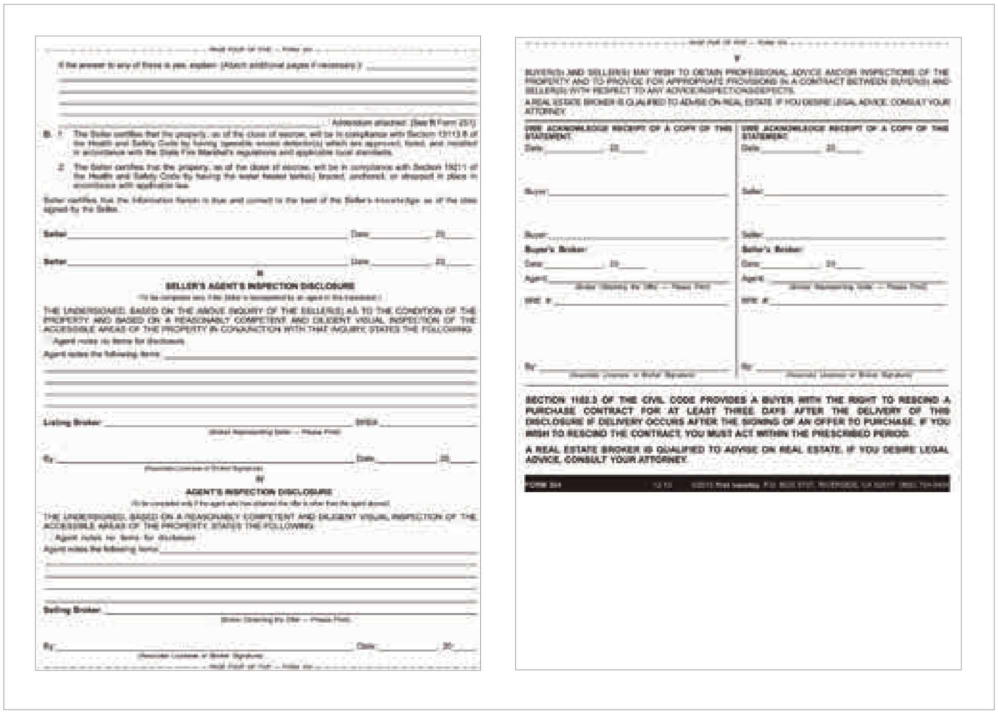
transfer disclosure statement (TDS)
A mandatory disclosure prepared by a seller-in-foreclosure and given to prospective buyers setting forth any property defects known or suspected to exist by the seller, generically called a condition of property disclosure. [See **ft** Form 304]

The seller's use of the *TDS* form is mandated. The seller is required to prepare it with *honesty and in good faith*, whether or not a seller's agent is retained to review its content.[2]

When preparing the TDS, the seller sets forth any property defects known or suspected to exist by the seller.

Any conditions known to the seller which might *negatively affect* the value and desirability of the property for a prospective EP investor are to be

2 CC §1102.7



SELLER'S AGENT'S INSPECTION DISCLOSURE

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'S INSPECTION DISCLOSURE

THE UNDERSIGNED, BASED ON A REASONABLY COMPETENT AND DILIGENT VISUAL INSPECTION OF THE ACCESSIBLE AREAS OF THE PROPERTY, STATES THE FOLLOWING:

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.

Figure 1 Cont'd

Form 304

Condition of Property Disclosure

Pages 4-5

disclosed, even though they may not be an item listed on the TDS. Disclosures to the EP investor are not limited to conditions preprinted for comment on the form.[3]

Also, the EP investor cannot waive delivery of the statutorily-mandated TDS. Any attempted waiver, such as the use of an **"as-is" clause** in the purchase agreement, is *void* as against public policy. The words *as is* are never to be used in the context of real estate transactions. The words "as is" imply a failure to disclose something adverse known to the seller or the seller's agent, a prohibited activity.[4]

"as-is" clause
An unenforceable provision stating the buyer accepts the property without a full disclosure of known conditions. Properties are sold "as-disclosed," never "as-is."

Delivery of the disclosure statement

While it is the seller who prepares the TDS, the TDS is delivered to the EP investor by the agent who is directly handed the purchase agreement offer by the EP investor. If the sales transaction is negotiated principal-to-principal, directly between the seller and EP investor without the participation of a transaction agent, the seller is obligated to deliver the TDS to the buyer.[5]

The failure of the seller or any of the agents involved to deliver the seller's TDS to the EP investor will not invalidate a sales transaction once it has closed. However, the seller and the seller's broker are both liable for the actual monetary losses incurred by the EP investor due to an undisclosed defect known to them or unknown due to their negligence.[6]

3 CC §1102.8
4 CC §1102.1(a)
5 CC §1102.12
6 CC §1102.13

Further, the TDS is mandated to be handed to the EP investor before the seller accepts a purchase agreement offer submitted by an EP investor. If the TDS is delivered to the EP investor *after* the seller enters into a purchase agreement, the delivery is untimely in violation of TDS rules, and the EP investor may:

- *cancel* the purchase agreement on discovery of undisclosed defects known to the seller or the seller's agent and unknown and unobserved by the EP investor or the EP investor's agent prior to acceptance;[7]
- *make a demand* on the seller to correct the defects or reduce the price accordingly before escrow closes [See **first tuesday** Form 150 §11.2]; or
- *close escrow* and make a demand on the seller for the costs to cure the defects.[8]

These EP investor rights are explained below.

EP investor's right to cancel on delayed disclosure

The TDS is to be delivered to prospective buyers, including EP investors, *as soon as practicable* on commencement of negotiations. Negotiations commence when an EP investor, after receiving preliminary marketing information on a property, makes further inquiries by asking questions or seeking more information relating to the specific property for sale.

Delivery of the seller's TDS to the EP investor is deemed to have occurred if the TDS is attached to the purchase agreement offer made by the EP investor or the counteroffer made by the seller.[9]

As with the delivery of the Natural Hazard Disclosure Statement (NHDS), which has been dictated by the California Attorney General to be delivered ASAP, the TDS is to be delivered before the seller enters into a purchase agreement with a buyer.[10]

If the TDS is belatedly delivered to the EP investor — after the EP investor and seller enter into a purchase agreement — the EP investor may, among other monetary remedies, *elect to cancel* the purchase agreement under a statutory three-day right to cancel. The EP investor's statutory cancellation right runs for three days following the day the TDS is actually handed to the EP investor (five days if delivered by mail).[11]

home inspection report
A report prepared by a home inspector disclosing defects in improvements on a property and used by the seller's agent to assure prospective buyers about actual property conditions. [See **ft** Form 130]

However, EP investors on their in-escrow receipt of an unacceptable TDS or **home inspection report** are not limited to canceling the purchase agreement and "going away." They have monetary remedies available to them.

7 CC §1102.3
8 **Jue** v. **Smiser** (1994) 23 CA4th 312
9 CC §1102.3
10 Calif. Attorney General Opinion 01-406 (August 24, 2001)
11 CC §1102.3

Demand to cure an undisclosed material defect

As an alternative remedy to cancelling the purchase agreement on a delayed receipt of an unacceptable TDS, the EP investor may *make a demand* on the seller to cure any undisclosed material defect affecting value which was *known or should have been known* to the seller or the seller's agent prior to entering into the purchase agreement. If the seller's agent knew or is charged with knowledge of the undisclosed defects at the time the EP investor and seller entered into the purchase agreement, the EP investor's demand to cure the material defect may also be made on the seller's agent. [See **first tuesday** Form 269]

When the seller will not voluntarily cure the defects on demand, the EP investor may close escrow and recover the cost incurred (or lost value) to correct the defect. The buyer is not limited in their recourse by the purchase agreement contingency provision referencing only the statutory right to cancel the transaction for failure to timely disclose. Defects *known and undisclosed*, or inaccurately disclosed, by the seller or the seller's agent at the time the seller accepts the EP investor's purchase offer impose liability on those who knew or are charged with knowledge.[12]

Another alternative to canceling is for the EP investor to perform on the purchase agreement by tendering an amount for the *price reduced* by the cost to repair or replace the defects known to the seller or the seller's agent and untimely disclosed or discovered by the EP investor while under contract. [See **first tuesday** Form 150 §11.2]

Include a home inspector

A competent seller's agent will aggressively recommend the seller retain a **home inspector** before they market the property. The inspector hired will conduct a physical examination of the property to determine the condition of its component parts. On the home inspector's completion of their examination, a *HIR* will be prepared on their observations and findings, which is forwarded to the seller's agent. [See Chapter 7]

The HIR is used in the preparation of the seller's TDS. Both are presented to EP investors before the seller accepts an offer to provide maximum mitigation of risks of claims made by the buyer on the seller and the seller's agent.

Mandatory inspection by the seller's agent

A seller's agent is obligated to personally carry out a competent *visual inspection* when they list a one-to-four unit residential property for sale. This is not an obligation of the buyer's agent.

Following their mandatory visual inspection, the seller's agent prepares the seller's TDS. In addition to observations, they may rely on *specific items* covered in a home inspector's report they obtained on the property.

An EP investor, as with any buyer of a 1-to-4 residential unit property, has *two years* from the close of escrow to pursue the seller's broker and agent to recover losses caused by the broker's or agent's *negligent failure* to disclose observable and known defects affecting the property's physical condition

12 Jue, *supra*

and value. Undisclosed and unknown defects permitting recovery by an EP investor for the cost to cure the defect or lose of value are those observable by a reasonably competent broker during a visual on-site inspection. A seller's agent is expected to be as competent as their broker in an inspection.[13]

However, the EP investor is unable to recover their losses from the seller's broker if the seller's broker or agent inspected the property and as a reasonable competent broker did not observe the defect and did not actually know it existed.[14]

The illegal "as-is" sale

Consider a seller's agent who, on conducting their visual inspection of a property, has reason to believe the property fails to conform to building and zoning regulations.

The agent knows a prospective EP investor interested in making an offer is not aware of the possible violations, and might view the property's value differently if they learn the violations may exist.

The EP investor submits a purchase agreement offer. The agent prepares a counteroffer and includes an *"as-is" clause* which the seller signs. The provision states the agent "makes no representations regarding the property and incurs no liability for any defects, the EP investor agreeing to purchase the property "as is." The counteroffer is submitted to the EP investor and accepted.

After closing, the city refuses to provide utility services to the residence due to building code and zoning violations.

The "as-is" disclaimer

Continuing our previous example, the EP investor makes a demand on the seller's broker and agent for the EP investor's money losses due to overpricing and the cost of corrective repairs. The EP investor claims the seller's broker and agent breached their *general agency duties* owed the EP investor. They failed to disclose material defects in the property known to the agent, but not the EP investor.

The agent claims the EP investor waived their right to collect money losses when they signed the purchase agreement with the "as-is" disclaimer.

Does use of an "as-is" disclaimer provision shield a seller's broker from liability for the EP investor's losses caused by the building and zoning violations which were *suspected to exist* by the broker's agent and not known or suspected by the EP investor?

No! The seller's broker and agent have a *general duty*, owed to all parties in the transaction, to personally conduct a competent visual inspection of the property sold. The breach of the seller's agent's duty to disclose their knowledge or observations about *potential adverse conditions* is not excused by placing an "as-is" disclaimer into the purchase agreement in lieu of factual disclosures.[15]

13 CC §2079.4
14 CC §1102.4(a)
15 **Katz** v. **Department of Real Estate** (1979) 96 CA3d 895

"As is" provisions are unnecessary to disclose the condition of the property since information giving notice of defects is presented in the seller's TDS mandated to be handed to the EP investor. The seller simply discloses the defects, whether or not they agree to make repairs.

Further, public policy prohibits the sale of one-to-four unit residential property "as is." Rather, all EP investors purchase property "as disclosed" by the seller, the seller's broker and the broker's agents, and as actually observed by the EP investor *prior to entering* into the purchase agreement. When defects are disclosed prior to entering into a purchase agreement, negotiations may call for the seller to correct some or all of the disclosed defects. If not, the EP investor takes ownership of the property subject to all those defects *as disclosed* at the time the EP investor's offer is accepted.[16]

Targeted property sales and exempt sellers

Unless a seller is *exempt*, sellers of one-to-four unit residential real estate are required to fill out and furnish EP investors with a statutory TDS when entering into a purchase agreement.[17]

Whether or not the seller is exempt from using the TDS, the seller's broker and their agents are never exempt from:

- conducting a *visual inspection* of a one-to-four unit residential property, sold or acquired on behalf of any seller or EP investor;[18] and
- disclosing their *observations and knowledge* about the property on a TDS form or other separate document.[19]

Transactions which exempt *the seller* (but not the seller's agent) from preparing and delivering the statutory TDS to an EP investor include transfers:

- by court order, such as probate, eminent domain or bankruptcy;
- by judicial foreclosure or trustee's sale;
- on the resale of real estate owned property acquired by a lender on a deed-in-lieu of foreclosure, or by foreclosure;
- from co-owner to co-owner;
- from parent to child;
- from spouse to spouse, including property settlements resulting from a dissolution of marriage;
- by tax sale;
- by reversion of unclaimed property to the state; and
- from or to any government agency.[20]

The seller-in-foreclosure is not exempt from preparing and delivering a TDS to an EP investor.

16 CC §1102.1(a)
17 CC §1102
18 CC §2079
19 CC §1102.1
20 CC §1102.2

Chapter 6 Summary

The seller of a one-to-four unit residential property completes and delivers to a prospective EP investor a statutory form called a Transfer Disclosure Statement (TDS).

The failure of the seller or any of the agents involved to deliver the seller's TDS to the EP investor will not invalidate a sales transaction once it has closed. However, the seller and the seller's broker are both liable for the actual monetary losses incurred by the EP investor due to an undisclosed defect known to them or unknown due to their negligence.

If the TDS is belatedly delivered to the EP investor — after the EP investor and seller enter into a purchase agreement — the EP investor may, among other monetary remedies, elect to cancel the purchase agreement under a statutory three-day right to cancel. As an alternative remedy to cancelling the purchase agreement on a delayed receipt of an unacceptable TDS, the EP investor may make a demand on the seller to cure any undisclosed material defect affecting value which was known or should have been known to the seller or the seller's agent prior to entering into the purchase agreement.

Also, the EP investor cannot waive delivery of the statutorily-mandated TDS. Any attempted waiver, such as the use of an "as-is" clause in the purchase agreement, is void as against public policy. The words "as is" are never to be used in the context of real estate transactions. The words "as is" imply a failure to disclose something adverse known to the seller or the seller's agent, a prohibited activity.

Chapter 6 Key Terms

Chapter 7

The home inspection report

Learning Objectives

After reading this chapter, you will be able to:

- understand an equity purchase (EP) investor's need for a home inspection report to confirm the physical condition of a property when entering into an EP agreement;
- exercise the care required in the selection of a qualified home inspector;
- appreciate the use of a home inspection report (HIR) to mitigate risks of misrepresentation in the preparation of the seller's Transfer Disclosure Statement (TDS) for delivery to prospective EP investors; and
- advise an EP investor when evaluating a property on the use of an energy efficiency audit report by a Department of Energy-certified Home Energy Rater.

Key Terms

California Home Energy Rating System (HERS)
home energy audit
home inspection report (HIR)
home inspector
material defect

HIR called for in the EP agreement

An equity purchase (EP) investor is interested in purchasing a seller-occupied one-to-four unit single family residential (SFR) property in foreclosure. The seller's agent has not prepared and made available a marketing package with property disclosures as mandated for delivery to prospective buyers.

The EP investor's agent prepares an EP agreement with **contingency and remedy provisions** regarding disclosures and investigation into the condition of the property.

Contingency and remedy provisions the EP buyer's agent includes in the EP agreement, among others, to confirm their expectations call for:

- the seller to furnish a **home inspection report (HIR)** prepared by an insured **home inspector** showing the land and improvements to be free of **material defects** [See **first tuesday** Form 156 §12.1(b)];
- the seller and the seller's agent to prepare, sign and deliver a condition of property disclosure (TDS) [See **first tuesday** Form 156 §12.2(b)]; and
- the EP investor to inspect the property twice — once to initially confirm the condition of the property and once again before closing escrow to confirm maintenance has not been deferred and *material defects* discovered after entering into the EP agreement have been corrected or eliminated. [See **first tuesday** Form 156 §12.4]

Transparency by design, not by default

On entering into a listing agreement with an SFR seller-in-foreclosure, the seller's agent asks the seller to give them authority to order an *HIR* on the property. [See Form 130 accompanying this chapter]

The home certification process is a cost the seller incurs to *properly market* the property to obtain the highest price a buyer will pay. The seller's agent explains the *HIR* is also used by the seller to prepare the **Transfer Disclosure Statement (TDS)** required of the seller and the seller's agent. [See **first tuesday** Form 304; see Chapter 6]

home inspection report (HIR)
A report prepared by a home inspector disclosing defects in improvements on a property and used by the seller's agent to assure prospective buyers about actual property conditions. [See **ft** Form 130]

Further, the HIR will be attached to the seller's *TDS*. Both are included in the agent's marketing package presented to prospective buyers who seek additional property information. With disclosures made at the earliest opportunity, the buyer's sense of symmetry of property information by an agent's up-front disclosures generally produces the best price paid for a property. [See **first tuesday** Form 304]

By handing an HIR to prospective buyers with the TDS (and other disclosures), the seller and the broker avoid claims by buyers about defective property conditions after a purchase agreement is entered into.

On receipt of the HIR from the home inspector, the seller has the choice to eliminate some or all of the deficiencies noted in the report. Sellers are not obligated to eliminate defects they disclose when offering a property for sale, unless they choose to. If a defect is eliminated, an updated HIR report is ordered out for use with the TDS for property disclosures to interested buyers.

The marketing role of the seller's agent

The task of gathering information about the condition of the property listed for sale and delivering the information to prospective buyers lies with the seller-in-foreclosure's agent.[1]

For the seller's agent to retain control throughout the process of marketing, selling and closing escrow with a buyer, the seller's agent on accepting a listing needs to counsel the seller and get authorization to request an HIR for use in the preparation of the TDS. [See Form 130]

1 Calif. Civil Code §2079

AUTHORIZATION TO INSPECT AND PREPARE A HOME INSPECTION REPORT

(Business and Professions Code §7195)

Prepared by: Agent ______________ Phone ______________
Broker ______________ Email ______________

DATE: __________, 20____, at ______________________, California.

Home Inspector/Rep. ______________	Agent's Name __________ DRE # ______
Home Inspection Company ______________	Broker's Name __________ DRE # ______
Address ______________	Address ______________
Phone __________ Cell: __________	Phone __________ Cell: __________
Fax ______________	Fax ______________
Email ______________	Email ______________

FACTS:

1. Property address ______________________________
____

1.1 Type of property ______________________________
____

2. Owner's name ______________________________
Phone ______________________________

3. The home inspection report is for use in the agent's preparation of a transfer disclosure statement and reporting of the property conditions to prospective buyers.

4. Your contract for inspection and report will be entered into by ☐ the Owner, ☐ the Buyer, or ☐ the Agent.

4.1 ☐ Include a copy of the binder with dates of effectiveness for your professional liability insurance coverage.

5. Call ☐ the Agent, or ☐ the Seller, to set up the day and time for your inspection.

5.1 ☐ The Agent will be present during the inspection.

5.2 If the Agent is not present, call the Agent to discuss your findings before preparing the report.

6. Your inspection and report to include the following items:

6.1 An energy efficiency inspection.

6.2 Any improvements that are not in compliance with building permits or codes and any improvements for which no permit exists.

6.3 The property's compliance with safety codes for child resistant pool barriers, hot tub covers, automatic garage doors, door locks/latches, gas valves, residential security bars and water heaters.

7. Your fee for this service will be paid in full on your delivery of your report to the Agent.

7.1 It is anticipated the amount of your fee will be $__________.

8. You are authorized to open an order and process this inspection.

Submitting Agent's Signature: ______________________________

FORM 130 03-11 ©2011 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Form 130

Authorization to Inspect and Prepare a Home Inspection Report

As part of the management of the home inspection process, the seller's agent needs to be present while the **home inspector** carries out the investigation of the property. The agent is to discuss the home inspector*'s* observations and whether the findings will affect the desirability, habitability or safety of the property, and thus its value to prospective buyers.

If the seller's agent cannot be present, they need to ask the home inspector to call the agent before the HIR is prepared to discuss the home inspector's findings and any recommendations for further investigation. On receipt and review of the HIR by the seller and seller's agent, any questions or clarifications they have on its content are followed up by a further discussion with the home inspector, and if necessary, an amended or new report.

home inspector
A professional employed by a home inspection company to inspect and advise on the physical condition of property improvements in a home inspection report for reliance by the seller, the seller's agents and the buyer as a warranty of the condition of improvements.

A home inspector's qualifications

An individual who holds themselves out as being in the business of conducting a home inspection and preparing a home inspection report on a one-to-four unit residential property is a *home inspector*. No licensing scheme exists to set the minimum standard of competency or qualifications necessary to enter the home inspection profession.[2]

However, some real estate service providers typically conduct home inspections, such as:

- general contractors;
- structural pest control operators;
- Architects; and
- registered engineers.

The duty of care expected of licensed members of these professions by prospective buyers who rely on their reports is set by their licensing requirements and professional attributes, i.e., the skill, prudence, diligence, education, experience and financial responsibility normally possessed and exercised by members of their licensed profession. These licensees are experts with a high level of duty owed to those who receive their reports.[3]

Home inspectors occasionally *do not hold* any type of license relating to construction, such as a person who is a construction worker or building department employee. However, they are required to conduct an inspection of a property with the same "degree of care" a reasonably prudent home inspector would exercise to locate material defects during their **physical examination** of the property and report their findings.[4]

However, a home inspector who is not a registered engineer cannot perform any analysis of systems, components or structural components which constitute the practice of a civil, electrical or mechanical engineer.[5]

Hire a home inspector with known credentials

For the seller's agent to avoid liability in the preparation of the TDS by relying on an HIR, the seller's agent needs to select a competent home inspector to inspect and prepare the HIR. Thus, the seller's agent needs to *exercise ordinary care* when selecting the home inspector.

When an agent's **care in the selection** of a home inspector is lacking and the home inspector's incompetence produces a defective HIR, the seller and seller's agent preparing the TDS in reliance on the HIR are not relieved of liability for their failure to report a defect they should have observed.

Further, use of an HIR by the seller's agent in the preparation of the TDS does not relieve the seller's agent (or broker) from conducting their mandatory visual inspection and report their observations on the TDS.[6]

---

2 Calif. Business and Professions Code §7195(d)

3 Bus & P C §7068

4 Bus & P C §7196

5 Bus & P C §7196.1

6 CC §1102.4(a)

The home inspector who holds a professional license or is registered with the state as a general contractor, architect, pest control operator or engineer is deemed to be qualified, unless the agent knows of information to the contrary.

Home inspector qualifications

When hiring a home inspector, the qualifications to look for include:

- educational training in home inspection related courses;
- length of time in the home inspection business or related property or building inspection employment;
- errors and omissions insurance covering professional liability;
- professional and client references; and
- membership in the California Real Estate Inspection Association, the American Society of Home Inspectors or other nationally recognized professional home inspector associations with standards of practice and codes of ethics.

Remember, the reason for hiring a home inspector in the first place is to assist the seller and the seller's agent to better represent the actual physical condition of the property to prospective buyers. In turn, use of an HIR reduces the risk of errors.

The home energy rater

home energy audit
An audit conducted by a Home Energy Rater evaluating the energy efficiency of the home. [See **ft** Form 156 §12.1h]

An EP investor and their buyer's agent are best served asking for a **home energy audit** (energy audit). When the seller and the seller's agent have not provided an audit, the buyer's agent needs to ask for one in the EP agreement conditions.

With the *energy audit* in hand, the investor has the data necessary to incorporate the costs of the recommended energy efficient updates into the total costs for acquisition they are willing to pay for the property. The investor is also able to use that information to compare the energy-efficiency of the home in consideration to other properties before making an offer. The audit becomes more important to the investor if the purpose of the purchase is to flip the property to an end user homebuyer.

In addition to ensuring the seller has hired a competent home inspector for an HIR, a *home energy audit* is to be performed by a competent **Home Energy Rater (Rater)**, as well. The home inspector is sometimes qualified to perform both tasks.

The *Rater* is trained and certified by one of the Department of Energy's (DOE) certified providers:

- The California Certified Energy Rating & Testing Services (CalCERTS);
- California Home Energy Efficiency Rating System (CHEERS); and
- California Building Performance Contractors Association (CBPCA).

California Home Energy Rating System (HERS)
California state system used to create a standard rating for energy efficiency and certify professional raters. [See **ft** Form 156 §12.1h]

Home energy audit providers are private, non-profit organizations approved by the DOE as part of the **California Home Energy Rating System (HERS)** program. Audit providers have the exclusive rights to train, test and certify professional Raters.

Although Home Energy Raters are specially trained and certified by these providers, any home inspector is permitted to perform a home energy audit provided the audit conforms to the *HERS* regulations established by the California Energy Commission.[7]

Reliance by buyers on the HIR

Consider a buyer under a purchase agreement who requests a home inspection report (HIR) on the property being purchased. On receipt and review of the report, the buyer cancels the purchase agreement. Another prospective buyer interested in the property receives the same home inspection report from the seller's agent and relies on it to acquire the property.

However, the report fails to correctly state the extent of the defects. The second buyer now owning the property discovers the errors and makes a demand on the home inspector who prepared the report for the first buyer to cover the cost to cure the defects which were the subject of the errors.

The home inspector claims the report was prepared only for use by the buyer who requested the report and no subsequent buyer is permitted to rely on it, as stated in the home inspection contract under which the report was prepared.

Here, the home inspector knew the seller's agent received the report and that the agent is duty bound to provide it to other prospective buyers if the buyer who ordered the report does not acquire the property. A home inspection report, like an appraisal-of-value report or a structural pest control report, is not a confidential document.

Thus, all prospective buyers of the property are *entitled to rely* on the existing home inspection report.

This reliance by other prospective buyers imposes liability on the home inspector for failure to exercise the level of care expected of a home inspector when examining the property and reporting defects. Liability for the defects is imposed regardless of the fact that the home inspection contract and report contained a provision restricting its use solely to the person who originally requested it.[8]

The home inspection contract

Provisions in a contract with a home inspector and home inspection company occasionally purport to limit the dollar amount of their liability for errors, inaccuracies or omissions in their reporting of defects to the dollar amount of the fee they received for the report. These limitations on liability are unenforceable.

7 Bus & P C §§ 7199.5, 7199.7

8 **Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109

Further, any provision in the home inspection contract or condition in the home inspection report which purports to waive or limit the home inspector's liability for the negligent investigation or preparation of the HIR is unenforceable.[9]

If the buyer discovers an error in the HIR regarding the existence or nonexistence of a defect affecting the value or desirability of the property, the buyer has **four years** from the date of the inspection to settle or file an action to recover any money losses.[10]

Any shorter time limitation the home inspector places on the period during which the buyer is to discover and make a claim is unenforceable.[11]

Further, the agent ordering a home inspection report needs to verify the home inspection company has *professional liability insurance coverage* before recommending or employing the company to conduct an investigation and prepare a report.

The inspection and report

A home inspection is a **physical examination** conducted on-site by a home inspector. The inspection of a one-to-four unit residential property is performed for a noncontingent fee.

The purpose of the physical examination of the premises is to identify material defects in the condition of the structure and its systems and components. **Material defects** are conditions which affect the property's:

- market value;
- desirability as a dwelling;
- habitability from the elements; and
- safety from injury in its use as a dwelling.

material defect
Information about a property which might affect the price and terms a prudent buyer is willing to pay for a property.

Defects are *material* if they adversely affect the price a reasonably prudent and informed buyer is willing to pay for the property when entering into a purchase agreement. As the report has the potential to affect value, the investigation and delivery of an existing home inspection report to a prospective buyer precedes the seller's acceptance of a prospective buyer's offer to purchase.[12]

The home inspection is a *non-invasive examination* of the mechanical, electrical and plumbing systems of the dwelling, as well as the components of the structure, such as the roof, ceiling, walls, floors and foundations.

Non-invasive indicates no intrusion into the roof, walls, foundation or soil by dismantling or taking apart the structure to the extent that it potentially disturbs components or causes repairs to be made to remove the effects of the intrusion.[13]

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9 Bus & P C §7198
10 Bus & P C §7199
11 **Moreno** v. **Sanchez** (2003) 106 CA4th 1415
12 Bus & P C §7195(b)
13 Bus & P C §7195(a)(1)

Form 269

Property Inspection

PROPERTY INSPECTION

Buyer's Request for Repairs

Prepared by: Agent ______________________ Phone ______________________

Broker ______________________ Email ______________________

DATE: ______________, 20____, at ____, California.

TO SELLER: ____

FACTS:

1. Buyer entered into a purchase agreement with you dated ______________, 20______ agreeing to buy real estate referred to as ____.
2. The purchase agreement calls for an **initial inspection** of the real estate by Buyer, or a representative of Buyer.
   2.1 The inspection is to confirm that the condition of the real estate is substantially the condition reasonably expected by Buyer based on observations by Buyer and representations made by Seller or Seller's Agent to Buyer or Buyer's Agent prior to acceptance of the purchase agreement.
3. The purchase agreement calls for Buyer to notify Seller, on completion of Buyer's initial inspection, of any material defects discovered by Buyer which were undisclosed and unknown to Buyer prior to acceptance of the purchase agreement.
4. The purchase agreement further calls for Seller to repair, replace or correct the noticed defects prior to closing the transaction and delivering possession to Buyer.
5. By this notice of material defects in need of repair, replacement or correction, Buyer does not intend to cancel the purchase agreement or avoid Buyer's obligation to perform on the purchase agreement.
   5.1 Buyer will close as scheduled or as soon thereafter as any noticed defects have been eliminated by repair, replacement or correction and completion has been verified by Buyer.

THUS:

6. Buyer hereby confirms the condition of the property on the initial inspection satisfies Buyer's expectations of its physical condition regarding both the land and its improvements, **except** for the following itemized material defects in the condition of the property.
   6.1 Buyer hereby notifies Seller of the material defects in the condition of the property which were undisclosed and unknown to Buyer prior to acceptance of the purchase agreement and makes a demand on Seller to repair, replace or correct the following itemized defects prior to closing:

I agree to the terms stated above.	Seller hereby acknowledges receipt of a copy.
Date: ______________, 20______	Date: ______________, 20______
Buyer: ______________________	Seller: ______________________
Buyer: ______________________	Seller: ______________________

FORM 269 11-13 ©2013 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Contents of the home inspection report

The home inspection report (HIR), a written report prepared by the home inspector, states the inspector's findings while conducting the physical examination of the property. The HIR prepared by the inspector:

- identifies each system and component of the structure inspected;
- describes any material defects the home inspector found or suspects;
- makes recommendations about the conditions observed; and
- suggests any further evaluation needed to be undertaken by other experts.[14]

14 Bus & P C §7195(c)

The seller's agent needs to make sure the report addresses the cause of any defect or code violation found which constitutes a significant defect in the use of the property or cost to remedy the defects. The report also includes suspicions the home inspector has which need to be clarified by further inspections and reports by others with more expertise.

The agent, or anyone else, is also permitted to request that the home inspector conduct an inspection on the energy efficiencies of the property and include the findings in the report. On a request for an **energy efficiency inspection**, the home inspector reports on items including:

- the R-value of the insulation in the attic, roof, walls, floors and ducts;
- the quantity of glass panes and the types of frames;
- the heating and cooling equipment and fans;
- water heating systems;
- the age of major appliances and the fuel used;
- thermostats;
- energy leakage areas throughout the structure; and
- the solar control efficiency of the windows.[15]

The home inspector's conflict of interest

The home inspector who prepares a home inspection report, the company employing the home inspector and any affiliated company is not permitted to:

- pay a referral fee or provide for any type of compensation to brokers, agents, owners or buyers for the referral of any home inspection business;
- agree to accept a contingency fee arrangement for the inspection of the report, such as a fee payable based on the home inspector's findings and conclusions in the report or on the close of a sales escrow;
- perform or offer to perform any repairs on a property which was the subject of a HIR prepared by them within the past 12 months [See Form 269 accompanying this chapter]; or
- inspect any property in which they have a financial interest in its sale.[16]

15 Bus & P C §7195(a)(2)
16 Bus & P C §7197

Chapter 7 Summary

The task of gathering information about the condition of the property listed for sale and delivering the information to prospective buyers lies with the seller-in-foreclosure's agent.

For the seller's agent to retain control throughout the process of marketing, selling and closing escrow with a buyer, the seller's agent on accepting a listing needs to request a Home Inspection Report (HIR) on behalf of the seller for use in the preparation of the Transfer Disclosure Statement (TDS). Both are included in the agent's marketing package presented to prospective buyers who seek additional property information.

The home inspection is a non-invasive examination of the mechanical, electrical and plumbing systems of the dwelling, as well as the components of the structure.

For the seller's agent to avoid liability in the preparation of the TDS by relying on an HIR, the seller's agent needs to select a competent home inspector to inspect and prepare the HIR. When hiring a home inspector, the qualifications to look for include:

- educational training in home inspection related courses;
- length of time in the home inspection business or related property or building inspection employment;
- errors and omissions insurance covering professional liability;
- professional and client references; and
- membership in the California Real Estate Inspection Association, the American Society of Home Inspectors or other nationally recognized professional home inspector associations with standards of practice and codes of ethics.

An EP investor and their buyer's agent are best served asking for a home energy audit (energy audit). With the energy audit in hand, the equity purchase (EP) investor has the data necessary to incorporate the costs of the recommended energy efficient updates into the total costs for acquisition they are willing to pay for the property.

Chapter 7 Key Terms

Chapter 8

Natural hazard disclosures by the seller's agent

Learning Objectives

After reading this chapter, you will be able to:

- identify the various types of natural hazards related to value and desirability;
- comply with mandated natural hazards disclosures owed to buyers by sellers and seller's agents on all types of property; and
- avoid liability by the use of a natural hazard expert to investigate the public record for known hazards.

Key Terms

Alquist-Priolo Maps
natural hazards
Natural Hazard Disclosure (NHD) Statement
restoration
termination

A unified disclosure for all residential sales

Natural hazards come with the **location** of a parcel of real estate, not with the man-made aspects of the property. Locations where a property may be subject to natural hazards include:

- special flood hazard areas, a federal designation;
- potential flooding and inundation areas;
- very high fire hazard severity zones;
- wildland fire areas;
- earthquake fault zones; and
- seismic hazard zones.[1]

natural hazards
Risks to life and property which exist in nature due to a property's location.

1 Calif. Civil Code §1103(c)

The existence of a hazard due to the geographic location of a property affects its desirability, and thus its value to prospective EP investors. Hazards, by their nature, limit an EP investor's ability to develop the property, obtain insurance or receive disaster relief.

Natural Hazard Disclosure (NHD) Statement
A report provided by a local agency or NHD vendor and used by sellers and seller's agents to disclose natural hazards which exist on a property held out for sale. [See **ft** Form 314]

Whether a seller lists the property with a broker or markets the property themselves, the seller is to disclose to prospective EP investors any *natural hazards* **known to the seller**, including those contained in **public records**.

To unify and streamline the disclosure by a seller (and in turn the seller's agent) for a uniform presentation to EP investors concerning natural hazards which affect a property, the California legislature created a statutory form entitled the **Natural Hazard Disclosure (NHD) Statement**. [See Form 314 accompanying this chapter]

The NHD form for uniformity

The NHD form is used by a seller and the seller's agent for their preparation (or acknowledgement on the form prepared by an NHD expert of their review) and disclosure of natural hazard information. The form is to include information known to the seller and seller's agent (and the NHD expert) and readily available to them as shown on maps in the public records of the local planning department.[2] [See Form 314]

Actual use of the *NHD Statement* by sellers and their agents is **mandated** on the sale of **all types of properties,** with some sellers (but not agents) being excluded. While some sellers need not use the form when making the NHD disclosures, agents are never excluded. Thus, the form, filled out and signed by the seller (unless excluded) and the seller's agent (never excluded), is included in marketing packages handed to prospective EP investors seeking additional information on every type of property.

Editor's note — Any attempt by a seller or seller's agent to use an "as is" provision or otherwise provide for the EP investor to agree to waive his right to receive the seller's NHD statement is void as against public policy.[3]

Sellers who are excluded from using the form still need to make the disclosures referenced in the NHD. However, they do not need to use the statutory NHD Statement to make those disclosures. For excluded sellers, the NHD is the **optional** method for making the mandatory disclosure of natural hazard information to their EP investors.

However, delivery of the information, whether disclosed by the use of one form or another, is not optional. A natural hazard disclosure is mandated on all types of property.[4]

All sellers, and any seller's or EP investor's agents involved in a sales transaction, have a general duty owed to prospective EP investors to disclose conditions on or about a property which:

- are **known to them;** and

2 CC §1103.2
3 CC §1103(d)
4 CC §1103.1(b)

- may adversely affect the EP investor's willingness to buy; or
- influence the price and terms of payment the EP investor is willing to offer.

Natural hazards, or the lack thereof, irrefutably affect a property's desirability, and thus value to a prospective EP investor.

If a hazard is known to any agent (as well as the seller) or noted in public records, it is to be disclosed to the prospective EP investor before they enter into a purchase agreement on the property. If not disclosed, the EP investor may cancel the transaction, called **termination**. And if the transaction has closed escrow, the lack of an NHD allows the buyer to **rescind** the sale and be **refunded** their investment, called **restoration**.[5]

termination
The cancellation of a transaction before escrow has closed. [See **ft** Form 183]

restoration
The return of funds and documents on a rescission of a purchase agreement sufficient to place all the parties in the position they held before entering into the agreement.

The need for an NHD when a prospective buyer is located, an anticipation held by every seller's agent on taking a listing, requires the NHD to be prepared, signed and part of the property marketing package handed to prospective buyers. If not prepared, the seller's agent is unable to meet their obligations to the public to deliver an NHD to prospective buyers before an offer is accepted or a counteroffer is made. It is mandated that delivery of the NHD to prospects be *as soon as practicable*. That practical moment comes before a buyer enters into a purchase agreement setting the prices and terms to be paid.[6]

Investigating the existence of a hazard

Natural hazard information is obtained from the **public records**. If not retrieved by someone, the seller-in-foreclosure and their agent cannot make their required disclosures to prospective EP investors.

To obtain the natural hazard information, the seller and the seller's agent are required to exercise **ordinary care** in gathering the information. They may gather the information themselves or the seller may employ an NHD expert to gather the information. When an expert is employed, the expert prepares the NHD form for the seller and the seller's agent to review, add any comments, sign and have ready for delivery to prospective buyers.[7]

Thus, the seller and seller's agent may obtain **natural hazard information**:

- directly from the *public records* themselves; or
- by employing a **natural hazard expert**, such as a geologist.

For the seller and the seller's agent to rely on an NHD report prepared by others, the seller's agent need only:

- **request** an NHD report from a reliable expert in natural hazards, such as an engineer or a geologist who has studied the public records (as some natural hazards clearly do not pertain to engineering or geology) [See **first tuesday** Form 131];

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5 **Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767
6 Calif. Attorney General Opinion 01-406 (August 24, 2001); CC §1103.3(a)(2)
7 CC §1103.4(a)

Case in Point

Seller's agent's limited duty to a buyer to confirm a hazzard report

Does a seller's agent owe a duty to a buyer to confirm an earthquake fault hazard report is compliant with current earthquake investigation standards?

> ***Facts:*** *A seller's agent listed an undeveloped parcel of land on the multiple listing service (MLS). The listing stated the parcel was located in an earthquake study zone. The listing also referenced a Fault Hazard Investigation report generated 25 years before by a licensed geologist declaring the parcel was suitable for development. A buyer submitted an offer to purchase the property with the intent to develop the land for commercial use. While in escrow, the seller's agent gave the Fault Hazard Investigation report to the buyer. After closing, the buyer discovered the report was not in compliance with current earthquake investigation standards and the county prohibited development of the land.*
>
> ***Claim:*** *The buyer sought money losses from the seller's agent, claiming the seller's agent did not fulfill their general duty to the buyer to be honest and avoid deceitful conduct by making false claims in the listing since the seller's agent did not confirm the findings of the outdated report concerning whether the parcel was suitable for development.*
>
> ***Counter claim:*** *The seller's agent claimed they did not breach their general duty to the buyer since they had no duty to further investigate the accuracy of the report as the listing correctly reflected what the report concluded, and displayed the date the report was published.*
>
> ***Holding:*** *A California court of appeals held the seller's agent did not breach their general duty of fair dealing with the buyer since the listing truthfully restated the information in the report and the seller's agent had no duty to further investigate the ongoing reliability of a report or confirm the report complied with current earthquake investigation standards. [**Saffie** v. **Schmeling** (2014) _CA4th_]*

*Editor's note – While the seller's agent owes a general duty to be truthful and timely disclose known facts about the condition of the property, the onus to confirm a property is suitable for the buyer's needs falls on the buyer's agent. It is the buyer's agent who owes the buyer a special **fiduciary duty** to care for and protect the buyer's best interest. The buyer's agent is therefore responsible for reviewing all natural hazard reports, investigating further and confirming the property meets the objectives of the buyer.*

*Though the buyer was unable to recover their losses from the seller's agent, the buyer separately pursued their losses from their agent and broker and prevailed. [See **first tuesday** Form 314]*

- **review** the NHD form prepared by the expert and **enter** any actual knowledge the seller or seller's agent may possess, whether contrary or supplemental to the expert's report, on the form prepared by the expert or in an addendum attached to the form; and
- **sign** the NHD Statement provided by the NHD expert and **deliver** it with the NHD report to prospective EP investors or EP investor's agents.[8]

When prepared by an NHD expert, the NHD report needs to also note whether the listed property is located within two miles of an existing or proposed airport, an environmental hazard zone called an *airport influence area* or *airport referral area*.

Occupancy of property within the influence of an airport facility may be affected by noise and restrictions, now and later, imposed on the use as set by the airport's land-use commission.[9]

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8 CC §1103.2(f)(2)

9 CC §1103.4(c)

Form 314

Natural Hazard Disclosure Statement

Page 1 of 2

NATURAL HAZARD DISCLOSURE STATEMENT

Prepared by: Agent ______________ **Phone** ______________
Broker ______________ **Email** ______________

NOTE: The seller's listing broker (and the seller) must prepare a Natural Hazard Disclosure (NHD) and deliver it to prospective buyers of any property prior to making a purchase agreement offer and indicate compliance in the purchase agreement or a counteroffer. If not so disclosed, the buyer has the right to cancel the purchase agreement within three days of delivery of the disclosure in person. [Calif. Civil Code §1103.3]

DATE: ____________, 20____, at ______________________________, California.

This disclosure statement is prepared for the following:

- ☐ Seller's listing agreement
- ☐ Purchase agreement
- ☐ Counteroffer
- ☐ ______________________________

dated ____________, 20____, at ______________________________, California,
entered into by ______________________________, as the ______________,
regarding real estate referred to as ______________________________
______________________________.

Natural Hazard Disclosure Statement:

Seller and Seller's Agent(s) or a third-party consultant disclose 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 action 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 SELLER AND SELLER'S AGENT(S) BASED ON THEIR KNOWLEDGE AND MAPS DRAWN BY THE STATE AND FEDERAL GOVERNMENT. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN BUYER AND SELLER.

THIS REAL PROPERTY LIES WITHIN THE FOLLOWING HAZARDOUS AREA(S): (Check appropriate response)

1. A SPECIAL FLOOD HAZARD AREA (Any type Zone "A" or "V") designated by the Federal Emergency Management Agency.

   Yes____ No____ Do not know/information not available from local jurisdiction____

2. AN AREA OF POTENTIAL FLOODING shown on an inundation map pursuant to Section 8589.5 of the Government Code.

   Yes____ No____ Do not know/information not available from local jurisdiction____

3. A VERY HIGH FIRE HAZARD SEVERITY ZONE pursuant to Section 51178 or 51179 of the Government Code. The owner of this property is subject to the maintenance requirements of Section 51182 of the Government Code.

   Yes____ No____

4. A WILDLAND AREA THAT MAY CONTAIN SUBSTANTIAL FOREST FIRE RISKS AND HAZARDS pursuant to Section 4125 of the Public Resources Code. The owner of this property is subject to the maintenance requirements of Section 4291 of the Public Resources Code. Additionally, it is not the state's responsibility to provide fire protection services to any building or structure located within the wildlands unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency for those purposes pursuant to Section 4142 of the Public Resources Code.

   Yes____ No____

5. AN EARTHQUAKE FAULT ZONE pursuant to Section 2622 of the Public Resources Code.

   Yes____ No____

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Also, the expert's report is to note whether the property is located within the jurisdiction of the San Francisco Bay Conservation and Development Commission.

Broker uses experts to limit liability

The Natural Hazard Disclosure scheme encourages brokers and their agents to use natural hazard experts to gather and report the information available to all from the local planning department rather than do it themselves. The

Form 314

Natural Hazard Disclosure Statement

Page 2 of 2

6. A SEISMIC HAZARD ZONE pursuant to Section 2696 of the Public Resources Code.

Yes (Landslide Zone)____ Yes (Liquefaction Zone)____

No____ Map not yet released by state____

THESE HAZARDS MAY LIMIT YOUR ABILITY TO DEVELOP THE REAL PROPERTY, TO OBTAIN INSURANCE OR TO RECEIVE ASSISTANCE AFTER A DISASTER.

THE MAPS ON WHICH THESE DISCLOSURES ARE BASED ESTIMATE WHERE NATURAL HAZARDS EXIST. THEY ARE NOT DEFINITIVE INDICATORS OF WHETHER OR NOT A PROPERTY WILL BE AFFECTED BY A NATURAL DISASTER. BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE REGARDING THOSE HAZARDS AND OTHER HAZARDS THAT MAY AFFECT THE PROPERTY.

Check only one of the following:

☐ Seller and their agent represent that the information herein is true and correct to the best of their knowledge as of the date signed by Seller and Seller's Agent.

☐ Seller and their agent acknowledge that they have exercised good faith in the selection of a third-party report provider as required in Civil Code Section 1103.7, and that the representations made in this Natural Hazard Disclosure Statement are based upon information provided by the independent third-party disclosure provider as a substituted disclosure pursuant to Civil Code Section 1103.4. Neither Seller nor their agent has independently verified the information contained in this statement and report or is personally aware of any errors or inaccuracies in the information contained on the statement. This statement was prepared by

Third-Party Disclosure Provider______________________________ Date __________

Date:____________, 20______	Date:____________, 20______
Seller: ______________________	Seller's Broker: ______________ BRE #________
Seller: ______________________	Agent: ______________ BRE #________

Buyer represents that he has read and understands this document. Pursuant to Civil Code Section 1103.8, the representations made in this Natural Hazard Disclosure Statement do not constitute all of Seller's or Seller's Agent's disclosure obligations in this transaction.

Buyer:______________________________ Date:__________

Buyer:______________________________ Date:__________

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use of an expert to gather information from the public record and prepare the report relieves the seller's agent of any **liability for errors** not known to the agent to exist.

While a seller's agent is not mandated to use an expert, the practice is prudent as a risk mitigation step undertaken to manage liability on sales listings. The other NHD risk for seller's agents is eliminated by the timely delivery of the NHD to prospective EP investors before going under contract.

Neither the seller nor any agent, whether the seller's or the EP investor's agent, is liable for the erroneous preparation of an NHD Statement they have delivered to the EP investor, if:

- the NHD report and form is prepared by an **expert in natural hazards**, consistent with professional licensing and expertise; and

- the seller and seller's agent used **ordinary care** in selecting the expert and in their review of the expert's report for any errors, inaccuracies and omissions of which they have **actual knowledge**.[10]

No indemnify agreemnt

Also, the seller and the seller's agent do not need to enter into an **indemnification agreement** with the natural hazard expert to avoid liability for errors. By statute, the expert who prepared the NHD is liable for any errors, not the seller or seller's agent who relied on the report of a non-negligently selected expert to fulfill their duty to check the public records.

However, if a EP investor makes a claim on the seller's broker for lost property value due to the inaccuracy of the expert's report, an *indemnity agreement* entered into by the expert in favor of the seller's broker, given in exchange for the request to prepare a natural hazard report, covers the cost of any litigation which has the potential to unnecessarily haul the broker into court. [See **first tuesday** Form 131]

Late delivery = no liability protection

Caution: The seller's agent's **dilatory delivery** of an expert's NHD to the EP investor or the EP investor's agent after the offer has been accepted does not protect the broker from *liability* for the EP investor's lost property value from the price paid due to the nondisclosure before acceptance. If the agent knew or is charged with knowledge of a natural hazard noted in the readily available planning department's parcel list, the agent is exposed to liability.

Liability exposure includes:

- costs the EP investor may incur to correct or remedy the undisclosed hazardous condition; and
- the portion of the agreed price which exceeds the property's fair market value based on the hazard undisclosed at the time the purchase agreement was entered into.[11]

Further, the agents, seller and expert are not exposed to liability from **third parties** to the sale transaction who receive their erroneous NHD Statement and rely on it to analyze the risk they undertake by their involvement. Such third parties include insurance companies, lenders, governmental agencies and other providers who may become affiliated with the transaction.[12]

Documenting compliance with NHD law

Compliance by the seller-in-foreclosure and the seller's agent to deliver the NHD Statement to the EP investor includes its documentation by a provision in the purchase agreement.[13] [See **first tuesday** Form 150 §11.5]

However, when the seller's agent fails to disclose a natural hazard and then provides in the purchase agreement for the compliance to be an untimely "in escrow" disclosure, his seller is **statutorily penalized**.

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10 CC §§1103.4(a), 1103.4(b)
11 CC §1103.13
12 CC §1103.2(g)
13 CC §1103.3(b)

The EP investor on an in-escrow disclosure after entering into a purchase agreement and, as an alternative to a money claim, has a statutory remedy allowing them to terminate the purchase agreement and avoid the transactions by exercising:

- a three-day right of cancellation following the date the NHD Statement was handed to the EP investor; or
- a five-day right of cancellation when the NHD Statement is mailed to the EP investor.[14]

Further, delivery of the NHD after acceptance of an offer imposes liability on the seller and seller's agent, but not the EP investor's agent. Liability is based on any money losses (typically reduced property value) inflicted on the EP investor by an untimely in-escrow disclosure for those EP investors who chose not to exercise their right to cancel. They may, instead, proceed with performance of the agreement by closing escrow before demanding restitution.[15]

Delivery of the NHD to the EP investor

It is the **EP investor's agent** who has the duty to hand the EP investor the NHD Statement the EP investor's agent receives from the seller or the seller's agent, called **delivery**.[16]

The **E**P investor's agent, on receiving the NHD form from the seller's agent, owes the EP investor a **special agency duty** to care for and protect the EP investor's best interest. This is accomplished by reviewing the NHD Statement themselves for any disclosure which potentially affects the property's value or its desirability for the EP investor. The EP investor's agent then delivers the NHD to the EP investor and makes any *recommendations or explanations* they may have regarding the adverse consequences of facts disclosed in its content.[17]

If the EP investor does not have a broker, the seller's agent is responsible for delivering the NHD Statement to the prospective EP investor.

Unlike the EP investor's agent, the seller's agent has no duty when in direct contact with the prospective EP investor to explain the effect hazards have on the property or the EP investor. Also, the seller's agent has absolutely no duty to voluntarily explain to a prospective EP investor the effect a known natural hazard (which is itself disclosed) potentially has on the property or the EP investor.

The task of explaining the consequence of living with a natural hazard is the duty of the EP investor's agent. If the EP investor is not represented by an agent, the EP investor undertakes the duty to protect themselves and investigate the consequences of the NHD information handed to them.

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14 CC §1103.3(c)

15 CC §1103.13; **Jue** v. **Smiser** (1994) 23 CA4th 312

16 CC §1103.12(a)

17 CC §§1103.2, 1103.12

Delivery may be in person or by mail. Also, delivery is considered to have been made if the NHD is received by the spouse of the EP investor.[18]

Sellers occasionally act as *"For Sale By Owners" (FSBOs)* and directly negotiate a sale of their property with EP investors or EP investor's agents. Here, the seller is responsible for preparing or obtaining an NHD statement and delivering the NHD Statement to the prospective EP investor – prior to entering into the purchase agreement.

No warranty, just awareness

A seller's NHD Statement is *not a warranty or guarantee* by the seller or seller's agent of the natural hazards affecting the property. The NHD Statement is a report of the seller's and seller's agent's (or the NHD expert's) knowledge (actual and constructive) of any natural hazards affecting the property.

However, prospective EP investors do rely on the NHD Statement as part of the documentation they review for information on a property. The NHD is designed to assist them in their decisions as to whether they want to buy the property, and if they do decide to buy, at what price and on what terms. To be meaningful, the EP investor is to be handed the information before the price and terms are set by acceptance of a purchase agreement offer, if the seller's agent is to avoid misleading the EP investor, called **deceit**.[19]

Disclosures concerning the value and desirability of a property, such as an NHD Statement and TDS, are *price-sensitive information*. If not timely disclosed, the seller and seller's agent subject themselves to claims for **price adjustments** (offsets) which the EP investor is entitled to make either before or after closing. Alternatively, the EP investor may exercise their statutory right to cancel the purchase agreement and have their deposit fully refunded.

Good marketing practice for broker offices is to arrange for delivery of the NHD to the prospective EP investor before an offer is made or no later than the acceptance of a counteroffer. At that moment in time, the EP investor remains the prospective EP investor as described by the disclosure statutes. Disclosures are not to be delayed until later when the prospect has *become the buyer* under a binding purchase agreement – after the price is set.

As a matter of good practice, the purchase agreement offer includes a copy of the seller's NHD Statement as an addendum (along with all other disclosures), noting the transaction was entered into in compliance with NHD and other disclosure law.

As for an **escrow officer** handling a sale in which the seller's agent has failed to hand the NHD to the EP investor's agent or the EP investor, the escrow officer has no duty to the seller or EP investor to provide for delivery of the NHD (or the TDS or other reports) to the EP investor. The obligation remains that of the seller and seller's agent. However, escrow may accept instruction to perform any of these activities, in which case escrow becomes obligated to follow the instructions agreed to by the escrow officer.[20]

18 CC §1103.10
19 AG Opin. 01-406
20 CC §1103.11

The seller's agent complies with their and their seller's duty to disclose by ordering an NHD report from a natural hazard expert.

On the seller's agent's receipt of the NHD report, the agent:

- reviews the report with the seller;
- adds what they and the seller know about hazards which are not included in the expert's report,
- signs the NHD statement accompanying the report;
- hands the entire NHD package to prospective EP investors; and
- does all this before an offer is accepted or a counteroffer submitted to a prospective EP investor.

Excluded sellers, not agents

Again, all sellers are required to disclose what is known or available to them about the natural hazards endemic to a property's location.

However, sellers in some transactions *do not need to use* the mandated NHD form to make their property disclosures, such as:

- court-ordered transfers or sales;
- deed-in-lieu of foreclosures;
- trustee's sales;
- lender resales after foreclosure or a deed-in-lieu;
- estates on death;
- transfers between co-owners;
- transfers to relatives/spouses; or
- transfers to or by governmental entities.[21]

However, any seller's agent involved in a transaction in which the seller is exempt from using the NHD form needs to make hazard disclosures themselves, even though the seller does not need to use the statutory form.[22]

Also, all sellers of any type of property, included or excluded, always disclose what *they know about any hazards*. Again, the disclosure is best accomplished by use of the NHD Statement on all sales. The NHD expert always includes the seller's statement as part of their report.[23]

Other disclosure statements distinguished

The NHD Statement handed to a prospective EP investor is unrelated to the **environmental hazards** and **physical deficiencies** in the soil or property improvements. These hazards are disclosed by use of the Transfer Disclosure Statement (TDS) and provisions in the purchase agreement. [See Form 304 §C(1)]

The TDS and purchase agreement provisions disclose health risks resulting from **man-made** physical and environmental conditions affecting the use

21 CC §1103.1(a)
22 CC §1103.1(b)
23 CC §1103.2(f)(2)

of the property. They are limited to facts known to the seller and seller's agent without concern for a review of public records on the property at the planning department or elsewhere.

The NHD Statement discloses risks to life and property which exist in nature due to the property's location, risks known and readily available from the public records (planning department).

The natural hazards disclosed

Sellers and seller's agents of **any type of real estate** are to disclose whether the property is located in:

- an area of potential flooding;
- a very high fire hazard severity zone;
- a state fire responsibility area;
- an earthquake fault zone; and
- a seismic hazard zone.[24]

Editor's note — The following discussion details these different hazards which are disclosed on the NHD Statement.

Flood zones

Investigating flood problems was facilitated by the passage of the National Flood Insurance Act of 1968 (NFIA).

The NFIA established a means for property owners to obtain flood insurance with the National Flood Insurance Program (NFIP).

The Federal Emergency Management Agency (FEMA) is the administrative entity created to police the NFIP by investigating and mapping regions susceptible to flooding.

Any flood zone designated with the letter "A" or "V" is a **special flood hazard area** and is to be disclosed as a natural hazard on the NHD Statement. [See Form 314 §1]

Zones "A" and "V" both correspond with areas with a 1% chance of flooding in any given year, called 100-year floodplains, e.g., a structure located within a special flood hazard area shown on an NFIP map has a 26% chance of suffering flood damage during the term of a 30-year mortgage.

However, Zone "V" is subject to additional storm wave hazards.

Both zones are subject to mandatory flood insurance purchase requirements.

Flood resources

Information about flood hazard areas and zones come from:

- city/county planners and engineers;
- county flood control offices;

24 CC §1103.2

- local or regional FEMA offices; and
- the U.S. Corps of Engineers.

Additional information concerning flood hazard areas is available in the Community Status Book. The book lists communities and counties participating in the NFIP and the effective dates of the current flood hazard maps available from FEMA.

The Community Status Book may be obtained via the web at: *http://www.fema.gov/fema/csb.shtm*.

Flood Insurance Rate Maps and Flood Hazard Boundary Maps are all available at the FEMA Flood Map store by calling (800) 358-9616 or via the web at: *http://msc.fema.gov/*.

Another flooding disclosure which needs to be made on the NHD Statement arises when the property is located in an area of **potential flooding**. [See Form 314 §2]

An area of potential flooding is a location subject to partial flooding if sudden or total **dam failure** occurs. The inundation maps showing the areas of potential flooding due to dam failure are prepared by the California Office of Emergency Services.[25]

Once alerted by the seller's agent to the existence of a flooding condition, the EP investor's agent is to inquire further to learn the significance of the disclosure to the EP investor.

Very high fire hazard severity zone

Areas in the state which are subject to significant fire hazards have been identified as **very high fire hazard severity zones**. If a property is located in a very high fire hazard severity zone, a disclosure needs to be made to the prospective EP investor. [See Form 314 §3]

The city, county or district responsible for providing fire protection have designated, by ordinance, very high fire hazard severity zones within their jurisdiction.[26]

The fire hazard disclosure on the NHD form mentions the need to maintain the property. Neither the seller nor the seller's agent need to explain the nature of the maintenance required or its burden on ownership. Advice to the EP investor on the type of maintenance and the consequences of owning property subject to the maintenance are the duties of the EP investor's agent, if they have an agent.

For example, an EP investor who acquires a residence located in a very high fire hazard severity zone is advised by the EP investor's agent that as the new owner, the EP investor is to, among other things:

- maintain a firebreak around the structure of a distance of no greater than 100 feet, but not past the property line, unless the state or local law requires more; and

25 Calif. Government Code §8589.5(a)
26 Gov C §51179

- clear dead or dying wood from trees and plants adjacent to or overhanging the structure.[27]

Also, if the property is in a very high fire hazard severity zone or a wildland area, the EP investor's agent needs to inform the client of the possible hardships in obtaining fire or hazard insurance and of the existence of the California Fair Access to Insurance Requirements (FAIR) program which offers a "last-resort" type of policy for properties in these areas.[28]

State Fire Responsibility Areas

If a property is in an area where the financial responsibility for preventing or suppressing fires is primarily on the state, the real estate is located within a **State Fire Responsibility Area**.[29]

Notices identifying the location of the map designating *State Fire Responsibility Areas* are posted at the offices of the county recorder, county assessor and the county planning agency. Also, any information received by the county after receipt of a map changing the State Fire Responsibility Areas in the county needs to be posted.[30]

If the property is located within a **wildland area** exposed to substantial forest fire risks, the seller or the seller's agent is to disclose this fact. If the property is located in a wildland area, it requires maintenance by the owner to prevent fires.[31] [See Form 314 §4]

In addition, the NHD Statement advises the prospective EP investor of a home located in a *wildland area* that the state has no responsibility for providing fire protection services to the property, unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency. No further disclosure about whether a cooperating agreement exists need be made by the seller or seller's agent. [See Form 314 §4]

However, if property disclosures place the property in a wildland area, the EP investor's agent has the duty to advise the EP investor about the need to inquire and investigate into what agency provides fire protection to the property.

Earthquake fault zones

To assist seller's agents in identifying whether the listed property is located in an earthquake fault area, maps have been prepared by the State Geologist.

The State Mining and Geology Board and the city or county planning department have maps available which identify special studies zones, called **Alquist-Priolo Maps**.[32]

Alquist-Priolo Maps
Maps which identify earthquake fault areas available from the State Mining and Geology Board and the city or county planning department. [See **ft** Form 314 §5]

The maps are used to identify whether the listed property is located within one-eighth of a mile on either side of a fault.

27 Gov C §51182
28 Calif. Insurance Code §§10095 et seq.
29 Calif. Public Resources Code §4125(a)
30 Pub Res C §4125(c)
31 Pub Res C §4136(a)
32 Pub Res C §2622

Also, the NHD Statement requires both the seller and the seller's agent to disclose to a prospective EP investor or the EP investor's agent whether they have knowledge the property is in a fault zone. [See Form 314 §5]

Seismic hazards

A **Seismic Hazard Zone** map identifies areas which are exposed to earthquake hazards, such as:

- strong ground shaking;
- ground failure, such as liquefaction or landslides;[33]
- tsunamis;[34] and
- dam failures.[35]

If the property for sale is susceptible to any of the earthquake (seismic) hazards, the *seismic hazard zone* disclosure on the NHD Statement is to be marked "Yes." [See Figure 1, **first tuesday** Form 314 §6]

Seismic hazard maps are not available for all areas of California. Also, seismic hazard maps do not show *Alquist-Priolo* Earthquake Fault Zones. The California Department of Conservation creates the seismic hazards maps.

The seismic hazard maps which exist are on the web at *http://www.conservation.ca.gov/cgs/shzp/Pages/Index.aspx.*

If the NHD indicates a seismic hazard, the EP investor's agent is to then determine which type of hazard, the level of that hazard and explain the distinction to the EP investor, or be certain someone else does. The seller's agent has no such affirmative obligation to explain the impact of the disclosures to the EP investor.

For example, property located in Seismic Zone 4 is more susceptible to strong ground shaking than areas in Zone 3. But which zone the property is located in is a question the EP investor's agent needs to answer. Most of California is in Zone 4, except for the southwest areas of San Diego County, eastern Riverside and San Bernardino Counties, and most of the Northern California Sierra Counties.

Homes in Zone 4 are able to be damaged even from earthquakes which occur a great distance away.

Ground failure is a seismic hazard which refers to landslides and liquefaction. Liquefaction occurs when loose, wet, sandy soil loses its strength during ground shaking. Liquefaction causes the foundation of the house to sink or become displaced. The condition is prevalent in tidal basins which are fills.

A **tsunami** is a large wave caused by an earthquake, volcanic eruption or an underwater landslide. Coastal areas are the ones at risk for loss of property and life.

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33 Pub Res C §2692(a)
34 Pub Res C §2692.1
35 Pub Res C §2692(c)

Tsunami inundation maps are available from the National Oceanic and Atmospheric Administration (NOAA) led National Tsunami Hazard Mitigation Program (NTHMP) at: *http://nctr.pmel.noaa.gov/inundation_mapping.html*.

Also, FEMA's Flood Insurance maps consider tsunami wave heights for Pacific coast areas.

Dam failure results in flooding when an earthquake ruptures a dam which serves as a reservoir. The city or county planning department has maps showing areas which flood if a local dam fails.

Areas susceptible to inundation due to dam failure caused by an earthquake are also noted on the NHD Statement as a potential flooding area.

Chapter 8 Key Terms

The existence of a hazard due to the geographic location of a property affects its desirability, and thus its value to prospective EP investors. A seller of property is to disclose any natural hazards affecting the property known to the seller, as well as those contained in public records to the EP investor. Natural hazards are disclosed using the statutory Natural Hazard Disclosure Statement (NHD).

The NHD Statement discloses risks to life and property which exist in nature due to the property's location, risks known and readily available from the public records (planning department) and are unrelated to the risks to life and property from man-made physical and environmental conditions disclosed by a TDS. The NHD assists EP investors determine whether they are to buy the property, and if so, on what price and on what terms.

To obtain the natural hazard information to disclose to prospective EP investors, a seller and their agent consult publically available records themselves. The use of an expert to gather information from the public record and prepare the report relieves the seller's agent of any liability for errors not known to the agent to exist.

Sellers and seller's agents of any type of real estate are to disclose whether the property is located in:

- an area of potential flooding;
- a very high fire hazard severity zone;
- a state fire responsibility area;
- an earthquake fault zone; and
- a seismic hazard zone.

Chapter 8 Key Terms

Chapter 9

Property operating data investigation

Learning Objectives

After reading this chapter, you will be able to:

- advise on the operating and ownership expenses a prospective buyer will experience on acquiring the seller's property;
- understand the general duties a seller's agent owes to an equity purchase (EP) investor to gather and disclose a property's operating costs; and
- determine the value of income producing property based on its rents and expenses.

Key Terms

net operating income (NOI)

property operating data

operating expenses

Profiling a property using an APOD form

On acquiring a single family residential (SFR) property, the buyer's intent is either:

- to retain ownership long term and either occupy the property themselves or rent it to a tenant; or
- to hold title short term for a profit ASAP on a resale to a buyer who, as a long term owner, will either occupy it or rent it to a tenant.

When an occupant buyer acquires an SFR property, they will incur monthly expenditures to carry ownership and maintain the property paid from their personal income. Alternatively, the buy-to-let buyer is going to collect rent from tenants to cover these expenditures.

Expenditures versus costs

For occupant buyers, the expenditures on maintenance and continued ownership affect a property's value when weighed against the operating and carrying costs of comparable properties, whether or not these expenditures are considered:

- low and advantageous;
- neutral in effect; or
- high and adverse .

Thus, expenditures incurred during ownership of an SFR property will have a long-term financial impact on an occupant buyer since they recur monthly. An EP investor and their buyer's agent need to gather and analyze the operating and carrying costs an occupant buyer – a pride-of-ownership type buyer who will pay the highest price – will incur when establishing a property's:

- present value;
- rental rate; and
- resale value.

A prudent *equity purchase (EP) investor* acquiring a residence in foreclosure requests that the seller provide them with data and information on the monthly expenditures they incur as owners. This data is delivered up before entering into an EP agreement, and if not then, before escrow closes with the right to cancel on disapproval.

To best assist the seller-in-foreclosure to disclose the ownership costs they have incurred, the EP investor or their agent on a request for the data hands the seller or the seller's agent a **property expense profile** sheet. The seller fills out and returns it to the EP investor for review, and approval if already under contract. These data and information are material to real estate transactions as they aid in the determination of a property's value. [See Form 306 accompanying this chapter]

Duties owed the EP investor

A seller's agent owes a *general duty* to an EP investor to gather and present readily available data on the costs and expenses they are going to experience on acquiring the seller's property. The data is a compilation of ownership obligations that potentially have an adverse effect on the property's value — and influence the EP investor's decision to purchase the property and on what terms.

property operating data
The actual costs of operating a property for its intended use.
[See **ft** Form 306 and 352]

The **property operating data** submitted to an EP investor in a *property expense profile* by a seller's agent may be relied on and need not be investigated for accuracy by the EP investor, unless it is noted to be a forecast, other type of opinion or from a source other than the broker. However, estimates are opinions that require reasonableness in the amounts given and a high degree of accuracy as they cannot be the product of conjecture or belief.[1] [See Form 306]

1 **Ford** v. **Cournale** (1973) 36 CA3d 172

An EP investor and their agent need to carefully evaluate the *property operating data* received from the seller and seller's agent. The EP investor on review determines what further inquiry or investigation is needed to understand the ramifications of the property operating data disclosed.

Alternatively, the EP investor who is not represented by a buyer's agent may hire an agent to take on the responsibility. Thus, the investor bears the burden of investigating and completing or confirming the numbers presented on the operating expense form prepared by the seller or seller's agent .[2]

The data of monthly **operating expenses** are one basis for comparing different available properties and their respective values with the seller's property. Comparison allows the EP investor to select the best value between competing sellers. Disruptively, seller's agents too often refuse to gather and provide property information, making claims the buyer does not understand the market when the buyer seeks information that helps set value.

operating expenses
The total annual cost incurred to maintain and operate a property for one year. [See **ft** Form 352 §3.21]

A seller who provides good faith estimates about their property's operating potential as a rental cannot be held liable for inaccuracies as long as the forecast figures are labeled as "estimates" and are not knowingly absurd.[3]

While the seller-in-foreclosure knows the costs and expenses incurred to own and occupy the property, they are likely unaware or biased about the property's *rental value*. This is market information an investor needs to analyze the property as a long-term investment. [See Form 352 accompanying this chapter]

Seller's good-faith assistance

The seller acting in good faith provides their agent – on request – with the costs and expenses the seller incurs as the owner. The information is used by the seller's agent to prepare an operating expense statement to be handed to prospective buyers seeking additional property information. [See Form 306]

Sellers employ a seller's agent to market their property and locate a buyer who will buy the property at the listed price. To this end, the seller owes a duty to the seller's agent to cooperate and assist the agent in good-faith to meet the objectives of the employment – market the property and locate a buyer.

Otherwise, the seller *wrongfully interferes* with the agent's ability to successfully market the property (and earn a fee). Without accurate ownership expense data, property cannot be honestly marketed to prospective buyers. Property has baggage, and *operating expenses* and tenant turnover are part of a property's entourage.

In turn, the duty owed to their seller by a seller's agent requires them to deliver for their seller the best business advantage **legally achievable**.

2 **Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488

3 Calif. Civil Code §1102.5

Form 306

Property Expense Report

PROPERTY EXPENSE REPORT

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

DATE: ____________, 20____, at ____________________________, California

Prospective Buyer ____________________________

1. **PROPERTY TYPE** ____________________________
   - 1.1 Location ____________________________
   - 1.2 Expense figures are estimates reflecting:
     - a. ☐ current expenses of occupancy/ownership.
     - b. ☐ forecast of anticipated expenses of occupancy/ownership.
2. **MONTHLY OPERATING EXPENSES:**
   - 2.1 Electricity . . . . . $________
   - 2.2 Gas . . . . . $________
   - 2.3 Water . . . . . $________
   - 2.4 TV (cable/satellite) . . . . . $________
   - 2.5 Phone . . . . . $________
   - 2.6 Internet . . . . . $________
   - 2.7 Trash . . . . . $________
   - 2.8 Sewage . . . . . $________
   - 2.9 General obligation bonds . . . . . $________
   - 2.10 Lawn/Gardening . . . . . $________
   - 2.11 Maid/Housekeeping . . . . . $________
   - 2.12 Pool/Spa . . . . . $________
   - 2.13 Homeowners' Association (HOA) . . . . . $________
   - 2.14 Maintenance and repair . . . . . $________
   - 2.15 Property Management Services . . . . . $________
   - 2.16 Insurance ____________ . . . . . $________
   - 2.17 Taxes ____________ . . . . . $________
   - 2.18 Other ____________ . . . . . $________
   - 2.19 **Total Operating Expenses** $0.00
   - 2.20 Monthly Loan Payment (Principal and Interest) . . . . . $________
   - 2.21 **Total Monthly Expenses** $0.00
3. **DEPOSITS:**
   - 3.1 Rental Security Deposit . . . . . $________
   - 3.2 Electricity Deposit . . . . . $________
   - 3.3 Water Deposit . . . . . $________
   - 3.4 Sewage and Rubbish Deposit . . . . . $________
   - 3.5 Gas Service Deposit . . . . . $________
   - 3.6 Phone Service Deposit . . . . . $________
   - 3.7 Other ____________ . . . . . $________
   - 3.8 **Total Deposits** $0.00

OWNER: I have read and approve this information.
Date____________, 20____
Owner's Name ____________________________

Signature ____________________________

Date Prepared: ____________, 20____
Broker: ____________________________
DRE #: ____________________________
Agent: ____________________________
Phone: ____________, Cell: ____________
Fax: ____________________________
Email: ____________________________

PROSPECTIVE BUYER:
I have received and read a copy of this estimate.
Date: ____________, 20____
Name: ____________________________

Signature: ____________________________
Name: ____________________________

Signature: ____________________________

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Seller's agent's duties

This duty is tempered by the seller's agent's *general duty* owed to all prospective buyers such as EP investors. Before a prospective buyer enters into a purchase agreement (or the seller accepts an offer), the seller's agent is to provide property information containing:

- accurate, factual information; and
- reasonable operating estimates.

Data and information **known or readily available** to the seller or seller's agent about the property's operations are required disclosures to be made to prospective buyers. The information is classified as *material facts* and may potentially affect the decisions of a reasonably prudent buyer regarding acquisition of the property.

As a result, the seller's agent is required to present known and readily available facts to a prospective buyer in a manner that does not mislead or deceive the buyer. The agent may not omit disclosing factors known or observable by the agent which adversely affect the property's value.

Often the seller is the source of the property's operating cost and expense data entered on the operating expense sheet. If the seller's agent has no reason to believe the data is false, the seller's agent has no duty to prospective buyers to investigate the truthfulness (accuracy) of the information before passing it on to prospective buyers. However, for the seller's agent to avoid liability for erroneous data obtained from others, the **source of the data** needs to be presented with the disclosures.

Estimating rental income

Residential properties controlled by EP statutes include not only SFR properties, but also those containing two-to-four residential units, **one of which is occupied** as the seller-in-foreclosure's principal residence.

With SFRs, as well as multi-family 2-to-4 unit income property, the income producing capacity of the property is established by:

- the **market rental rate** for the unit occupied by the seller-in-foreclosure;
- the **scheduled rental income** for each unit held out for rent; and
- an amount set for the uncollectible portion of the scheduled rents due to likely vacancies and nonpayment of rent, called a **vacancy factor**.

The scheduled rental income for the seller-occupied unit is to be set based on the rental rates charged for comparable properties in the area (including rented units on the property). As always, the EP investor or their agent needs to consider some investigation into the rental rates charged by landlords of comparable units to confirm the scheduled rents are in line with the local market.

EP investors need to be warned: *estimated, anticipated, forecasted, or projected rental income* and expense figures provided by most sellers' agents are highly suspect as unreliable due to generally negligent guesswork in their preparation. Often, the data on rents and expenses is adjusted so the *capitalization rate (cap rate)* conveniently appears acceptable based on the asking price and the fabricated NOI. However, the EP investor cannot hold the seller-in-foreclosure or the seller's agent liable for estimates honestly made in good-faith based on the best possible information available when the estimates later prove to be erroneous.[4]

4 CC §1102.5

Form 352

Annual Property Operating data Sheet

Page 1 of 2

ANNUAL PROPERTY OPERATING DATA SHEET

APOD

Prepared by: Agent ______________ Phone ______________
Broker ______________ Email ______________

DATE: ______________, 20____, at ______________, California.

1. **PROPERTY TYPE:** ______________
   - 1.1 Location ______________
   - 1.2 APOD figures are estimates reflecting:
     - a. ☐ Current operating conditions.
     - b. ☐ Forecast of anticipated operations.
     - c. Prepared by ______________

			%
2. **INCOME:**			
2.1 **Scheduled Rental Income**		$	100 %
a. Less: Vacancies, discounts and uncollectibles.	– $		%
2.2 **Effective Rental Income** [Lines 2.1 less 2.1 a and b]		$ 0.00	%
a. Other income		+ $	%
2.3 **Gross Operating Income**		$ 0.00	%
3. **EXPENSES:**			
3.1 Electricity	$		%
3.2 Gas	$		%
3.3 Water	$		%
3.4 Rubbish	$		%
3.5 Insurance	$		%
3.6 Taxes	$		%
3.7 Management Fee	$		%
3.8 Resident Manager	$		%
3.9 Office Expenses/Supplies	$		%
3.10 Advertising	$		%
3.11 Lawn/Gardening	$		%
3.12 Pool/Spa	$		%
3.13 Janitorial	$		%
3.14 Maintenance	$		%
3.15 Repairs and Replacements	$		%
3.16 CATV/Phone	$		%
3.17 Accounting/Legal Fees	$		%
3.18 Credit card charges	$		%
3.19 ______________	$		%
3.20 ______________	$		%
3.21 **Total Operating Expense** [Lines 3.1 to 3.20]		– $ 0.00	%
4. **NET OPERATING INCOME:** [Line 2.3 less 3.21]		$ 0.00	%

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The unrented unit occupied by the seller in a triplex or fourplex structure is typically grander in proportion and contains more amenities than found in the other units. The upgraded seller-occupied unit typically does not command a rent that is pro rata to the rent received for the size/square footage of the other units, a condition called **over-built**.

Thus, the estimates of rental income scheduled for the upgraded seller-occupied unit are to be viewed with some suspicion. Comparable units for setting the rent are to be of same size and design.

Form 352

Annual Property Operating data Sheet

Page 2 of 2

PAGE TWO OF TWO — FORM 352

5. **SPENDABLE INCOME** (annual projection):

5.1 **Net Operating Income** (enter from section 4). . . . . $0.00 ______ ______%

5.2 Loan	Principal Balance Amount	Monthly Payment	Rate	Due Date
a. 1st	$______	$______	______%	______
b. 2nd	$______	$______	______%	______
c. 3rd	$______	$______	______%	______

5.3 Total Annual Debt Service [Lines 5.2 a, b and c] . . . . – $0.00 ______ ______%

5.4 **Spendable Income** [Lines 5.1 less 5.3] . . . . $0.00 ______ ______%

6. **PROPERTY INFORMATION:**

6.1 Price $______________; Loan amounts $______________; Owner's equity $______________.

6.2 Current vacancy rate or vacant space ______%.

6.3 Assessor's allocations for depreciation schedule:
Improvements ______%; Land ______%; Personal property ______%.

6.4 Property disclosures:

a. ☐ Rental Income Rent Roll available: [See ft Form 352-1] ☐ need confidentiality agreement.
b. ☐ Rent control restrictions.
c. ☐ Condition of improvements available: ☐ by owner [See ft Form 304-1], ☐ by inspector.
d. ☐ Environmental report available.
e. ☐ Natural Hazard Disclosure Statement available. [See ft Form 314]
f. ☐ Soil report available.
g. ☐ Termite report available.
h. ☐ Building specification available.
i. ☐ ______________________________
j. ☐ ______________________________

7. **REPORTABLE INCOME/LOSS** (annual projection): For Buyer to fill out.

7.1 **Net Operating Income** (NOI) (enter from section 4) $0.00

7.2 Deductions from NOI

a. Annual interest expense . . . . $______________
b. Annual depreciation deduction . . . . $______________
c. Total deductions from NOI . . . . – $0.00

7.3 **Reportable Income/Loss** (annual projection) $0.00

Broker: ______________	**I have reviewed and approve this information.**
Address: ______________	Date: ______________, 20______
______________	
Phone: ______________	Owner's name: ______________
Cell: ______________	
Fax: ______________	Signature: ______________
Email: ______________	
	Signature: ______________

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Completing the APOD

On receipt of the property's income and expense information by the EP investor and their agent and preparation of their own **annual property operating data (APOD)** sheet, they are then able to calculate expenses as a percentage of rental income. This calculation reveals the property's cost-effectiveness which is then compared to other like-type properties. [See Form 352]

Expenses, as a percentage of scheduled income, are calculated on the *APOD* in the column to the right of the dollar amount. Percentages calculated for each operating expense alert the EP investor to costs that vary from a standard cost range used for income property analysis. [See the **first tuesday** Income Property Brokerage (IPB) suite of forms]

For example, if the percentage allocated to utility expenses is abnormally high compared to comparable local properties, this cost is evaluated to determine:

- what may be done, if anything, to bring the utility expenses into an acceptable percentage range; and
- what effect the expense has on the value of the property as reflected by the resulting **net operating income (NOI)**.

net operating income (NOI)
The net revenue generated by an income producing property as the return on capital, calculated as the sum of a property's gross operating income less the property's operating expenses. [See **ft** Form 352 §4]

Subtracting the operating expenses from gross rental income calculates the *NOI*. The NOI represents the income used to most accurately determine a **property's value.** A property's value is set *before considering* mortgage payments and depreciation/capital recovery schedules.

The NOI, when divided by the EP investor's desired annual yield on their total capital investment — called the **capitalization rate** or **cap rate** — gives the EP investor a basis for establishing the value of the property.

Mortgage payments

Mortgage payments entered on the APOD are limited to principal and interest (PI) payments. When impounded (escrowed) funds are collected by the mortgage holder with the PI payment, the two are to be separated. Impounds are merely a **reserve** of funds for payment of some annually recurring property operating expenses by the lender. Impounds paid are not a mortgage charge; impounds are used to pay the owner's operating expenses disclosed in the expense section of the APOD.

Impounds typically change on transfer of the property, primarily due to an increase in property taxes triggered by reassessment on a change of ownership. Thus, when the EP investor is taking title subject to or formally assuming the seller's mortgage the increase in impounds is calculated. The amount estimated for future payment of impounds is entered on the APOD in the mortgage payment section. The seller-in-foreclosure's present impound payment is not considered.

The exact balances and terms of existing financing are forwarded to escrow in the *beneficiary statement* provided by the mortgage holder on request. Information from the beneficiary statement confirms the seller-in-foreclosure's representations of the loan amount, payments, interest impounds, and delinquencies. [See Chapter 20; see **first tuesday** Form 415]

An *assumption* of the loan by the EP investor will likely include a modification of the interest rate and loan payment schedule. This is particularly so in a rising long-term interest rate market relative to the rate on the mortgage being formally assumed. [See Chapter 16]

Other valuation considerations

In addition to the ongoing monthly ownership costs and occupancy expense information collected, the EP investor is to consider other **facts affecting** the marketability of the property, including:

- the *physical condition* of the property's improvements and soil;
- *title conditions* and *zoning* use restrictions;
- the *area surrounding* the property location and the natural and environmental hazards of the location; and
- the *capital investment* required to own the property.

The EP investor **physically inspects** the property for any deferred maintenance and rehabilitation costs. Additionally, a home inspector's investigation and report of the property condition helps avoid surprise discoveries after escrow closes. [See Chapter 6 and 7]

A **preliminary title report** exposes any recorded title problems, such as judgment liens, assessment bonds or easements which may interfere with closing.

Further, the EP investor is to confirm with local agencies what uses of the property are allowed by zoning ordinances. Zoning on the property and in the surrounding area affects the future income and expenses of the property. [See Chapter 10]

In addition to all the various property analyses, an EP investor who intends to flip the property ASAP for a profit needs to prepare a resale **cost analysis** of the residence they consider acquiring. Without an analysis of costs of acquisition, carrying costs and resale costs to develop a full understanding of the property's economic feasibility as a profitable investment, the EP investor seeking profits on a resale acts at their peril. [See **first tuesday** Form 365]

Chapter 9 Summary

A prudent equity purchase (EP) investor acquiring a residence in foreclosure requests that the seller provide them with data and information on the monthly expenditures they incur as owners. This data is delivered up before entering into an EP agreement, and if not then, before escrow closes with the right to cancel on disapproval.

To best assist the seller-in-foreclosure to disclose the ownership costs they have incurred, the EP investor or their agent on a request for the data hands the seller or the seller's agent a Property Expense Profile sheet. The seller fills out and returns it to the EP investor for review, and approval if already under contract. The data is a compilation of ownership obligations that potentially have an adverse effect on the property's value and influence the EP investor's decision to purchase the property and on what terms.

A seller's agent owes a general duty to a prospective buyer of a property to gather and present readily available data on the costs and expenses the EP investor is going to experience on acquiring the seller's property. An EP investor and their agent need to carefully evaluate the property operating data received from the seller and seller's agent.

After the EP investor and their agent receive the property's income and expense information and confirm or prepare an annual property operating data (APOD) sheet, they are able to calculate expenses as a percentage of rental income. This calculation reveals the property's cost-effectiveness which is then compared to other like-type properties.

The EP investor physically inspects the property for any deferred maintenance and rehabilitation costs. Additionally, a home inspector's investigation and report of the property condition helps avoid surprise discoveries after escrow closes.

Chapter 9 Key Terms

net operating income (NOI)..pg. 106
operating expenses ....pg. 101
property operating data...pg. 100

Chapter 10

Preliminary title reports

Learning Objectives

After reading this chapter, you'll be able to:

- advise an EP investor on the limited use of a preliminary title report;
- explain the function of a preliminary title report in the closing of an EP transaction; and
- distinguish between a preliminary title report and an abstract of title.

Key Terms

abstract of title
date-down search
preliminary title report

An offer to issue title insurance

A **preliminary title report** is intended to disclose the current *vesting* and *encumbrances* affecting a property's title as reflected by the public record. Encumbrances listed on a *preliminary title report* include:

- general and special taxes;
- assessments and bonds;
- covenants, conditions and restrictions (CC&Rs);
- easements;
- rights of way;
- liens; and
- interests of others.

A preliminary title report, also known as a **prelim**, is not a representation of the condition of title or a policy of title insurance. Unlike an **abstract of title**, a prelim cannot be relied on by anyone and imposes no liability on the title company for errors in its preparation.

preliminary title report
A report constituting a revocable offer by a title insurer to issue a policy of title insurance used by a buyer and escrow to initially establish the current vesting and encumbrances attached to title of a property as reflected by public record.

A title insurer has no duty to accurately report title conditions and encumbrances on the prelim, shown as *exceptions* in the proposed policy.[1]

A prelim is no more than a title insurer's **offer to issue** a title insurance policy based on the contents of the prelim. Further, the offer may be modified by the title company at any time before issue a policy.[2]

Contents of a property profile

The preliminary title report is distinguishable from a **property profile report.** Agents representing EP investors typically pull a *property profile* on a property they want to check out before making an offer. A property profile is downloaded from the website of a title insurance company based on the common address of the property.

What is received as a property profile is limited, but crucial information on:

- the vesting to title of the property (with a copy of the recent grant deeds or equivalent transfer documents);
- any trust deed liens recorded by owners and not yet reconveyed;
- any default notices (NODs) and trustee's sale notices (NOTS) on any of the trust deeds or record; and
- property tax status and assessment bonds.

Occasionally, some CC&R information is provided as part of the title information in a property profile. A general index search on vested owners is not included, but is the subject of a preliminary title report for judgment abstracts or other involuntary liens indirectly attached to title due to separate liabilities of owners.

Use of the prelim by an EP investor in escrow

The closing of a purchase escrow is typically contingent on the EP investor's approval of items in the prelim. Before closing, the EP investor needs to be assured the conditions of title are consistent with the EP investor's expectations on entering into the purchase agreement. Also, the EP investor, the agents and the escrow officer review the report for title conditions and encumbrances inconsistent with the terms for the seller's delivery of title set in the purchase agreement and escrow instructions.

In practice, the EP investor's agent looks for title conditions which may interfere with any *intended use or change in the use* of the property contemplated by their EP investor. Interferences come in the form of unusual easements or use restrictions which obstruct known plans the EP investor has to make improvements or alter the use of the property.

Escrow relies in part on items approved and disapproved in the prelim to carry out its instructions to record grant deeds, trust deeds, leaseholds, or options which are to be covered by a policy of title insurance.

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1 **Siegel** v. **Fidelity National Title ISnsurance Company** (1996) 46 CA4th 1181

2 Calif. Insurance Code §12340.11

Typically, escrow instructions call for closing when the deed may be recorded and insured, subject only to taxes, CC&Rs and other encumbrances as agreed and approved in the instructions.

Ultimately, it is the escrow officer who, on review of the prelim, advises the seller of any need to eliminate defects or encumbrances on title which interfere with closing as instructed.

The initial prelim and a last-minute **date-down** search of title conditions are used by escrow and the title insurer to reveal any additional title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents when recorded.

date-down search
A further search of the public records performed immediately prior to closing an equity purchase (EP) transaction and issuance of a policy of title insurance.

The title insurer's *date-down* of the prelim prior to closing may turn up title defects or encumbrances not included in the prelim. These occur due to error on the part of the insurer or by a recording after the preparation of the prelim. In any case, the title company then **withdraws its offer** under the prelim. The title company then issues a new prelim, offering to issue a policy on different terms.

Prelim vs. abstract of title

Title companies have long been aware of the public's reliance on their prelim. This reliance was so extensive the California courts consistently held title companies liable for their erroneous reports. However, legislation drafted by the title insurance industry was introduced and enacted in 1981 to eliminate title insurer liability for their preparation of faulty prelims.

Prelims were once compared to *abstracts of title*. An abstract of title is an accurate, factual representation of title to the property being acquired, encumbered or leased. Thus, an abstract of title may be relied on by those who order them as an absolute representation of the conditions of title.[3]

abstract of title
An accurate, factual representation of title to the property being acquired, encumbered or leased.

An abstract of title is a **statement of facts** collected from the public records. An abstract is not an insurance policy with a dollar limit on the insurer's liability as is set in a policy of title insurance. The content of an abstract is intended by the insurance company to be relied upon as fact. Thus, the insurer is liable for all money losses of the policy holder flowing from a failure to accurately state all conditions of title in the abstract they issue.[4]

In an effort to shield title companies from an *abstractor's liability* on the issuance of a defectively prepared prelim, the prelim has been legislatively redefined as being neither an abstract of title nor a representation of the condition of title. Instead, the prelim is defined as a report furnished in connection with an application for title insurance.[5]

The prelim has become and is simply an *offer* by a title company to issue title insurance. The prelim is thus merely a statement of terms and conditions on which the title company is willing to issue a policy — subject to any changes they may make prior to issuing the policy of title insurance.

3 Ins C §12340.10
4 **1119 Delaware** v. **Continental Land Title Company** (1993) 16 CA4th 992
5 Calif. Insurance Code §12340.11

Chapter 10 Summary

A preliminary title report (prelim) is intended to disclose the current vesting and encumbrances affecting a property's title as reflected by the public record. A title insurer has no duty to accurately report all title defects and encumbrances on the prelim.

A prelim is not a representation of the condition of title and cannot be relied on by anyone. Thus, a prelim is no more than an offer to issue a title insurance policy based on the contents of the prelim and any modifications made by the title company before the policy is issued.

Agents representing EP investors typically pull a property profile on a property they want to check out before making an offer. A property profile contains crucial information on:

- the vesting to title of the property;
- any trust deed liens recorded by owners and not yet reconveyed;
- any default notices (NODs) and trustee's sale notices (NOTS) on any of the trust deeds or record; and
- property tax status and assessment bonds.

Further, prelims are distinct from abstracts of title. Abstracts of title are written statements which may be relied on by those who order them as an accurate, factual representation of title to the property being acquired, encumbered or leased.

Chapter 10 Key Terms

Chapter 11

Title insurance coverage

Learning Objectives

After reading this chapter, you'll be able to:

- explain how a policy of title insurance indemnifies a person who acquires an interest in real estate against a monetary loss caused by an undisclosed encumbrance on title;
- differentiate between the various types of title insurance policies, endorsements and binders available, such as those presented by the California Land Title Association (CLTA) and the American Land Title Association (ALTA);
- comprehend the six operative sections of a title insurance policy;
- observe the dollar limitations placed on coverage provided under the policy exclusions; and
- understand the process of settling a claim.

Key Terms

abstract of title
encumbrance
exception
exclusion
preliminary title report
proof-of-loss statement
Schedule A
Schedule B
title insurance

Identifying an actual loss

A policy of **title insurance** is the contract issued by a title insurance company agreeing to reimburse or hold harmless an insured person who acquires an interest in real estate against a monetary loss caused by an **encumbrance** on title that:

- is not listed in the title insurance policy as an exception to coverage; and
- the insured policy holder was unaware of when the policy was issued.[1]

encumbrance
A claim or lien on a parcel of real estate, such as trust deeds, CC&Rs, easements, taxes or assessments.

1 Calif. Insurance Code §12340.1

title insurance
A form of indemnity insurance by which a title insurance company holds harmless a person who acquires an interest in real estate against a monetary loss caused by an encumbrance on title that is not listed in the policy and the insured was unaware of when the policy was issued.

Thus, a policy of *title insurance* is a form of **indemnity insurance**, not a guarantee of title conditions. Title insurance policies are issued on one of several general forms used by the entire title insurance industry in California. The policies are typically issued to:

- *buyers* of real estate;
- *tenants* acquiring long-term leases; and
- *lenders* whose mortgage are secured by real estate.

As an *indemnity* agreement, a title insurance policy is a contract. The terms of coverage in the policy set forth the extent of the title insurance company's obligation, if any, to indemnify the policy holder for money losses caused by an encumbrance on title.[2]

Depending on the type of transaction, an EP investor's agent advises their client to include in the EP agreement title coverage in the form of either:

- a **California Land Title Association (CLTA)** policy;
- an **American Land Title Association (ALTA)** policy; or
- a **title insurance binder**.

Binder: A commitment to issue

An EP investor acquiring property for resale within two years after their purchase is best served by having the seller provide a **title insurance binder** on closing, also called a *commitment to issue*, in lieu of a policy of title insurance.

A *title insurance binder* is an important component of real estate transactions when the buyer intends to sell or flip the property acquired within two years. The request for a binder first begins by use of the title insurance provision in the EP agreement to call for the type of policy provided by the seller-in-foreclosure to be a binder, not a policy of title insurance.

The cost of a binder is 10% to 15% more expensive than a CLTA policy. If the seller refuses to bear the extra cost, it is cost effective for the EP investor to pay for it rather than buying two policies — one when the property is purchased, and another on the later resale or refinance.

With a binder, the resale policy will be at no further charge, except for the premium for any increased liability coverage requested for any increase in the resale price.

A binder entitles the EP investor to title insurance coverage until the EP investor requests a policy be issued to a new buyer on resale of the property or to a new lender on a refinance.

Under a binder, a policy of title insurance is issued in the name of the substitute buyer on close of the resale escrow on the flip – within two years of the EP investors being issued the binder.

2 Ins C §12340.2

Encumbrances unknown, undisclosed

Almost all losses due to the reduction in the value of real estate below the policy limits arise out of an encumbrance. An *encumbrance* is any condition which affects the ownership interest of the insured, whether the interest insured is a:

- fee;
- leasehold;
- life estate; or
- the security interest of a lender.

The word "encumbrance" is all encompassing. Any right or interest in real estate held by someone other than the owner which **diminishes the value** of the real estate is considered an encumbrance.

Encumbrances on title include:

- covenants, conditions and restrictions (CC&Rs) limiting use;
- reservations of a right of way;
- easements;
- encroachments;
- trust deeds or other security devices;
- pendency of condemnation; and
- leases.[3]

Property improvement and use not covered

Physical conditions on the property itself are not encumbrances affecting title. Accordingly, title insurance policies do not insure against open and notorious *physical conditions* which exist on the property.

Physical conditions are uses which exist and are visible on the property, such as:

- canals;
- highways;
- irrigation ditches; and
- levees.

A buyer is always presumed to have contracted to acquire property subject to known and visible physical conditions on the property which impede its use or impair its value. In the case of encumbrances, recorded or not, no such presumption exists.

Underwriting only indemnifies a loss

A title insurance policy is not an **abstract of title** which warrants or guarantees the nonexistence of title encumbrances. Instead of receiving a guarantee of title conditions, the named insured on the policy is indemnified up to the *policy's dollar limits* against a money loss caused by a title condition (encumbrance) not listed as an exception or exclusion in the policy.

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3 **Evans** v. **Faught** (1965) 231 CA2d 698

abstract of title
An accurate, factual representation of title to the property being acquired, encumbered or leased.

Under a title insurance policy, the title company only covers the risks of a **monetary loss** caused by an encumbrance which is not listed as an exception or exclusion to coverage, and was unknown to the named insured at the time of closing. Thus, the title company has no obligation under a policy to clear title of the unlisted encumbrance.

A title insurance company issuing a policy of title insurance has two underwriting options when its title search reveals an encumbrance affecting title:

preliminary title report
A report constituting a revocable offer by a title insurer to issue a policy of title insurance used by a buyer and escrow to initially establish the current vesting and encumbrances attached to title of a property as reflected by public record.

- list the encumbrance in a **preliminary title report (prelim)**, requiring the parties to either eliminate it or accept it as an *exception* to coverage in the policy of title insurance to be issued; or
- insure against the encumbrance by **writing over** the encumbrance — i.e., not listing it as an exception — and assuming any risk of loss connected to it.

When title companies *write over* a known encumbrance, they usually demand an indemnity agreement from the person responsible for eliminating the encumbrance. This encumbrance typically takes the form of a money lien, such as a mechanic's lien, money judgment or blanket encumbrance. Thus, the title company may recover for a third-party guarantor if a claim by the insured is later paid due to the encumbrance.

Additionally, a title policy is not a representation – guarantee – of the nonexistence of encumbrances that are not listed in the policy. Infrequently, an encumbrance exists that is not known to the named insured, such as the buyer or lender, or to the title insurer. Thus, it is not listed as an exception in the policy. Here, an insured's claim against the insurer for money in excess of the policy limits cannot be based on the insurer's *negligent preparation* of the encumbrances excluded from coverage. Similarly, a claim on an erroneous *prelim* cannot be based on negligent preparation.

However, a title insurer might *intentionally write over* an encumbrance at the request of a seller. If the buyer is not notified the encumbrance exists, the insurer is liable for actual losses in excess of the policy coverage. In this instance, the insurer breached the implied covenant of good faith and fair dealing imposed on title companies as a duty owed to the insured.[4]

Introduction to title policy forms

Title insurance is purchased to assure real estate buyers, tenants and lenders the interest in title they acquire is what they bargained for.

A policy of title insurance is broken down into six operative sections, including:

- the *risks of loss covered*, called **insuring clauses**, which are based on a completely unencumbered title at the time of transfer;
- the *risks of loss not covered,* comprised of encumbrances arising after the transfer or known to or brought about by the insured, called **exclusions**, which are a boilerplate set of title conditions;

4 **Jarchow** v. **Transamerica Title Insurance Company** (1975) 48 CA3d 917

- *identification* of the insured, the property, the vesting, the dollar amount of the coverage, the premium paid and the recording, called **Schedule A**;
- the *recorded interests*, i.e., any encumbrances affecting title and any observable on-site activities which are listed as risks agreed to and assumed by the insured and not covered by the policy, called **exceptions**, which are itemized for all types of coverage in **Schedule B**;
- the *procedures,* called **conditions**, for claims made by the named insured and for *settlement* by the insurance company on the occurrence of a loss due to any encumbrance on title which is not an exclusion or exception to the coverage granted by the insuring clauses; and
- any *endorsements* for additional coverage or removal of exclusions or pre-printed exceptions from the policy.

Schedule A
Identification of the property interest the insured acquired, the legal description of the insured property, the date and time coverage began, the premium paid for the policy, and the maximum total dollar amount to be paid for all claims settled.

Insuring clauses

Coverage under the broadly worded *insuring clause* of a policy of title insurance indemnifies the named insured for risks of loss **related to the title** due to:

- anyone making a claim against title to the real estate interest;
- the title being unmarketable for sale or as security for financing;
- any encumbrance on the title; and
- lack of recorded access to and from the described property.

Exclusions from coverage

All title insurance policies contain an *exclusions* section. The exclusions section eliminates from coverage those losses incurred by the insured buyer, tenant or lender due to:

- *use ordinances* or *zoning laws*;
- *unrecorded claims known* to the insured, but not to the title company;
- encumbrances or adverse *claims created after* the date of the policy;
- claims arising out of *bankruptcy* or due to a *fraudulent conveyance* to the insured;
- *police power* and *eminent domain*; and
- *post-closing events* caused by the insured.

exclusion
Risks of loss not covered under a policy of title insurance, comprised of encumbrances arising after the transfer or known to or brought about by the insured.

Schedule A data

All policies of title insurance on *Schedule A* set forth:

- the property interest the insured acquired;
- the legal description of the insured property;
- the date and time coverage began;
- the premium paid for the policy; and
- the maximum total dollar amount to be paid for all claims settled.

Exceptions to coverage

In addition to the policy exclusions, a policy's coverage under its "no-encumbrance" insuring clause is further limited by *Schedule B* exceptions in the policy.

Schedule B
Itemization of title insurance policy exemptions and items which need to be complete before escrow may close and title insurance is issued.

The *exceptions* section contains an itemized list of recorded and unrecorded encumbrances which are known to the title company and affect the insured title. While the existence of these known encumbrances is insured against in the insuring clauses, they are removed by Schedule B as a basis for recovery under the policy.

exception
Any encumbrances affecting title and any observable on-site activities which are listed as risks agreed to and assumed by the insured and not covered by a policy of title insurance.

An ALTA policy includes a set of pre-printed exceptions setting forth risks assumed by the insured buyer, tenant or lender, including:

- taxes, assessments, liens, CC&Rs, or any other interests, claims or encumbrances which have not been recorded with the county recorder or tax collector on the date of closing;
- any unrecorded and observable on-site activity which includes conflicts regarding boundary lines, encroachments or any other facts which a survey would disclose;
- unpatented mining claims; and
- all water rights.

Claims and settlements

Lastly, a policy of title insurance includes a *conditions* section. The conditions section outlines the procedures the insured policy holder needs to follow when making a claim for recovery under the policy. Also set forth are the settlement negotiations or legal actions available to the title company before paying a claim.

Owner's policies for buyers

Several types of title coverage are available, including:

- a **California Land Title Association (CLTA)** standard policy;
- an **American Land Title Association (ALTA)** owner's extended coverage policy;
- an **ALTA residential (ALTA-R)** policy; and
- an **ALTA homeowner's** policy.

When making an offer to purchase property, a prospective buyer is informed by their agent about the coverage each type of title insurance policy provides. The buyer's need for title coverage is to be reviewed when the buyer enters into a purchase agreement as the agreement's title insurance provision calls for the buyer to designate the type of title insurance policy and states who pays its premium. [See **first tuesday** Form 156 §13.5; see Figure 1]

The buyer's choice of a title policy as selected in the purchase agreement depends on whether the buyer or seller is paying the title insurance premium. Customarily, the seller pays the premium, except in some northern California counties, since it is the seller's deed of conveyance that is insured.

Figure 1

Form 156 Excerpt

Equity Purchase Agreement

13.5 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by ____________________ title company on a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements ____________________

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

The CLTA standard policy

The *CLTA standard policy* is purchased solely by buyers, carryback sellers and private lenders.

The CLTA standard policy insures against all encumbrances affecting title which may be discovered by a search of **public records** prior to issuance of the policy. Any encumbrance not recorded, whether or not observable by an inspection or survey, is not covered due to the CLTA policy exclusions and standard exceptions.

For example, a deed conveying a parcel of real estate which is *recorded and indexed* by the county recorder's office imparts constructive notice to buyers and lenders who later acquire an interest in the property.[5]

Additionally, the CLTA standard policy (as well as the ALTA policy) protects the insured against:

- the unmarketability of title or the inability to use it as security for financing;
- lack of ingress and egress rights to the property; and
- losses due to the ownership being vested in someone other than the buyer.

All title insurance policies provide coverage forever after the date and time the policy is issued. Coverage is limited to the dollar amount of the policy, which is generally adjusted for inflation. Coverage is further limited by the exclusions, exceptions and conditions on claims.

Policy exclusions

The CLTA standard policy (as well as the ALTA policy) contains Schedule A exclusions to coverage which bar recovery by the buyer or joint protection carryback seller for losses due to:

- zoning laws, ordinances or regulations restricting or regulating the *occupancy, use or enjoyment* of the land;
- the character, dimensions or location of any *improvement erected* on the property;
- a *change in ownership* or a parceling or combining of the described property by the insured buyer;

5 Calif. Civil Code §1213

- *police power*, *eminent domain* or violations of *environmental protection laws*, unless a notice or encumbrance resulting from the violation was recorded with the county recorder before closing;
- *encumbrances known to the insured buyer* or lender which are not recorded or disclosed to the title company;
- encumbrances which do not result in a *monetary loss*;
- encumbrances which are created or become encumbrances *after issuance* of the policy;
- encumbrances resulting from the buyer's payment of *insufficient consideration* for the property or delivery of improper security to the lender also insured under the policy; and
- the unenforceability of the insured lender's trust deed lien due to the lender's *failure to comply* with laws regarding usury, consumer credit protection, truth-in-lending, bankruptcy and insolvency.

CLTA pre-printed exceptions

The CLTA standard policy contains **pre-printed exceptions** listed in the policy as Schedule B, also called **standard exceptions** or **regional exceptions**. It is the inclusion of these pre-printed boilerplate exceptions which makes the CLTA policy a *standard* policy.

An ALTA owner's policy does not contain pre-printed exceptions, only the typewritten exceptions listing the encumbrances which are known to the title company and affect title to the property.

The pre-printed standard exceptions in Schedule B of the CLTA standard policy eliminate coverage for losses incurred by the buyer due to:

- taxes or assessments not shown in the records of the county recorder, the county tax collector or any other agency which levies taxes on real property;
- unrecorded rights held by others which would have been discovered by the buyer on an inspection of the property or inquiry of persons in possession;
- easements or encumbrances which are not *recorded and indexed* by the county recorder;
- unrecorded encroachments or boundary line disputes which a survey would have disclosed; and
- recorded or unrecorded, unpatented mining claims or water rights.

A lower premium is charged to issue a CLTA policy since the title company undertakes a lower level of risk for indemnified losses due to the CLTA pre-printed exceptions, as compared to the extended risks covered by the more expensive ALTA owner's policy.

Most policies issued today are of the ALTA variety since the CLTA policy format with pre-printed standard exceptions does not provide protection for unrecorded encumbrances or claims to title.

The ALTA owner's policy and survey

The ALTA owner's policy provides greater coverage than the CLTA policy. If the pre-printed exceptions are included in Schedule B and attached to the ALTA policy, the policy becomes an ALTA standard policy, comparable in cost and coverage to the CLTA standard policy since unrecorded encumbrances are not to be covered.

As the ALTA owner's policy covers **off-record matters** not covered under the CLTA standard policy, prior to issuance of a policy, the title company may require:

- the parcel to be surveyed; and
- those in possession of the property to be interviewed or estopped.

The exclusions section of an ALTA owner's policy is identical to exclusions in the CLTA policy, except for additional exclusions relating to an insured lender or carryback seller. The ALTA owner's policy is not issued to secured creditors. More precisely, a *joint protection* ALTA policy is never issued.

Separate policies and duplicate premiums are required for a lender's ALTA coverage when a buyer of property records a new loan. Thus, the premium is nearly doubled to pay for both a lender's policy and the buyer's policy when a new loan is recorded to fund the purchase of real estate acquired by the buyer. This is not the case for a CLTA joint protection policy covering both the lender and the buyer.

The ALTA residential policy

For buyers of parcels of real estate containing one-to-four residential units, *an American Land Title Association Residential (ALTA-R)* policy is available in lieu of the ALTA owner's or homeowner's policies. Parcels insured include lots and units in common interest developments (CIDs), such as condominiums.

The ALTA-R is referred to by the title companies as the "plain language" policy. Thus, the ALTA-R is written with wording which avoids legalese. Also, the ALTA-R policy contains a user-friendly *table of contents* and an *owner's information sheet* which outlines the policy's features.

The coverage, exclusions and exceptions in the ALTA-R policy are similar to the ALTA owner's policy. In addition, the ALTA-R policy covers losses due to:

- *mechanic's liens* incurred by someone other than the buyer; and
- the inability of the buyer to occupy the property if the residence violates the CC&Rs listed in the Schedule B exceptions in the policy or existing zoning.

The premium for an ALTA-R policy is priced lower than the premium for an ALTA owner's policy. This is due to the fact that the ALTA-R policy is usually issued only on parcels in an existing subdivision or CID which has no known problems with easements, encroachments or legal access.

The ALTA homeowner's policy

A **homeowner's policy** exists to provide more coverage than the ALTA owner's or the ALTA-R policies.

Before an *ALTA homeowner's policy* is issued by a title insurer, two requirements need to be met:

- the property needs to be *improved* with a one-to-four unit family residence; and
- the buyer needs to be a natural person, not an entity such as a corporation, limited liability company (LLC) or partnership.

In addition to the risks covered by the ALTA owner's and ALTA-R policies, the homeowner's policy covers several risks to ownership which may arise *after closing*, including:

- the *forging* of the buyer's signature on a deed in an attempt to sell or encumber the buyer's property;
- the construction on an adjoining parcel of a structure which *encroaches* onto the buyer's property, excluding a boundary wall or fence;
- the *recording of a document* which prevents the buyer from obtaining a secured loan or selling the property;
- claims of *adverse possession* or *easement by prescription* against the buyer's property; and
- claims by others of a right in the buyer's property arising out of a lease, contract or option *unrecorded and unknown* to the buyer at the time of closing.

The ALTA homeowner's policy also covers losses arising out of a lack of vehicular and pedestrian access to and from the property. Other owner's policies only cover losses resulting from the lack of a legal right to access, not a practical means of access which is covered by the ALTA homeowner's policy.

Other risks

Also covered by the ALTA homeowner's policy are losses incurred due to many other risks which may exist at the time of closing, including:

- the correction of any pre-existing violation of a CC&R;
- the inability to obtain a building permit or to sell, lease or use the property as security for a loan due to a pre-existing violation of a subdivision law or regulation;
- the removal or remedy of any existing structure on the property if it was built without obtaining a building permit, excluding a boundary wall or fence;
- damage to existing structures due to the exercise of a right to maintain or use an easement;
- damage to improvements due to mineral or water extraction;
- the enforcement of a discriminatory CC&R;

- the assessment of a supplemental real estate tax due to construction or a change of ownership or use occurring before closing;
- an incorrect property address stated in the policy; and
- the map attached to the policy showing the incorrect location of the property.

Encumbrances relating to the insured title and known to the title company are itemized in the policy as additional *exceptions* which limit coverage. The exceptions are reviewed by the buyer and buyer's agent in a prelim before closing and issuance of a policy.

The ALTA homeowner's policy contains the same exclusions from coverage stated in the ALTA-R policy, plus an exclusion for any *building code violations*, unless notice of the violation has been recorded with the county recorder.

Many title insurance companies use the ALTA homeowner's policy as their default policy which is used if a specific title policy is not requested by escrow. The premium for the policy is approximately 10% more than the CLTA owner's policy.

The CLTA standard joint protection policy

A lender or carryback seller has options when calling for title insurance.

The lender or carryback seller may either:

- be named as an additional insured on a CLTA standard **joint protection JP** title insurance policy with the buyer; or
- request a separate ALTA loan policy as a only named insured.

The *JP policy* enables one or more individuals or entities to be named as insured. Thus, in addition to the owner's standard CLTA title coverage, the JP policy provides coverage for a trust deed held by a lender or carryback seller.

The JP policy indemnifies the lender or carryback seller against losses arising from risks such as:

- the invalidity or unenforceability of the insured creditor's trust deed lien;
- the priority of a lien or other encumbrance which was not listed in the policy exceptions; and
- the invalidity or unenforceability of an assignment of the insured trust deed when the assignment is listed in the exceptions as affecting the trust deed.

If a loss covered by a JP policy occurs, the named insureds who suffer from the loss share in any recovery up to the dollar limit of the policy. The recovery is subject to disbursements based on their priority or pro rata interest between them in title. Thus, recovery by both the owner and the secured creditor under the JP is not cumulative, nor need it be.

Accordingly, no windfall occurs since title policies only indemnify an insured against the insured's actual monetary loss. If there is no loss of value, there is no basis for recovery.

Most policy limits are established based on the value of the property, and as part of that value, the mortgage amount. Thus, the owner and the lender are fully protected under a JP policy. The aggregate value of their interests (debt plus equity) do not exceed the policy limits on closing.

Thus, once a policy loss has been paid to an insured owner, lender or carryback seller, the amount of coverage under the policy is reduced.

However, the JP policy is only available under a CLTA standard policy. If either the buyer or lender in a cash-to-new-loan transaction requests ALTA coverage, a separate ALTA loan policy is issued to each for total premiums of approximately double the CLTA-JP cost.

The ALTA loan policy increases costs

An **institutional lender** usually requires its trust deed lien on a parcel of real estate to be insured under an ALTA loan policy.

The ALTA loan policy insures against money losses incurred by lenders and carryback sellers due to the loss of priority of the insured trust deed lien, unless listed in the exceptions, to encumbrances such as:

- a mechanic's lien, if the work was *commenced prior to* recording the trust deed (which is the same date and time as the date of the policy) and the trust deed did not secure a loan to pay for the construction;
- a mechanic's lien arising out of *work financed by proceeds* from the construction loan secured by the insured trust deed, if no part of the construction work was commenced before the trust deed was recorded; and
- assessments such as Mello-Roos for street improvements under construction or completed prior to recording the trust deed.

However, the ALTA policy does not cover losses resulting from lack of priority of the insured trust deed to a mechanic's lien if:

- the secured loan was not a construction loan designed to finance construction; and
- no part of the construction work which led to the mechanic's lien commenced before the trust deed was recorded.

ALTA exclusions in lender policies eliminate coverage for claims arising out of a loan transaction due to the operation of federal bankruptcy law, state insolvency or similar creditors' rights laws, if the claims are based on:

- a *fraudulent conveyance* to the vested owner to conceal assets;
- the *equitable subrogation* (a court ordered assignment) of the insured lender's lien; or

- the insured lender's trust deed being deemed a *preferential transfer* by a bankruptcy court due to the recording of the trust deed within 90 days before a bankruptcy filing.

Who is insured?

Those insured under the CLTA standard policy, ALTA owner's policy or ALTA-R policy include the name of the insured in *Schedule A*. They also include the name of those who succeed to the interest of the named insured by *operation of law*, not by purchase, including:

- heirs;
- distributees;
- devisees;
- joint tenancy or community property survivors;
- personal representatives;
- next of kin by intestate succession; and
- corporate or fiduciary successors.

If title is to be transferred to another vesting, concurrently or within a few months, the title company needs to be requested to include that vesting as a named insured by endorsement for coverage.

However, the ALTA homeowner's policy requires the insured and any covered successor to be an individual or the trustee of an inter vivos (living) trust, not an entity such as a Limited Liability Company (LLC). A transfer of title by an insured to their revocable inter vivos trust is covered by the ALTA homeowner's policy without endorsement. This is not the case for other policies.

A policy covering an owner does not cover a buyer who purchases the insured property from the owner. A new policy needs to be obtained, unless the seller holds a **binder** and uses it to request the title insurer issue a policy naming the buyer as the insured.

Those insured under a lender's policy of title insurance include:

- the lenders described in the policy;
- future purchasers of the insured trust deed, except assignees who acquire the trust deed as a result of an indemnity, guaranty, other policy of insurance or bond held by the insured lender; and
- any government agency which insures or guarantees the loan secured by the insured trust deed.

Setting a claim

To begin the claims process on becoming aware of an encumbrance covered as a loss by the policy of title insurance, the insured promptly gives the title insurance company written **notice of claim**.

- Upon being notified of the claim, the title company has 15 days to:
- acknowledge receipt of the claim or pay the claim;

- provide the insured with all forms, instructions, assistance and information necessary to prove the claim; and
- begin any investigation of the claim.[6]

proof-of-loss statement
A statement submitted to the title insurance company by the insured referencing the encumbrance discovered after the policy was issued, the amount of the loss and the basis for calculating the loss.

Further, the insured needs to provide the title company with a **proof-of-loss statement** within 90 days after incurring the loss. The statement sets forth:

- the encumbrance discovered;
- the amount of the loss; and
- the basis for calculating the loss.

The title company may also require the insured party to make available records, checks, letters, contracts, insurance policies and other papers related to the claim.

After receipt of the 90-day *proof-of-loss statement*, the title insurance company has 40 days to **accept or reject** the claim, in whole or in part.[7]

On accepting a claim, the title company may handle the claim in one of several ways, including:

- *pay policy limits*, plus any authorized costs, attorney fees and expenses incurred by the insured;
- *pay the loss* incurred by the insured, plus costs, attorney fees and expenses;
- negotiate a *settlement*;
- bring or defend a *legal action* on the claim; or
- for an insured lender, *purchase the loan* from the lender for the amount owed by the borrower, plus any authorized costs, attorney fees and expenses incurred by the insured lender.

Extent and limitation of liability

The **conditions section** of a title insurance policy limits the amount the title company is required to pay to settle a claim made by an insured.

For owners, the title company may *settle a claim* by paying the lesser of:

- the full dollar amount of the policy; or
- the reduction in value of the insured's ownership interest caused by the title defect or encumbrance missed by the title company and not listed in the policy exceptions.

For lenders, the title company may settle a claim by paying the lesser of:

- the full dollar amount of the policy;
- the impairment or reduction in value of the security interest due to the title defect or encumbrance not listed in the policy exceptions; or
- the amounts due on the unpaid loan at the time of the loss caused by a defect or encumbrance not listed in the policy exceptions.

6 10 Calif. Code of Regulations §2695.5(e)(1-3)
7 10 CCR §2695.7(b)

The title company does not pay a claim:

- if the title company is able to remove the encumbrance from title;
- until any litigation over the encumbrance has become final; or
- if the owner or lender settles the claim without written permission of the title company.

All claim payments made by the title insurance company, except payments made for costs, attorney fees and expenses, reduce the dollar amount of coverage remaining under the title policy.

Chapter 11 Summary

A policy of title insurance is the contract issued by a title insurance company agreeing to reimburse or hold harmless an insured person who acquires an interest in real estate against a monetary loss caused by an encumbrance on title that:

- is not listed in the title insurance policy as an exception to coverage; and
- the insured policy holder was unaware of when the policy was issued.

Depending on the type of transaction, an EP investor's agent advises their client to include in the EP agreement title coverage in the form of either:

- a California Land Title Association (CLTA) policy;
- an American Land Title Association (ALTA) policy; or
- a title insurance binder.

The buyer's choice of a title policy is initially stated in the purchase agreement, including whether the buyer or seller pays the title insurance premium.

An EP investor acquiring property for resale within two years after their purchase is best served by having the seller provide a title insurance binder on closing, also called a commitment to issue, in lieu of a policy of title insurance.

The CLTA standard policy insures against all encumbrances affecting title which may be discovered by a search of public records prior to issuance of the policy.

The ALTA owner's policy provides greater coverage than the CLTA policy. The ALTA owner's policy covers off-record matters.

Chapter 11 Key Terms

Chapter 12

Clearing a lien-clouded title

Learning Objectives

After reading this chapter, you will be able to:

- negotiate the release of a lien from title to a seller-in-foreclosure's residence;
- understand the process a judgment creditor uses to create a valid lien on real estate owned by a debtor; and
- advise a homeowner how to preserve their equity on a sale under California homestead exemption laws.

Key Terms

abstract of judgment
declaration of homestead
federal tax lien
homestead
judgment lien

Negotiate a release to create equity

An equity purchase (EP) investor enters into an EP agreement negotiated by their agent to buy a seller-occupied residence in foreclosure, called an **EP transaction**. [See **first tuesday** Form 156]

After expiration of the seller-in-foreclosure's five-business-day cancellation period, the agent opens escrow. A **preliminary title report** is ordered. On receipt of the title report, the buyer's agent discovers an **abstract for a money judgment** awarded to a creditor against the seller has been recorded clouding title to the seller's residence, called a **judgment lien**. The seller did not record a **declaration of homestead** prior to the creditor recording the *abstract*.

judgment lien
A money judgment against a property owner that is recorded as an abstract and attaches to the title of their properties.

The *judgment lien* was not specifically provided for in the EP agreement since neither the seller nor the title profile the buyer's agent pulled advised the agent it existed, as the judgment lien is listed in the General Index which is not searched for title profile purposes.

However, the terms of the EP agreement call for:

- the down payment to be reduced by the amount of any unreferenced lien; and
  - the responsibility for satisfying and releasing the lien is shifted to the EP investor to be negotiated prior to closing; or
  - the EP investor may take title subject to the judgment lien and negotiate its satisfaction and release after closing. [See **first tuesday** Form 156 §13.3]

Further, the title insurance company, as a requisite to issuing a title insurance policy, requires either a *partial* or *full release* be recorded. Doing so clears title of the lien before they will eliminate the judgment lien as a listed exception to the prelim. The EP investor chooses to have the lien released before closing, rather than offsetting the down payment and leaving the lien on title and dealing with it after closing.

However, the seller is uninformed about debt management and has no understanding about **lien avoidance**. Needing to clear title of the judgment lien before escrow can close, the buyer's agent obtains written authority from the seller to contact the judgment lienholder, directly or through escrow, to negotiate a partial or full release of the lien. These negotiations are comparable to those for a short payoff of a mortgage on a property.

The lienholder initially demands full payment of the debt since it is now secured by the property, the very reason the lienholder recorded the abstract.

Automatic homestead exemption

Continuing our previous example, the EP investor as a buyer of the seller's interest in the property has economic leverage over the creditor in negotiations for a release of the judgment lien. Here, the mortgage on the property is in foreclosure, greatly increasing the creditor's risk of loss of their lien on the property. More importantly, the seller qualifies for an **automatic homestead exemption** depriving the creditor of any ability to collect on the judgment by forcing a judicial foreclosure by sale of the property.

homestead
Dollar amount of equity in a homeowner's principal dwelling the homeowner qualifies to exempt from creditor seizure. [See **ft** Form 465]

Both the mortgage and the **homestead** claims on title are *senior* interests in title. Being senior claims, they have priority over the creditor's right to recover the amount of their judgment from the property's value.

For example, a trustee's foreclosure sale on the mortgage, if it takes place, wipes out the judgment lien, the security in the property exhausted. Unless excess funds flow from the trustee's sale to be distributed to junior lien holders, the judgment creditor receives nothing.

Also, the *homestead exemption* available to the head of a household protects a minimum of $300,000 up to a maximum of $600,000 (adjusted annually for inflation) of the homeowner's equity or the median sale price for a single family residence (SFR) in their county. Thus, the exemption frees that amount of equity from collection on the judgment by a **court-ordered sale.**

The lien about to be wiped out

Generally, a good bargaining tactic with the judgment creditor for obtaining a **release of a lien** from a seller's residence is a combination of:

- a "gentle reminder" that the lien is on the verge of being *wiped out by foreclosure* of the mortgage without the likelihood of an overbid to provide funds for the creditor;
- a review of the homeowner's *homestead exemption* rights as having a claim on equity senior to the creditor's lien, leaving no ability for the creditor to collect by forcing a judicial sale [See Chapter 13];
- an *offer to pay* a lesser amount in **full satisfaction** of the debt owed to the lienholder; and
- a partial (or full) satisfaction and the execution of a partial (or full) release, allowing the **abstract of judgment** to remain of record (unless fully released) while *releasing the residence* from its lien so escrow may close.

abstract of judgment
A condensed written summary of the essential holdings of a court judgment.

The objective of the EP investor's agent's negotiations is to give the lienholder sufficient incentive to cooperate. The objective is a release of the property from the lien without the homeowner filing a bankruptcy petition to remove the creditor's lien from title and approve the sale. The EP investor (or the seller's agent) is in a better position to deal with the lienholder in an aggressive manner than the seller-in-foreclosure, who long ago exhausted their goodwill with the judgment creditor.

Mutually beneficial situation

A financially advantageous situation is created for all parties when:

- the **lienholder** collects a portion of the money owed, which is not available via a sale of the residence if a foreclosure wipes out the judgment lien, or a recorded or *automatic homestead exemption* exists with the seller;
- the **seller** closes the sale of their residence, avoiding the loss of their equity to the mortgage holder's foreclosure, and receives the amount of proceeds protected by their homestead exemption; and
- the **EP investor** keeps their purchase agreement alive by negotiating a release of the lien in exchange for a less-than-full payoff of the lienholder's judgment out of the seller's proceeds from the sale.

Often a judgment lienholder will agree to release a residence from their lien. To document the release, a signed and notarized **release of recorded instrument** is obtained from the lienholder and recorded. All aspects of the paperwork are handled through escrow after negotiations have been completed. [See Form 409 accompanying this chapter]

The release contains all the information necessary to clear the judgment lien from the record title to the property.

When the release is notarized and recorded, the judgment lien attached to the residence is removed from the record and a policy of title insurance will be issued covering title free of the lien.

The abstract of judgment lien

A judgment creditor creates a valid lien on real estate owned by the debtor by recording an *abstract of judgment* issued by a state court.[1]

A judgment lien continues in effect for 10 years from the date it is recorded, unless the money judgment is either satisfied or released.[2]

However, the recording of a certified copy of a judgment awarded by a federal court attaches without the need to obtain and record an abstract of judgment.

For example, a judgment creditor obtains a federal district court money judgment against an individual. A **certified copy** of the judgment is recorded in the county where the individual is the vested owner of real estate.

The owner later mortgages the property. A dispute between the mortgage holder and the judgment creditor arises over who has priority and is entitled to funds remaining after a payoff of the first trust deed.

The mortgage holder claims the recorded federal judgment is not a valid lien since it is not documented by a recorded *abstract of judgment* to give the lien priority to the mortgage.

Does the judgment creditor hold a valid lien senior to the mortgage?

Yes! The judgment creditor holds a valid lien senior to the lender's trust deed. A federal judgment creditor creates a lien on real estate owned by the judgment debtor on recording a **certified copy** of the federal judgment.[3]

A money judgment from a court of the United States becomes a valid lien on real estate on the recording of:

- an abstract of judgment; or
- a certified copy of the money judgment.[4]

The FTB as a judgment creditor

A *personal income tax lien* on a residence recorded by the Franchise Tax Board (FTB) is enforced under the same procedure as any creditor's judgment lien. The FTB issues and records a **warrant** for the amount claimed due by the state. The *warrant* has the same force and effect as an abstract of judgment issued by a court.[5]

The FTB lien created by recording the warrant attaches to real estate owned by the taxpayer in the same priority as a judgment lien. More importantly, the taxpayer who is a homeowner and head of the household has a homestead exemption that is senior to the FTB lien. The exemption shields a minimum of $300,000 or the median sale price for a single family residence (SFR) in their county, not to exceed $600,000 (adjusted annually for inflation) of the seller's equity from seizure by the FTB.[6]

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1 Calif. Code of Civil Procedure §697.310(a)
2 CCP §697.310(b)
3 **In re McDonell** (9th Cir. BAP 1996) 204 BR 976
4 CCP §697.060
5 CCP §688.020
6 CCP §688.030; Calif. Government Code §§7170 et seq.

Unfortunately for the seller and the EP investor, no statutory or regulatory authority exists for the FTB to negotiate a partial payment of the tax bill in exchange for releasing the residence from the tax lien. At first glance, it appears to be an all or nothing situation.

However, California's **Taxpayer Bill of Rights** provides some relief. Under it, the FTB is obligated to release its lien from the residence if the proceeds from the sale do not result in a reasonable reduction of the seller-in-foreclosure's debt to the FTB. Again, negotiations are an all or nothing analysis for a release of the FTB lien on a short sale of the property.[7]

declaration of homestead
A document signed by a homeowner and filed with the county recorder's office to protect the owner-occupant's homestead equity from seizure by creditors. [See **ft** Form 465]

Nevertheless, no case law exists testing whether the statute may be used as an offensive weapon by the seller to quiet title to real estate and eliminate the cloud of a state income tax lien when a *declaration of homestead* was recorded prior to the FTB warrant.

Releasing an IRS lien

Consider an EP investor's agent whose preliminary title report reveals the existence of a **federal tax lien** junior to a mortgage in foreclosure.

federal tax lien
A lien recorded against the title of property owned by a taxpayer who owes the Internal Revenue Service (IRS) outstanding taxes.

When property is sold at a trustee's sale and a timely recorded and junior *federal tax lien* exists, the Internal Revenue Service (IRS) may later *redeem* (purchase) the property from the successful bidder at the trustee's sale by paying the successful bidder the amount of the bid within 120 days, plus interest and foreclosure costs. Thus, the equity may be acquired by the IRS after the trustee's foreclosure sale to satisfy the delinquent payment of income tax owed by the now wiped-out owner. The IRS later holds its own auction and resells the residence.

When a junior lien exists on the residence, the IRS typically waits until the first trust deed lender completes its foreclosure, wiping out the junior lienholder and **creating an equity** where none existed before the trustee's sale. The IRS then steps in within 120 days after the trustee's sale and acquires the residence from the buyer at the trustee's sale.

On a regular sale of property, the IRS has the *authority to negotiate* with the seller/taxpayer or their authorized agent (or the EP investor after closing the EP transaction) to accept partial or no payment in exchange for a **certificate of discharge** from the income tax lien. The discharge is authorized when the IRS's recovery under its lien and redemption and resale rights are economically unfeasible beyond the amount available to the IRS from a sale of the property at current value.[8]

EP investor's agent negotiates the discharge

The discharge of the IRS tax lien from title may be negotiated by the EP investor's agent on behalf of the taxpayer. The agent will use the same persuasive facts used to negotiate a release of a judgment lien with a creditor or a short payoff with a lender using a **hardship letter**.

7 Calif. Revenue and Taxation Code §21016(a)(3)

8 Internal Revenue Code §6325(b)(2)

To release the tax lien from title when the property is in foreclosure, the seller submits a written request to the district director of the IRS for a discharge of the residence from the federal tax lien. The required **Form 4422**: **Application for Certificate of Discharge of Property from Federal Tax Lien,** is available in IRS Publication 783 at *www.irs.gov*.[9]

General information the IRS wants with *Form 4422* is:

- a preliminary title report;
- proposed closing statement, also known as a settlement statement (HUD-1);
- two opinions of value documented in an appraisal report; and
- a declaration and signature of the payer under penalty of perjury.

Attached to the application is a statement from the taxpayer providing the reasons why they are requesting a discharge of the tax lien. The statement must be honest and to the point. Good, solid reasons are essential when preparing the statement. Hardships necessitating the discharge may include:

- reduced income;
- job loss;
- an illness, medical emergency or death in the family;
- a job transfer (voluntary or involuntary);
- a divorce or separation;
- an exotic mortgage (i.e. adjustable-rate mortgage);
- incarceration; and
- increased expenses and excessive debt.

If relevant, have the taxpayer use concrete numbers to explain loss of income or negative cash flow. Taxpayers need to be advised to limit this part of the statement to what has occurred, and not what they fear or expect from the future.

Take subject to the lien if little or no equity exists

Current IRS policy dictates the IRS, not the seller, is to receive all of the proceeds from any equity remaining in the residence up to the amount of the lien.

Additionally, the EP investor is to consider whether it is more advantageous to take the residence subject to the IRS tax lien, especially if the property is a "fixer-upper." Often little or no equity exists beyond the encumbrances senior to the IRS lien. Here, the agent acting on behalf of the EP investor who is the new owner may negotiate with the IRS for the release of the lien. The investor offers a small cash payment in exchange for the release — often an amount less than the IRS was normally willing to accept from the seller prior to the EP investor becoming the owner.

9 Revenue Regulations §301.6325-1(b)

Form 409

Release Of Recorded Instrument

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

RELEASE OF RECORDED INSTRUMENT

Prepared by: Agent ______________ **Phone** ______________
Broker ______________ **Email** ______________

DATE: __________, 20____, at ______________________, California.

Items left blank or unchecked are not applicable.

1. From the Document entitled ______________________,

2. dated __________, and recorded on __________, as Instrument No. __________,
in the Official Records of ______________________ County, California,

3. pursuant to the judgment entered in the __________ branch of the ______________ County
__________ Court, dated __________, renewed __________,
in a legal action entitled ______________________,
docket number ______________,

4. held by ______________________
and against ______________________,

5. is hereby released:
5.1 ☐ all interests in real property situated in the County of record, owned or hereafter acquired by ______________________
5.2 ☐ the real property situated in the County of record described as ______________________

THIS FORM IS NOT A RECONVEYANCE OF A TRUST DEED. DO NOT USE THIS FORM TO RECONVEY A TRUST DEED FROM RECORDED TITLE.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: __________, 20____ ______________ (Print name) ______________ (Signature)

Date: __________, 20____ ______________ (Print name) ______________ (Signature)

STATE OF CALIFORNIA
COUNTY OF ______________
On ______________ before me,
______________ *(Name and title of officer)*
personally appeared ______________,

who 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.
I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.
WITNESS my hand and official seal.
Signature ______________ *(Signature of notary public)*

(This area for official notarial seal)

FORM 409 10-12 ©2012 **first tuesday**, P.O. BOX 5707, RIVERSIDE, CA 92507 (800) 794-0494

However, taking the residence subject to the IRS lien entails a risk of loss for the EP investor. The IRS may decide to leave its lien intact on the property if the property has been taken out of foreclosure. Thus, they are able to participate in the future property value added by:

- inflation;
- appreciation; or
- the efforts of the EP investor.[10]

10 **Han** v. **United States of America** (9th Cir. 1991) 944 F2d 526

The homestead exemption coup

California homeowners qualify for a *net equity* homestead protection of up to:

- $300,000 or the median sale price for a single family residence (SFR) in their county in the calendar year prior to the year in which they claim the exemption, not to exceed $600,000 (adjusted annually for inflation).

Two types of homestead procedures are available to California homeowners:

- the **declaration of homestead**, which is recorded;[11] and
- the **automatic homestead**, also called a *statutory homestead exemption*, which is not recorded.[12]

The homestead protection is *automatic* when the judgment lienholder or the FTB attempts to enforce its money judgment by a sheriff's sale of the homeowner's residence. The residence cannot be sold by the lienholder when the net proceeds of the sale will be less than the homestead exemption amount.

However, the automatic homestead exemption only applies to execution sales ordered by a court to satisfy money judgments against the homeowner and to any sale of the home in a bankruptcy proceeding.

Homestead as an offensive tool

While limited as a defensive tool for the homeowner, the automatic homestead exemption becomes a powerful offensive tool in a bankruptcy proceeding. Through bankruptcy proceedings, the homeowner is able to clear their title of judgment and state tax liens that impair the value of their homestead equity in the property.[13]

Alternatively, the homeowner may have recorded their *declaration of homestead* prior to the date a judgment or FTB lien was recorded. If the recorded homestead is senior to the judgment creditor's or FTB's lien and the net proceeds of a voluntary sale entered into by the owner of the residence will be less than the homestead amount, the owner may quiet title to the property and eliminate the effect of the judgment or FTB tax lien on their home.

However, like the automatic homestead exemption, the recorded homestead has no priority over an IRS tax lien. Thus, the IRS may still force the sale of the residence under its tax lien if a certificate of discharge is not arranged.[14]

In practice, the release of an IRS lien under a Certificate of Discharge from title is always negotiated based on whether it has recorded priority over voluntary encumbrances and judgment liens on the residence. The homestead has no effect on the **lien rights of the IRS**.

Whether it is by an automatic exemption or recorded declaration, the homestead is leverage to be used to induce judgment lienholders and the FTB to voluntarily release their lien from the title to the residence. The effects

11 CCP §704.920
12 CCP §704.720
13 **U.S.** v. **Heffron** (9th Cir. 1947) 158 F2d 657; 11 USC §545
14 **U.S.** v. **Rodgers** (1983) 461 US 677

of foreclosure, a bankruptcy, or quiet title action to enforce the homestead exemption and clear title gives lienholders an incentive to negotiate the release.

The lienholder unilaterally executes the release by **signing** it and **dating** their signature. If more than two signature lines are required, check the box to indicate a signature page addendum is attached. [See **first tuesday** Form 251]

Notarize the release for recording. **Record** the release to clear the seller's title of the lien.[15]

15 Gov C §27287

Chapter 12 Summary

The agent of equity purchaser (EP) investor negotiates the release of a recorded lien to create equity. Good bargaining tactics for obtaining a release of a lien from a seller's residence include:

- a reminder to the creditor that junior lien is on the verge of being wiped out by foreclosure of the mortgage without the likelihood of an overbid to provide funds for the creditor;
- a review of the homeowner's homestead exemption rights as having a claim on equity senior to the creditor's lien, leaving no ability for the creditor to collect by forcing a judicial sale;
- an offer to pay a lesser amount in full satisfaction of the debt owed to the lienholder; and
- a partial (or full) satisfaction and the execution of a partial (or full) release, allowing the abstract of judgment to remain of record (unless fully released) while releasing the residence from its lien so escrow may close.

A financially advantageous situation is created for all parties when:

- the lienholder collects a portion of the money owed, which is not available from a sale of the residence if a foreclosure wipes out the judgment lien, or a recorded or automatic homestead exemption exists;
- the seller closes the sale of their residence, avoiding the loss of their equity to the lender's foreclosure, and receives any proceeds protected by their homestead exemption; and
- the EP investor keeps their purchase agreement alive by negotiating a release of the lien in exchange for a less-than-full payoff of the lienholder's judgment out of the seller's proceeds from the sale.

A judgment creditor creates a valid lien on real estate owned by the debtor by recording an abstract of judgment issued by a state court.

Similarly, a money judgment from a court of the United States becomes a valid lien on real estate on the recording of an abstract of judgment or a certified copy of the money judgment.

A personal income tax lien on a residence recorded by the Franchise Tax Board (FTB) is enforced under the same procedure as any creditor's judgment lien.

Under the California's Taxpayer Bill of Rights, the FTB is obligated to release its lien from the residence if the proceeds from the sale do not result in a reasonable reduction of the seller-in-foreclosure's debt to the FTB.

When property is sold at a trustee's sale and a timely recorded and junior federal tax lien exists, the Internal Revenue Service (IRS) may later purchase the property from the successful bidder at the trustee's sale by paying the successful bidder the amount of the bid within 120 days, plus interest and foreclosure costs.

Through bankruptcy proceedings, the homeowner is able to clear their title of judgment and state tax liens that impair the value of their homestead equity in the property under California homestead exemption laws. However, the automatic homestead exemption is not enforceable against an IRS tax lien in bankruptcy.

Chapter 12 Key Terms

Chapter 13

Automatic and declared homesteads

Learning Objectives

After reading this chapter, you will be able to:

- advise a homeowner whether they qualify to voluntarily sell and protect the equity in their residence from creditor seizure;
- differentiate between an automatic homestead and a recorded declaration of homestead and the protections afforded under each;
- determine the specified dollar amounts of net equity homestead protection available; and
- understand the components of a recorded homestead declaration.

Key Terms

abstract of judgment	**declaration of homestead**
automatic homestead	**quiet title**

Home-equity shield against judgments

The agent for an equity purchase (EP) investor tracks **abstracts of judgment** recordings by creditors against owners of real estate to locate financially distressed ownership of real estate suitable for the EP investor.

The EP investor's agent finds an abstract attached as a lien on the principal residence of an owner who owes the creditor $80,000 on the judgment. The owner recorded a **declaration of homestead** before the abstract was recorded, data provided by a title company property profile. Also, the property is not presently listed "For Sale."

declaration of homestead
A document signed by a homeowner and filed with the county recorder's office to protect the owner's homestead equity from seizure by creditors. [See **ft** Form 465]

On completing a **comparable market analysis (CMA)**, the agent concludes the property has a value for the EP investor's investment purposes of approximately $20,000 more than the mortgage amount. When considering the $80,000 *abstract of judgment* that is attached as a lien, the property appears to be over-encumbered and to have no equity.

On contact by the agent's FARM letter, the owner indicates they need to sell the home. The owner has other creditor problems as well as being delinquent on their home loan. The owner is aware they have a $300,000 **homestead** to protect them from the judgment creditor selling their home. However, the owner does not know how their home may be sold when title is clouded by the abstract.

The EP investor's agent prepares an offer on a regular purchase agreement form since a **Notice of Default (NOD)** has not been recorded commencing foreclosure. The price is payable $20,000 cash (down payment) to a new loan. Two contingency provisions are attached to the purchase agreement:

- one calling for a 10% discount on a short payoff of the mortgage from cash funds provided by the EP investor; and
- the other calling for a release of the property from the **abstract of judgment** held by the creditor.

abstract of judgment
A condensed written summary of the essential holdings of a court judgment.

When submitting the offer to the owner, the EP investor's agent explains that the approximate $30,000 in down payment and lender discount belongs to the owner as the seller (less closing costs), not the judgment creditor, due to the recorded *homestead* of $300,000.

Short sale and release

Continuing the previous example, the EP investor's agent obtains *written authorization* from the seller-in-foreclosure (no listing needed) to negotiate with the mortgage holder and the judgment creditor to arrange for the short pay and the release. The EP investor and the owner understand the owner's receipt of cash on a short sale may trigger the interference of the lender's moral bias with their desire to mitigate a loss by avoiding a foreclosure on the over-encumbered property.

The mortgage holder is induced to discount since the title is encumbered with liens of $50,000 in excess of the property's market value. Alternatively, a more compelling reason for a discount is the fact the mortgage holder has to complete a foreclosure due to the existence of the junior lien (abstract). A short pay is in the lender's best interest to mitigate losses they otherwise will incur due to deteriorating or flat real estate prices in the current phase of the real estate market.

The judgment creditor is asked for a release of the owner's home on the close of escrow. The creditor is aware they have no claim against the property due to the recorded homestead declaration and the lack of more than $300,000 in equity over the amount of the mortgage. It is possible that negotiations for the release of the lien may necessitate the payment of $5,000 to $10,000 to motivate the judgment creditor to release the property from the judgment creditor's lien if the threat of a **quiet title** action to clear title of the judgment creditor's cloud does not do so.

quiet title
A court action to establish title to a property or remove a cloud from title.

Thus, the seller-in-foreclosure now has the incentive to accept this offer. The seller nets some cash from a short sale in which the EP investor's agent negotiations to clear up title and perfect an equity in the property. [See Chapter 22]

The owner's homestead interest in title

As the recovery from recession increases home prices – reducing the number of *negative equity* homes by creating equity – recession wary homeowners begin to reconsider their right to protect this restored equity from loss.

Since many homeowners experience and continue to experience financial difficulty in economic recoveries, they are concerned about losing their homes to creditors other than their mortgage holder. Thus, a *declaration of homestead* needs to be considered as vital to the preservation of the wealth stored in their home's equity. [See Form 465 accompanying this chapter]

When an abstract of judgment is recorded against a homeowner by a **judgment creditor** in the county where their residence is located, the abstract attaches as a lien on title to their home. However, the type of homestead the homeowner asserts as the *shield* they use to protect the dollar amount of their homestead exemption from loss to the creditor determines the homeowner's ability to:

- *voluntarily sell* the home and buy a replacement home with the homestead dollar amount they have in their equity; or
- bar the judgment creditor from *forcing a sale* of the home to satisfy the judgment when the homestead amount is greater than the net equity in the property.

A homestead is the dollar amount of equity in a homeowner's dwelling the homeowner qualifies to exempt from creditor seizure. The dollar amount of the homestead held by the homeowner in the equity in their home has priority on title over most judgment liens and some government liens.

Homestead procedures

Two types of *homestead* procedures are available to California homeowners:

- the *declaration of homestead*, which is recorded;[1] and
- the **automatic homestead**, also called a *statutory homestead exemption*, which is not recorded.[2]

Both homestead arrangements provide Californians the same dollar amount of home-equity protection. However, a homeowner needs to record a declaration of homestead to receive all the benefits available under the homestead laws. These benefits allow homeowners the right to sell, receive the net sales proceeds up to the dollar amount of the homestead and reinvest the funds in another home. [See Form 465]

automatic homestead
The dollar amount of equity in a homeowner's principal dwelling the homeowner is automatically qualified to exempt from creditor seizure. Also known as a statutory homestead exemption.

Neither the declared nor the automatic homestead interferes with:

- **voluntary liens** previously or later placed on title to the property by the homeowner, such as trust deeds; and
- **involuntary liens** given priority to the homestead exemption under public policy legislation; or
- the homeowner's credit ratings or title conditions.

1 Calif. Code of Civil Procedure §704.920

2 CCP §704.720

Some *involuntary liens* and encumbrances are given priority by statute and are enforced as senior to the amount of the homestead exemption, including:

- mechanic's (contractor's) and vendor's (seller's) liens;
- homeowners' association (HOA) assessments;
- judgments for alimony or child support;
- real estate property taxes; and
- Internal Revenue Service (IRS) liens.

Involuntary liens that are subordinate and junior to the homestead amount include:

- Franchise Tax Board personal income tax liens;
- Medi-Cal liens; and
- judgment creditor's liens.

Automatic and declared homesteads

An *automatic homestead* is always available on the principal dwelling occupied by the homeowner or their spouse when:

- a judgment creditor's abstract is recorded against the homeowner and attaches as a lien on the property; and
- the occupancy by the homeowner continues until a court determines the dwelling is a homestead.[3]

The *automatic homestead exemption* applies to the equity in:

- a real estate dwelling (and its outbuildings);
- a mobilehome;
- a condominium;
- a planned development;
- a stock cooperative;
- a community apartment project together with the land it rests on; or
- a houseboat or other waterborne vessel used as a dwelling.[4]

Conversely, a *recorded declaration of homestead* applies only to real estate dwellings. Thus, mobilehomes which are not established as real estate on the property tax records and houseboats are protected only by the automatic homestead, not a recorded declaration of homestead.

Real estate to be homesteaded

As long as the homeowner claiming the exemption uses the homesteaded property as the **principal residence** for themselves and their family, the type of real estate qualifying for a homestead includes such properties as:

- two five-room flats;[5]

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3 CCP §704.710(c)
4 CCP §704.710(a)
5 **Viotti** v. **Giomi** (1964) 230 CA2d 730

*The **recorded homestead declaration** includes:*

- *the name of the homeowner declaring the homestead;*
- *a description of the property homesteaded; and*
- *a statement that the declared homestead is the principal dwelling in which the homeowner resides on the date the homestead is recorded. [Calif. Code of Civil Procedure §704.930(a); see Form 465]*

The declaration needs to be signed, notarized, and recorded to take effect. [CCP §704.930]

*The homestead declaration may be **signed and recorded** by any one of several individuals, including:*

- *the owner of the homestead;*
- *the owner's spouse; or*
- *the guardian, conservator, or a person otherwise authorized to act for the owner or the owner's spouse, such as an attorney-in-fact. [CCP §704.930(b)]*

*An individual's personal residence that is vested in the name of a revocable inter vivos (living) trust, or other type of title holding arrangement established for the benefit of the homeowner, may also be declared a homestead by anyone who has an interest in the property and resides there. [**Fisch, Spiegler, Ginsburg & Ladner** v. **Appel** (1992) 10 CA4th 1810]*

Additionally, a declaration of homestead in no way restricts the homeowner's ability to voluntarily sell, convey, or encumber their homesteaded property. [CCP §704.940]

A recorded homestead declaration does not appear in credit reports or impact the homeowner's credit reputation or ability to borrow funds. Title companies disregard recorded homestead declarations, except in litigation guarantee policies.

Sidebar

Declaring a homestead as asset preservation

- an 18-unit apartment building where the owner occupies only one unit;[6] and
- 523 acres of rural land with a house and water rights for the land.[7]

Amount of equity protected

The dollar amount of home equity protection a homeowner qualifies to preserve is the same under either the automatic homestead or a recorded declaration of homestead.

Homeowners qualify for a *net equity* homestead protection of up to

- $300,000 or the median sale price for a single-family home in your county in the calendar year prior to the year in which you claim exemption, not to exceed $600,000 (adjusted annually for inflation)

Combating a creditor's attempt to sell the home

A judgment creditor with a recorded abstract of judgment *lien* always needs to first petition a court for authorization to sell a homesteaded property and collect on a money judgment. The court then determines whether the owner's *net sales equity* in their home is a dollar amount greater than the amount of the owner's homestead exemption. If it is, the creditor may proceed to judicial foreclosure on their judgment lien by an **execution sale**.[8]

6 **Phelps** v. **Loop** (1944) 64 CA2d 332
7 **Payne** v. **Cummings** (1905) 146 C 426
8 CCP §704.740(a)

A home with a net equity less than the homestead amount (after transactional costs of a sale) leaves nothing for the creditor to sell and receive too apply to the debt owed under the judgment. However, the sale of a homesteaded dwelling may be forced by a creditor if a net equity exists beyond the amount of the homestead the homeowner holds in the property.

If the homeowner has not recorded a declaration of homestead on the property, they need to prove their residency in the dwelling qualifies the property for the automatic homestead exemption.[9]

Automatic homestead is a shield

A creditor may be permitted by the court to force the sale of the debtor's home. However, the court first excludes the dollar amount of the *automatic homestead* from the anticipated net sales proceeds to determine if any funds remain to apply on the judgment. If so, the dollar amount of the homestead received by the homeowner on the sale is protected from the creditor's attachment during a **six-month reinvestment period** following the sale.

Further, an automatic homestead exemption is provided on the replacement residence to protect the reinvested funds.[10]

However, if the replacement home acquired is in the same county where the judgment lien is recorded, the lien attaches to the new residence (subject to the owner's homestead exemption) the instant title is transferred into the homeowner's name.

Further, a homeowner who proceeds to *voluntarily sell* their residence when title is subject to a creditor's lien cannot use the automatic homestead exemption to protect the sales proceeds from being taken by the judgment creditor.

In contrast, a *declaration of homestead* recorded prior to the recording of the judgment lien allows the homeowner who voluntarily sells their home to first withdraw their homestead amount from the net sales proceeds before the judgment creditor receives any funds.

Although an insufficient net equity may exist barring the judgment creditor from forcing a sale of the home, the homeowner claiming only an automatic homestead exemption may not use a *quiet title* action to remove the lien and sell the home, unlike what is accomplished under a declared homestead.

Declared homestead allows the owner to sell

In contrast to an automatic homestead exemption, a *recorded declaration of homestead* coupled with a quiet title action allows the homeowner to remove **judgment liens** attached to their title.

Also, judgment liens do not attach to the exempt homestead amount in the equity under a declared homestead if the homestead declaration is recorded prior to the recording of the creditor's abstract of judgment.[11]

9 CCP §704.780(a)(1)
10 CCP §704.720(b)
11 CCP §704.950(a)

Form 465

Declaration Of Homestead

Page 1

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DECLARATION OF HOMESTEAD

Prepared by: Agent ____________________ | **Phone** ____________________

Broker ____________________ | **Email** ____________________

DATE: ____________, 20_____, at ____, California.

Items left blank or unchecked are not applicable.

1. The name of the owner or owners of the real estate subject to this declared homestead

____

(Enter the name of the individual entitled to the Homestead Exemption)

2. The declared homestead regards real estate situated in the City of ______________________________,
County of ______________________________, California, referred to as:

2.1 The property is more commonly referred to as

____.

(Enter the street address and the city)

— — — — PAGE ONE OF TWO — FORM 465 — — — —

It takes a creditor several months of litigation to obtain and record an abstract of judgment. In contrast, a declaration of homestead may be prepared and recorded by the homeowner on readily available forms in a matter of hours. Thus, the issue of priority of the recorded declaration over a later recorded judgment creditor lien is accomplished by the prudent homeowner. [See Form 465]

Once recorded, a declaration of homestead lasts until:

- the homestead owner records a declaration of **abandonment of the homestead**; or

Form 465

Declaration Of Homestead

Page 2

PAGE TWO OF TWO — FORM 465

3. The declared homestead is the principal dwelling and is now resided in as the residence of:

- ☐ A declared owner of the homestead;
- ☐ The declared owners of the homestead; or
- ☐ The spouse of the declared owner of the homestead.

4. I execute this declaration of homestead as:

- ☐ a declared homestead owner.
- ☐ the spouse of the declared homestead owner.
- ☐ the guardian or conservator of the person or estate of the:
  - ☐ declared homestead owner; or
  - ☐ spouse of the declared homestead owner.
- ☐ an attorney in fact for the:
  - ☐ declared homestead owner; or
  - ☐ spouse of the declared homestead owner.

4.1 As a guardian, conservator or attorney in fact acting on behalf of the declared homestead owner or the spouse of the declared homestead owner, I am authorized to execute this declaration under the authority vested in me by ______________________________.
(Enter identification of the source of your authority)

5. The facts stated above are known to me to be true as of my own personal knowledge.

Date: _____________, 20______ ______________________________
(Print name) (Signature)

Date: _____________, 20______ ______________________________
(Print name) (Signature)

STATE OF CALIFORNIA
COUNTY OF______________________
On ______________________ before me,
____
(Name and title of officer)
personally appeared ______________________
______________________.

who 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.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature: ______________________
(Signature of notary public)

(This area for official notarial seal)

FORM 465	10-12	©2012 **first tuesday**, P.O. BOX 5707, RIVERSIDE, CA 92507 (800) 794-0494

Duration of homestead declaration

- the homestead owner records a **new declaration** of homestead on another residence.[12]

If a homeowner decides to sell their home which is subject to a *declared homestead* when title to their home has become clouded with a creditor's lien, the homeowner may either:

- negotiate a release of the lien with the creditor; or
- clear title to the home through a quiet title action based on the priority of their declaration of homestead.

12 CCP §§704.980, 704.990

After title is cleared and the homeowner sells their property, they have *six months* to reinvest the homestead proceeds in another home. If the proceeds are reinvested in a new residence within six months, the new residence may then be declared a homestead by recording a new homestead declaration.

When the homeowner records a new homestead declaration on their replacement residence, the recording *relates back* to the time the prior homestead was recorded.[13]

Homestead equity exemption amounts are increased from time to time. If the amount changes after the creditor records their abstract of judgment, the amount of exemption, even on the new replacement residence, is the amount that was in effect when the abstract of judgment was recorded, not the later increased amount.

However, if the homeowner does not invest the proceeds of the sale in a new homestead within six months, and the proceeds are still in the State of California, the exempt proceeds from the sale may be attached by the judgment creditor.

13 CCP §704.960

Chapter 13 Summary

A homestead is the dollar amount of equity in a homeowner's dwelling the homeowner qualifies to exempt from creditor seizure. Two types of homestead procedures are available to California homeowners: the automatic homestead and the declaration of homestead.

The dollar amount of the homestead held by the homeowner has priority on title over most judgment liens and some government liens. Homeowners qualify for one of three specified dollar amounts of net equity homestead protection with either type of homestead.

When a creditor is permitted by a court to force the sale of a debtor's home, the automatic homestead protects the amount of the net sales proceeds up to the dollar amount of the homestead from the creditor's attachment during a six-month reinvestment period from the close of escrow.

However, a homeowner needs to record a declaration of homestead to receive all the benefits available under the homestead laws. In contrast to an automatic homestead exemption, a recorded declaration of homestead coupled with a quiet title action allows the homeowner to remove judgment liens attached to their title. A declaration of homestead allows homeowners to voluntarily sell their home, receive the net sales proceeds up to the dollar amount of the homestead and reinvest the funds in another home.

Once recorded, a declaration of homestead lasts until the homestead owner records a declaration of abandonment of the homestead or the homestead owner records a new declaration of homestead on another residence.

Chapter 13 Key Terms

Chapter 14

Due-on-sale regulation

Learning Objectives

After reading this chapter, you will be able to:

- understand the nature of a due-on clause in trust deeds as a restriction on the mobility of an owner's title and pricing in times of rising mortgage rates;
- explain ownership activities which trigger due-on enforcement by mortgage holders;
- apply the exemptions barring mortgage holders from due-on enforcement; and
- negotiate a limitation or waiver of a mortgage holder's due-on rights.

Key Terms

acceleration

due-on clause

Garn-St. Germain Federal Depository Institutions Act of 1982

inter vivos trust

novation

waiver agreement

Events triggering the call provision

Consider an existing first trust deed encumbrance on an owner-occupied, one-to-four unit residential property. The trust deed provisions include a due-on clause.

A Notice of Default (NOD) is recorded, commencing foreclosure due to a default on the trust deed note payments. A buyer's agent representing an equity purchase (EP) investor who seeks to acquire small residential units becomes aware of the property due to the recorded NOD.

The agent submits an EP offer to the seller-in-foreclosure. The EP agreement calls for the EP investor to:

- make a lump-sum **cash payment** for the seller's ownership interest;
- **acquire title** to the property subject to the existing first trust deed lien that is in foreclosure; and
- **reinstate**, negotiate a short payoff, or **refinance** the trust deed loan on or after closing.

The seller-in-foreclosure accepts the offer and escrow is opened.

On expiration of the five-business-day seller's EP cancellation period, escrow closes. The investor takes possession intending to fix up the property and immediately:

- resell the property in a cash or installment (carryback) sale; or
- sell it and acquire §1031 replacement property for a continuing investment in real estate.

The lender discovers the transfer and calls the loan due, giving the EP investor 30 days to pay the loan off or make other arrangements with the lender. If the EP investor fails to do so, the lender will commence another foreclosure due to the EP investor's failure to pay on the call.

If the lender refuses to allow the EP investor to assume the mortgage, the EP investor needs to pay off the loan by refinancing the property, by a resale of the property or by the investor's use of cash reserves. The worst case scenario: all fails for the EP investor and the lender proceeds to foreclosure based on the unsatisfied call.

Rising rates bring lender interference

During times of upward sales volume, increasing mortgage originations and rising absorption rates for space available to rent, the marketplace functions at full throttle. This is known economically as a **virtuous cycle**.

Responsibility for to individuals in the market during this frenzy lies with the gatekeepers to real estate ownership — brokers, builders and lenders. To keep those responsible for the activity from harming the greater society, the government implements regulations to reduce adverse conduct in the real estate and mortgage markets.

During times of rising prosperity, buyers put up with the onerous threshold of entry procedures maintained by the gatekeepers. In the rush to close deals, all the numerous steps to ownership seem justified for the buyers. There is plenty of money for everyone, or so it seems.

However, when mortgage rates and short-term interest rates rise, lending standards suddenly tighten. At this point, buyers become unwilling to further cope with the regime of higher rates, increased credit standards, seller price expectations, and excessive documentation requirements. This recurring paradigm shift triggers a **vicious cycle** which begins quickly but takes years to unwind after it bottoms.

Enter **due-on-sale** restrictions.

When the boom turns to bust, and stagnation

A burden on the use and mobility of ownership is created by the existence of the **due-on clause** buried within all trust deeds serviced by mortgage holders.

due-on clause
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

During boom years and long-term cyclical episodes of declining interest rates, the *due-on clause* is not an issue. The clause lays dormant and is unused. The decades of the '80s, '90s and 2000s is an example of a period when buyers could easily qualify for a new mortgage at ever decreasing interest rates to cash out the seller. Further, sellers are relatively unconcerned about the size of any prepayment penalty on the payoff of their mortgages during these prosperous times.

However, as the boom turns to bust and buyers are induced to purchase property as prices fall, the most efficient arrangement for financing the purchase price is for the buyer to take over the seller's mortgage – if it has an interest rate lower than the current rates charged by lenders.

However, mortgage holders in the past have refused to consent to any type of mortgage takeover or assumption. The reason: they prefer to receive a prepayment penalty and re-lend the money at the higher current rate. Consumer mortgages greatly restrict the duration (three years) and amount (declines yearly) of these penalties for payoff of the debt.

Thus, though the due-on clause was not a burden during the Millennium Boom, it becomes a noose around the seller's neck during periods like the **secular stagnation** of the 2010s. The combination of generally rising interest rates (following the 2009-2015 zero lower bound interest rates) and due-on clauses in existing mortgages tends to tie the seller to their property. Thus, the sellers are too often fettered to their home without a financially suitable way out.

Editor's note – Prepayment penalties on consumer mortgages are restricted to only fixed- and step-rate qualified mortgages (QMs).[1]

Attempts to circumvent the sales restraint

Consider a parcel of real estate listed for sale. The parcel is encumbered by a mortgage containing a due-on clause. The seller's agent locates a buyer for the property.

The purchase agreement negotiated by the seller's agent calls for closing to be contingent on the buyer entering into an **assumption agreement** with the existing mortgage holder allowing the buyer to take over the mortgage on the property. The seller will carry back a note secured by a second trust deed for the balance of the purchase price after the buyer's down payment.

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1 12 Code of Federal Regulations §1026.43(g)

Editor's note – For mortgage holders under Regulation Z (Reg Z), when an assumption involves a consumer mortgage, mortgage holder acceptance and a written agreement, it is considered a new consumer mortgage subject to new disclosures, ability-to-repay (ATR) and QM rules.[2]

The buyer is advised the senior mortgage holder may:

- refuse to allow the mortgage to be assumed, forcing the buyer to arrange new financing; or
- require a modification of the note at a less favorable interest rate than the current note rate on the mortgage and demand a large assumption fee.

Before contacting the mortgage holder to process the assumption, the buyer suggests the sale of the property be structured as a *lease-option* in an attempt to avoid due-on enforcement by the mortgage holder. [See **first tuesday** Form 163]

The buyer and seller discuss entering into a two-year lease agreement with an option to extend the lease for an additional two years at an increased monthly payment. The buyer will be granted an option to purchase the property from the seller for the life of the lease.

The down payment will be restated as **option money**. The *option money* will apply to the purchase price of the property, as will a portion of each monthly rent payment.

Meanwhile, the seller will continue making payments on the underlying mortgage. When the buyer exercises their purchase option, the mortgage will be assumed or paid off and the buyer will become the record owner of the property.

Does the lease-option sale avoid due-on enforcement by the mortgage holder?

No! Any lease agreement which contains an *option to purchase* triggers due-on enforcement by the mortgage holder on discovery.[3]

Interference by mortgage holders is federal policy

Generally, mortgage holders are allowed to enforce due-on sale clauses in mortgages on most transfers of any interest in any type of real estate.[4]

Thus, federal mortgage law deprives Californians of their state law right to convey real estate subject to trust deed liens without the mortgage holder interfering with the transfer of ownership for additional profit.

To interfere with the sale of the secured property under state law, the mortgage holder needs to demonstrate the buyer:

- lacks creditworthiness; or

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2 12 CFR §1026.20(b)

3 12 CFR §591.2(b)

4 12 United States Code §1701j-3; Garn-St. Germain Depository Institutions Act of 1982 (Garn)

- is wasteful of property in their management.

Essentially, the mortgage holder need to prove the buyer is an *insolvent arsonist*. However, the federal legislative process called **preemption** bars application of state law to the contrary.

The occurrence of an event triggering due-on enforcement automatically allows the mortgage holder to:

- *call the mortgage*, demanding the full amount remaining due to be paid immediately, also known as **acceleration**; or
- *recast the mortgage*, requiring a modification of the note's terms as a condition for the mortgage holder's consent to a transfer, called a **waiver by consent**.

acceleration
A demand for immediate payment of all amounts remaining unpaid on a loan or extension of credit by a mortgage lender or carryback seller. Also known as "calling the loan."

The **Garn-St. Germain Federal Depository Institutions Act of 1982 (Garn)** itself encourages mortgage holders to allow buyers to assume real estate mortgages at existing rates, but provides mortgage holders no incentives for doing so. The congressional intent in 1982 when passing *Garn* was to preempt state law restrictions of due-on enforcement solely to allow mortgage holders to increase their profits on an old mortgage whenever the owner:

- sells;
- leases with a term over three years; or
- further encumbers the secured property.

Garn-St. Germain Federal Depository Institutions Act of 1982
Federal legislation which preempts state-level limitations on a mortgage holder's enforcement of the due-on clause contained in trust deeds and other security devices.

However, the enforcement of the due-on clause by mortgage holders was not intended to occur at the expense of permitting excessive interference by mortgage holders with real estate transactions.[5]

Yet, when the Federal Home Loan Bank Board (which later became the now defunct *Office of Thrift Supervision (OTS)*) issued due-on regulations to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights. The following 30 years saw mortgage rates drop, and buyers were no longer willing to take over existing mortgages at higher than current rates. Thus, the granting of leniency was never an issue during the period of constantly declining rates. However, leniency will certainly become an issue in the coming years, as occurred in the 1960s.

No leniency when exercising due-on rights

The regulations under *Garn* allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few family-related, owner-occupied single family residence (SFR) exceptions.

No encouragement or guidelines were established in the regulations for consent by a mortgage holder to mortgage assumptions or to limit interference in commonplace transactions. However, regulatory encouragement will be needed to avoid the inevitable interference as buyers attempt to take over the seller's low-rate mortgages when the seller will not lower their price.

5 12 USC §1701j-3(b)(3)

Sidebar

It has recently come to our attention

Mortgage called or recast at mortgage holder's option

Events triggering the due-on clause

Sale:

- *transfer of legal title (grant or quitclaim deed);*
- *land sales contract or holding escrow;*
- *court-ordered conveyance; or*
- *death.*

Lease:

- *lease for more than three years; or*
- *lease with an option to buy.*

Further encumbrance:

- *creation or refinance of a junior lien; or*
- *foreclosure by junior lienholder.*

Transfers not triggering due-on enforcement (owner-occupied, four-or-less residential)

- *creation of junior lien where owner continues to occupy;*
- *transfers to spouse or child who occupies;*
- *transfer into inter vivos trust (owner obtains lender's consent and continues to occupy);*
- *death of a joint tenant; or*
- *transfer on death to a relative who occupies.*

In the absence of any regulatory obligations, mortgage holders use their due-on clauses to maximize their financial advantage over owners by calling or recasting mortgages on the sale of the secured property. Thus, they increase their portfolio yield in a rising interest rate market by adjusting the rate of interest.

Economic recessions and recoveries

In times of stable or falling interest rates, mortgage holders generally permit assumptions of mortgages at the existing note rate, unless a **prepayment penalty clause** exists. Mortgage holders have no financial incentive to recast mortgages, or call and re-lend the funds at a lower rate when interest rates are dropping.

However, in times of steadily rising rates, mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio. Here, mortgage holders employ title companies to advise them on recorded activity affecting title to the properties they hold mortgages on. Once the due-on clause is triggered, the mortgage holder requires the mortgage to be recast at current market rates as a condition for allowing:

- a loan assumption;

- a lease with a term over three years; or
- a further encumbrance of the property by the owner.

Thus, real estate ownership encumbered by due-on mortgages becomes increasingly difficult to transfer as interest rates rise. This imprisons owners in their home when they are unable to sell and relocate without accepting a lower price.

Adverse economic effects on sales

The **inhibiting effect** the due-on clause has on buyers during recessions has a similar adverse economic effect on real estate sales, as well as the availability of private junior financing and long-term leasing.

Ultimately, as rates and interference by mortgage holders rise, many buyers, equity lenders and long-term tenants are driven out of the market, further depressing property values.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below the remaining balance on encumbrances, often leaving owners with *negative equity* in the property. It is a vicious cycle which evolves into a dramatic increase in mortgage foreclosures, the antithesis of the profit motive for automatic enforcement of the due-on clause by mortgage holders.

Due-on interference was an obscure issue during the 30-year period (1982-2012) after *Garn* became law. During this period, fixed mortgage rates declined from 15% to 3.25% and mortgage money became more plentiful. All that downward rate movement was reversed in 2008 with zero lower bound interest rates and mortgages at historically low note rates in 2012.

Due-on-sale

Due-on clauses are most commonly known as **due-on-sale** clauses. However, "due-on clause" is a more accurate term. A sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the mortgage holder's due-on clause is a sale of property which is subject to the mortgage holder's trust deed lien.

The due-on clause is triggered not only by a transfer using a grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, recorded or not. [See **first tuesday** Form 404 and 405]

Examples include a:

- land sales contract;
- lease-option sale; or
- other wraparound carryback devices, such as an **all-inclusive trust deed (AITD)**.

For example, a land sales contract does not involve a conveyance of real estate to the buyer by grant deed until the price is fully paid by the buyer. The seller retains title as security for the carryback debt owed by the buyer.

However, the buyer under a land sales contract becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession transferred. This structuring of a carryback sale triggers the due-on clause in any existing trust deed.[6]

Due-on-lease

The due-on clause is also triggered by:

- a lease with a term over three years; or
- a lease for any term when coupled with an option to buy.[7]

For example, an owner with a short-term construction loan for nonresidential rental property obtains a conditional commitment from a lender for long-term financing to pay off the construction loan. Funding of the loan is conditioned on the property being 80% occupied by tenants with an initial lease term of at least five years.

The owner locates tenants for 80% of the newly constructed property, all with a lease term of five years or more. The lender funds the mortgage which contains a due-on clause. The existing five-year leases do not trigger the due-on clause in the trust deed. The long-term leases were entered into before the loan funded and the trust deed recorded.

However, after obtaining the mortgage, the owner continues to lease out space in their property for five-year terms. Later, after interest rates rise, a representative of the lender visits the property and observes the new tenants. On inquiry, the lender learns that some of the tenants entered into leases, or had their leases extended for periods greater than three years, after the mortgage was originated.

The lender sends the owner a letter informing them it is calling the mortgage due since the owner entered into lease agreements with terms over three years without their prior consent.

The owner claims the lender cannot call the mortgage since long-term leases were initially required by the lender as a condition for funding the mortgage.

Can the lender call the mortgage due or demand a recast of its terms?

Yes! By requiring leases with terms over three years as a condition for funding the mortgage, the lender did not waive its right to call or recast the mortgage under its due-on clause if a lease with a term over three years is entered into after the mortgage was originated.

Due-on modification

An **assignment** or **modification** of an existing lease does not trigger the due-on clause, unless:

- the lease is modified to extend the term beyond three years; or
- a purchase option is granted to the tenant.

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6 **Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629

7 12 CFR §591.2(b)

For example, consider an owner of real estate who enters into a lease with an initial term of 10 years. Later, the owner takes out a mortgage containing a due-on clause. Later, the tenant assigns the lease with the owner's approval, as provided in the lease agreement which has priority to the mortgage.

Here, the due-on clause is not triggered by the lease assignment. The trust deed is attached as a lien only on the owner's fee interest, not the leasehold interest the owner previously conveyed to the tenant. The fee owner whose interest is encumbered by the mortgage transferred nothing. The assignment of a leasehold by a tenant is not a transfer of any interest in the fee encumbered by the mortgage.

Now consider a landlord who releases the original tenant from all liability under the lease as part of an assumption of the lease by the new tenant and substitution of liability. The release of the original tenant from liability creates a **novation** of the lease — a new agreement conveying an interest in the secured property to the new tenant by the owner of the fee. Since the *novation* included a leasing period of over three years, the mortgage holder may call the mortgage.[8]

novation
An agreement entered into by a mortgage holder, equity purchase (EP) investor and seller to shift responsibility for a mortgage obligation to the investor by an assumption and release the seller of liability.

Thus, an assumption of the lease by a new tenant, and a release of the former tenant from liability by the landlord, constitutes a present transfer of an interest affecting the fee ownership of the real estate since it is a novation.

Accordingly, a lease novation triggers the due-on clause if the lease has a remaining term of over three years or includes an option to purchase.

This interference addresses owners of nonresidential income property. Typically, the owners want long-term leases which run more than three years in their term. Here, the leasing periods have to be held to three years each, the initial term, and each extension of the periods of occupancy under a lease agreement. Otherwise, the mortgage holder may call the mortgage if the initial period is more than three years, or when exercised, the extension of the lease term is for more than three years.

Due-on-further encumbrance

Consider an owner-occupant of an SFR subject to a first mortgage. The owner applies for an *equity loan* to be secured by a second trust deed on their property. The first mortgage contains a due-on clause.

The lender tells the owner they are concerned about due-on enforcement by the senior mortgage holder during times of rising rates. The lender is aware encumbering the property with a second mortgage triggers the existing mortgage holder's due on clause, unless the activity is exempt. On inquiry, the owner informs the lender they will continue to occupy the property as their residence.

8 **Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424

The lender assures the owner that as long as they continue to occupy the property, the second mortgage will not trigger the senior mortgage's due-on clause. Due-on enforcement based on a further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted.[9]

However, on real estate other than an owner-occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing mortgage holder's consent and waiver of their due-on clause triggers the due-on clause.

Thus, junior financing in the form of an equity loan without a waiver of the senior mortgage's due-on clause becomes a risky enterprise for lenders in times of rising interest rates. Increasing market rates give mortgage holders an incentive to call mortgages on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

Due-on waiver

A lender who accepts a junior position on a property other than an owner-occupied, one-to-four unit residence without first obtaining a **due-on waiver** from the senior mortgage holder risks having the economic value of its position in title:

- **reduced** by an increase in the interest rate on the senior mortgage; or
- **wiped out** by the senior mortgage's foreclosure if its due-on rights were exercised based on the further encumbrance and it was not paid in full.[10]

Owners are driven to look elsewhere for funds when the existing mortgage holder does not grant a due-on waiver. Thus, an owner is forced to unnecessarily refinance existing mortgages in order to generate cash from their equity in the property, a more expensive process due to prepayment penalties and increased rates than had they obtained an equity loan.

Now consider a seller who carries back a second mortgage on the sale of property without the consent of the holder of the first mortgage which contains a due-on clause.

The holder of the first mortgage learns of the sale and calls the mortgage. To avoid the call, the buyer assumes the first mortgage and modifies the note by shortening the due date.

The carryback seller claims their second mortgage now has priority over the first mortgage since the modification of the first mortgage substantially impairs their security by increasing the potential for default on the carryback mortgage.

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9 12 CFR §591.5(b)(1)(i)

10 **La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864

Sidebar

FHA-insured 203(b) loans and the no-investor rule

EP investors are prohibited from owning property financed under Section 203(b), the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, the most common Federal Housing Administration (FHA) insurance program. All loans insured under Section 203(b) give the FHA the authority to approve the potential buyer.

Loans insured by the FHA contain a due-on-sale clause which allows the FHA to accelerate the loan if the property is sold in violation of assumability requirements. The lender, however, is not to impose the restrictions on the resale of the property or automatically call the loan due-on-sale without specific permission of the FHA. If property encumbered by an FHA-insured loan is sold to an unapproved buyer (such as an EP investor), the lender is required to request and receive permission from the Department of Housing and Urban Development (HUD) to accelerate the loan.

However, HUD does not call loans unless payments on the loan are delinquent.

Here, the modification of the first mortgage without the consent of the junior carryback seller does not result in a change in mortgage priorities since the existence of the second mortgage is in violation of the due-on clause in the first mortgage.

When the secured property is sold and the seller accepts a second mortgage without receiving the mortgage holder's prior written consent, the due-on clause has been breached under federal mortgage law. Thus, no duty is imposed on the holder of the first mortgage to avoid further subordinating the interest of the holder of the unconsented-to junior mortgage by recasting the first mortgage.[11]

Due-on-foreclosure

Consider a parcel of real estate subject to a first and a second mortgage which the holder of the first mortgage previously consented to.

The property owner defaults on the first mortgage. The junior mortgage holder reinstates the first mortgage and forecloses on the second, acquiring the property at the trustee's sale. At all times, the second mortgage holder keeps the first mortgage current and advised of the foreclosure proceedings.

On acquiring title at foreclosure, the junior mortgage holder advises the senior mortgage holder they are now the **owner-by-foreclosure**. The senior mortgage holder informs the junior mortgage holder, now the owner of the property, that they are calling their mortgage due based on the transfer of the property by trustee's deed – unless they are to receive points for an assumption of the mortgage and a modification of the note's interest rate and payments to current market rates.

May the senior mortgage holder call their mortgage due based on the completion of foreclosure by the second mortgage holder?

Yes! A senior mortgage holder may call a mortgage due on completion of the **foreclosure sale** by a junior mortgage holder on any type of real estate. A **trustee's deed** on foreclosure is considered a voluntary transfer by the owner, since the power-of-sale authority in the junior mortgage was agreed to by the owner of the real estate.

11 **Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869

The due-on clause is not only triggered by the voluntarily agreed-to trustee's sale, it is also triggered by any involuntary foreclosure, such as a tax lien sale.[12]

Federal regulations allow due-on enforcement on *any transfer* of real estate which secures the lien, whether the transfer is voluntary or involuntary.[13]

The risk of a senior mortgage holder enforcing their due-on clause on a trustee's sale by the junior mortgage holder has a **debilitating effect** on the availability of junior mortgages and carryback sales. Prudent lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt if they are forced to foreclose on the real estate.[14]

Due-on-death and exceptions

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner. However, as with due-on enforcement triggered by further encumbrances, narrow exceptions apply to the death of an owner who occupied a one-to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause. However, this is conditioned on the relative becoming an occupant of the property.[15]

Also, where two or more people hold title to one-to-four unit residential property as **joint tenants**, the death of one *joint tenant* does not trigger due-on enforcement.

However, at least one of the joint tenants, whether it was the deceased or a surviving joint tenant, needs to have occupied the property when the mortgage was originated. Conversely, occupancy is not required for a surviving joint tenant who qualifies for the joint tenancy exception.[16]

On all other transfers, the death of a vested owner, joint tenant or other co-owner triggers the mortgage holder's due-on clause.

Thus, due-on enforcement is triggered on death by:

- a transfer of the deceased's residence to a non-relative, by will or by trust, following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which was not originally occupied by any of the surviving joint tenants;
- the death of a co-owner of any type of property other than one-to-four residential units; and

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12 **Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423 [Disclosure: the legal editor of this publication was an attorney in this case]

13 12 CFR §591.2(b)

14 **Pas** v. **Hill** (1978) 87 CA3d 521

15 12 CFR §591.5(b)(1)(v)(A)

16 12 CFR §591.5(b)(1)(iii)

- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

Divorce and inter-family transfers

Consider a married couple who occupies a residence vested in the name of the husband and owned as his separate property. The residence is encumbered by a mortgage containing a due-on clause.

The couple separates and the residence is transferred to the wife as part of the property settlement to dissolve the marriage. The wife continues to occupy the residence.

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the mortgage holder?

No! Federal due-on regulations bar due-on enforcement on the transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property.[17]

However, if the acquiring spouse chooses to lease the residential property for any period of time rather than occupy it, the mortgage holder may call or recast the mortgage.

Inter-family exception

The due-on clause is not triggered by an owner's transfer of their one-to-four unit residential property to a **spouse or child** who occupies the property.[18]

This *inter-family transfer exception* applies only to transfers from an owner to a spouse or child. Any transfer from a child to a parent triggers due-on enforcement.

Consider an owner-occupant of one-to-four unit residential property who transfers the property into an **inter vivos trust**, naming themselves as beneficiary. The owner continues to occupy the property after transferring title into the living trust.

inter vivos trust
A title holding arrangement used as a vesting by a property owner for probate avoidance on death. Also known as a living trust. [See **ft** Form 463]

The owner notifies the mortgage holder prior to transfer. The owner agrees to give the mortgage holder notice of any later transfer of their beneficial interest in the trust or change in occupancy of the property as requested by the mortgage holder.

Does this transfer into the *inter vivos trust* trigger the due-on clause in a mortgage encumbering the owner's residence?

No! The owner met the federal regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an inter vivos trust.[19]

To meet regulations, the owner needs to provide means acceptable to the mortgage holder by which the mortgage holder is given notice of any later

17 12 CFR §591.5(b)(1)(v)(C)
18 12 CFR §591.5(b)(1)(v)(B)
19 12 CFR §591.5(b)(1)(vi)

transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the mortgage holder's approval, the mortgage holder may call the mortgage due.

Thus, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the mortgage holder may call or recast the mortgage.

Lender waiver by negotiations and by conduct

waiver agreement
An agreement in which a mortgage holder consents to the owner's present or future transfer of an interest in the mortgaged property as a waiver of the mortgage holder's due on rights. Also known as an assumption agreement. [See **ft** Form 431 and 432]

An owner intending to enter into a transaction to sell, lease or further encumber their real estate without interference by the mortgage holder needs to first negotiate a *limitation* or *waiver* of the mortgage holder's due-on rights.

Waiver agreements are trade-offs. In return for waiving or agreeing to limit the exercise of its due-on rights in the future, the mortgage holder demands consideration such as:

- additional points in the instance of an origination;
- additional security;
- the borrower's pay-down of principal balance;
- increased interest;
- a shorter due date; or
- an assumption fee.

Consider a buyer who applies for a mortgage to purchase a residence they intend to occupy for only a few years. The buyer is concerned due-on enforcement will later make it more difficult to resell their property.

The buyer and lender negotiate the conditions on which a qualified buyer in a later sale of the property will be able to assume the buyer's mortgage without a call by the mortgage holder. In exchange, the buyer agrees to pay increased points or a higher interest rate, subject to applicable Reg Z fee caps.

The mortgage holder's waiver of their due-on rights under an *assumption agreement* applies only to the present transfer to the buyer. Unless additionally agreed to, any *later transfer* of an interest in the property will trigger the due-on clause, allowing the mortgage holder to call or recast the mortgage again.

In addition to a *waiver agreement*, waiver of the mortgage holder's due-on rights may occur *by conduct* when the mortgage holder fails to promptly enforce its due-on rights.

For example, a buyer purchases real estate subject to a mortgage containing a due-on clause. The mortgage holder is informed or discovers the transfer and immediately calls the mortgage. However, the mortgage holder then accepts payments from the buyer for over 12 months. After interest rates increase, the mortgage holder later seeks to enforce their prior call by refusing further payments.

Here, the mortgage holder waived the right to enforce their due-on clause by their conduct.[20]

Broker liability for due-on avoidance

When the seller intends to transfer ownership of the property to the buyer, the senior mortgage holder's due-on clause is triggered regardless of the form used to document the sales transaction.

Regardless, the mortgage holder can only call the mortgage when they actually discover a change of ownership has taken place. If the buyer's option is not recorded, and the lease agreement is for a term of three years or less, the mortgage holder may not discover any transfer of an interest in the real estate which triggered their due-on clause has taken place.

If the mortgage holder later discovers a change of ownership has taken place, their only remedy against the buyer and seller is to call the mortgage due, or arrange to recast the mortgage as a condition for waiving their right to call and allowing an assumption by the buyer. Additionally, the mortgage holder may not recover the *retroactive interest differential* (RID) for the period before they discovered the transfer and called the mortgage.[21]

However, an **adviser**, such as a broker or attorney, assisting the buyer or seller to *mask the change of ownership* from the mortgage holder with the primary purpose of avoiding due-on enforcement may be held liable for wrongfully interfering with the mortgage holder's right to call or recast the mortgage, an offense called **tortious interference with prospective economic advantage**.

The *adviser's* liability arises based on the extent to which their actions were *specifically intended* to conceal the transfer and prevent a call by the mortgage holder, and on the foreseeability the mortgage holder will incur losses due to the concealment.[22]

The mortgage holder's losses caused by the adviser's wrongful interference are calculated based on the *interest differential* between the note rate and the market rate on the date of sale, retroactively applied from the date of discovery by the mortgage holder to the date of the transfer.

20 **Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292

21 **Hummell** v. **Republic Federal Savings & Loan** (1982) 133 CA3d 49 [Disclosure: the legal editor of this publication was the attorney of record for the borrower in this case.]

22 **J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799

Chapter 14 Summary

Lenders and carryback sellers are allowed to enforce due-on sale clauses in trust deeds on most transfers of any interest in any type of real estate. The occurrence of an event which triggers due-on enforcement automatically allows the mortgage holder to call or recast the mortgage. In times of rising rates, mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio.

The due-on clause is triggered by any conveyance of legal or equitable ownership of real estate, such as a sale. A due-on clause is also triggered by:

- a lease with a term over three years;
- a lease for any term when coupled with an option to purchase;
- further encumbrance of a non-owner-occupied, one-to-four unit residential property; and
- on completion of the foreclosure sale by a junior mortgage holder on any type of real estate.

Further, transfers of real estate resulting from the death of a vested owner also trigger due-on enforcement, with narrow exceptions based on occupancy of residential property.

Exceptions to due-on enforcement exist. Due-on enforcement based on the further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted. Similarly, the due-on clause is not triggered by an owner's transfer of property to a spouse or child who then occupies the property, or on the transfer of one-to-four unit residential property to a spouse after a divorce if the spouse occupies the property.

An owner wishing to sell, lease or further encumber their real estate without interference by the mortgage holder needs to first negotiate a limitation or waiver of the mortgage holder's due-on rights. Waiver of the mortgage holder's due-on rights may also occur by conduct when the mortgage holder fails to promptly enforce them.

An adviser assisting the buyer or seller to mask the change of ownership for the purpose of avoiding the mortgage holder's due-on enforcement may be held liable for interfering with the mortgage holder's right to call or recast the mortgage.

Chapter 14 Key Terms

Chapter 15

FHA and VA loan assumptions

Learning Objectives

After reading this chapter, you will understand:

- the assumption rules on Federal Housing Administration (FHA)- and Veterans Administration (VA)-insured loans;
- how to close a sale subject to an FHA-insured loan;
- the seller's risk of FHA recourse when permitting a buyer to take title subject-to their FHA-insured loan
- when a buyer of property secured by a VA-guaranteed loan is able to take over the loan; and
- how a lender calculates a VA assumption fee based on the out-of-pocket costs or reasonable cost estimates for processing the assumption.

Key Terms

Federal Housing Administration (FHA) insured mortgage

no-investor policy

rent skimming

U.S. Department of Veterans Affairs (VA) mortgage guarantee

VA assumption fee

Avoiding fees and investor prohibitions

The **Federal Housing Administration (FHA)** and the **U.S. Department of Veterans Affairs (VA)** are Federal loan programs that:

- offer down payment assistance for low- to moderate-income buyers and first-time buyers;
- mortgage refinance or modification programs to distressed owners; and
- special programs for veterans.

Federal Housing Administration (FHA) insured mortgage
A mortgage originated by a lender and insured by the FHA, characterized by a small down payment requirement, high loan-to-value (LTV) ratio and high mortgage insurance premiums (MIPs), typically made to first-time homebuyers.

U.S. Department of Veterans Affairs (VA) mortgage guarantee
A program that assists qualified veterans or their surviving spouses to buy a home with zero down payment. [See **ft** Form 153]

The *FHA* insures lenders against loss for the full amount of a mortgage. FHA-insured mortgages permit small cash down payments and higher loan-to-value ratio (LTV) requirements than mortgages originated by conventional lenders.

The *VA* mortgage guarantee program assists qualified veterans or their surviving spouses to buy a home with zero down payment.

Consider an equity purchase (EP) investor and their licensed agent who discuss the EP investor's intent to add more single family residences (SFRs) to the pool of rentals the EP investor owns. This exchange between the agent and the EP investor is called **counseling**.

The EP investor is interested in low price-tier SFR properties in foreclosure financed with maximum loan-to-value (LTV) fixed-rate loans insured by the Federal Housing Administration (FHA).

Specifically, the EP investor wants to **take over** existing financing rather than obtain new financing to fund their purchase of the SFRs. The EP investor's cash reserves are to be used to upgrade the properties.

The EP investor is aware the interest rate and the mortgage insurance premium (MIP) on FHA loans is higher by approximately 0.6% than conventional loans with private mortgage insurance (PMI), the result of greater leverage.

EP investors, however, generally have a high default rate compared to owner-occupants of SFRs. The Department of Housing and Urban Development (HUD) is committed to reducing the number of defaults on FHA loans. Thus, EP investors are discouraged from taking over FHA loans.

However, the EP investor is made aware that before the lender is permitted to *call* an FHA-insured loan on the sale of the SFR property, the lender is to first obtain HUD's approval.[1]

In practice, HUD does not grant the right to call unless a default already exists. Thus, lenders are limited to using the due-on clause as a device to pressure an EP investor to assume the loan, typically accomplished by contacting the seller prior to the close of escrow.

The objective of lenders is extra *revenue*. They obtain it by demanding and receiving an assumption fee of one-half point or more on the sale.

Taking over an FHA-insured loan

Prudent long-term EP investors seek out desperate property owners who are in default, then pay little or no money down and convert the property to a rental unit based on investment fundamentals of:

- price;
- time; and
- location.

1 HUD Mortgagee Handbook 4155.1 Rev-5 Ch-7 §1.b

The best time for property acquisition is during a crisis, such as a recession, when the market is temporarily devoid of sufficient buyers to keep prices at their past levels and property selection within recession-proof rental locations is extensive.

However, some individuals entering the real estate market are not in the ownership of real estate for long-term income benefits. **Speculators** enter the market during boom times intending to immediately flip the property upon buying it, without investing any further capital. In doing so, they often do not make payments to the lender, looking only to pay off the loan on a prompt resale.

Homeowners' associations (HOAs) and the local tax collector (supplemental tax billings) also get burned by the conduct of *speculators* as they sandwich themselves between sellers and homebuyers or rental investors to withdraw wealth from the real estate market.

Speculators often collect and keep rent without making payments on the loan, called **rent skimming,** or **equity skimming** when done on a scale of five or more units. *Rent and equity skimming* is a crime under federal and state law.[2]

rent skimming
When a speculator purchases a single family residence (SFR), and collects and keeps rent without making payments on the underlying loan.

In response to the activities of rent-skimming speculators during the 1980s, HUD prohibited investor assumptions of FHA-insured SFR loans. Thus, FHA only allows the assumption or take-over of an FHA-insured SFR loan by qualified owner-occupant buyers. Further, HUD has the right to call the loan if taken over by anyone other than an owner-occupant buyer.[3]

In spite of the HUD due-on enforcement policy, the servicing lender is permitted to call the loan on a subject-to transfer to an EP investor only with HUD's prior approval. However, as a matter of practice, HUD has not authorized a call when an EP investor acquires the property, unless the EP investor defaults on loan payments.

Closing sales subject to FHA-insured loans

Rental investors and unqualified buyers who have the financial ability to make payments on an FHA-insured loan need to obtain a **beneficiary statement** from the lender, through escrow, to confirm the seller's representation of the loan terms. [See **first tuesday** Form 415]

The buyer then closes escrow, taking over the loan by either:

- cashing out the seller's equity; or
- combining cash and a note carried back by the seller to pay for the seller's equity.

The seller's risk of FHA recourse

Sellers face a **risk of loss** when permitting a buyer to take title subject-to their FHA-insured loan.

2 12 United States Code §1709-2; Calif. Civil Code §§890 et seq.
3 HUD 4155.1 Ch-7 § 1.b

The downside risk for a seller of a property encumbered by an FHA-insured loan is the seller's **personal liability** for any loss the FHA incurs due to a deficiency in the property value at the time of a default by the buyer. This deficiency in the property value may arise after the close of escrow if property values fall.

If the subject-to buyer fails to make payments on the FHA-insured loan, and the property's value becomes insufficient to satisfy the remaining loan balance, HUD has the right to collect a deficiency from the seller who is the original borrower.

The right to pursue the seller as the original borrower for any deficiency belongs to HUD, not the lender.

Borrowers under programs insured by the FHA or Veterans Administration (VA) do not receive California **anti-deficiency protection** for losses sustained by these federal agencies. The federal statutory right to collect losses on the HUD loan insurance program preempts state law to the contrary.[4]

Thus, the seller, on a transfer of title subject to an FHA loan, is to consider entering into an **assumption agreement** with the buyer and securing the agreement by a performance trust deed. [See **first tuesday** Forms 432 and 451]

Then, if the buyer does not perform on the *assumption agreement* by making payments on the loan, the seller has the option to call all amounts due by the terms of the assumption agreement and foreclose under the trust deed to protect the seller's interests.

Release of liability

To be released from liability for any deficiency on an FHA-insured loan taken over by a buyer, a seller is obligated to obtain a formal **release of liability** as part of the assumption package presented by the lender on an FHA-insured loan.[5]

A *release of liability* is granted by the lender if:

- the seller requests a release from personal liability;
- the prospective buyer is creditworthy;
- the prospective buyer assumes the loan; and
- the lender uses an FHA-approved form to release the seller from personal liability.[6]

If the conditions for a release of liability exist, but the seller does not request the release from personal liability, the seller remains liable to the FHA for any losses due to a default occurring within five years after the sale.[7]

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4 **Carter** v. **Derwinski** (9th Cir. 1993) 987 F2d 611

5 HUD 4155.1 Ch-7 § 1.e

6 HUD Form 92210.1; 24 Code of Federal Regulations §203.510(a)

7 12 USC §1709(r)

However, after five years pass from the time the property is resold, the seller is released from personal liability, if:

- the buyer assumes the loan with the lender;
- the loan is not in default at the end of the five-year period; and
- the seller requests the release of liability from the lender.[8]

Many owners sell their properties subject-to FHA-insured loans knowing full well the risks of a deficiency. However, sellers generally believe future appreciation and HUD's refusal to pursue collection of loan losses minimize any real risk of value-deficiency exposure.

In economically depressed parts of the country, property is conveyed subject-to FHA-insured loans as a way to obtain buyers. It is an activity which tends to decrease the level of foreclosures against homeowners who are no longer able to afford to own the property or are compelled to relocate for job opportunities.

Conversely, a demand for a substitution of liability and assumption fees on a loan takeover tends to drive potential buyers away. Thus, the prices of properties are driven down, adversely affecting the level of foreclosures and increasing the risk of loss in homeownership.

FHA inactivity on a sale

Any hesitation a seller has about selling an SFR subject-to an FHA-insured loan is put at ease by HUD's internal policy not to collect deficiencies against owners who made loan payments in **good faith**.

After foreclosure by a lender, the FHA pays the lender for any loan losses under their mortgage insurance policy (MIP) or acquires the property by paying off the loan. If acquired, the FHA resells the property to offset its losses. FHA then sends collection letters but does not have a history of otherwise contacting the homeowner.

Sellers who receive cash for their equity occasionally ignore the loan assumption provision and lender threats, and close subject to a FHA-insured loan.

Sellers with well-seasoned loans, or who are extremely motivated to sell, possibly disregard the due-on clause when selling their property.

Through its **no-investor policy**, HUD severely cripples a defaulting seller's ability to sell their property in order to:

- financially right themselves, or
- obtain mobility to relocate to a better job.

no-investor policy
HUD policy which restricts a defaulting seller from selling their FHA-insured single family residence (SFR) to an investor.

If, hypothetically, HUD's *no-investor* policy were enforced, the number of FHA repossessions will increase and unemployment levels will remain higher than if owners were able to readily sell and move near places of employment.

8 24 CFR §203.510(b)

Thus, buying a residence subject-to an FHA-insured loan, regardless of when the loan was originated, naturally progresses without further government interference and lender assumption threats, so long as the loan is kept current.

Assuming a VA loan

The VA loan assumption policy is entirely different from the HUD/FHA assumption policy.

A buyer of property secured by a VA-guaranteed loan is able to take over the loan if:

- the loan is **current**;
- the buyer **assumes** the loan; and
- the buyer is **creditworthy**.[9]

For a buyer to assume a VA loan, a fee of 0.5% of the loan balance is to be paid to the VA by the buyer.[10]

VA assumption fee
A fee of 0.5% of a VA loan, assumed by the buyer of a VA-guaranteed single family residence (SFR) upon closing.

The **VA assumption fee** is to be paid to the lender on closing the sale with the buyer. The lender has 15 days to forward the fee to the VA or faces late charges.[11]

Additionally, the lender is permitted to charge and retain an assumption fee of the lesser of:

- $300, plus the costs of a credit report; or
- the maximum amount for an assumption fee allowed under state law.[12]

While no statutory rule exists in California for calculating assumption fees, the fees are to reflect actual *out-of-pocket costs*, or reasonable cost estimates for processing the assumption.

When an assumption application is approved by the lender, the VA borrower is released from further liability to the VA under the mortgage insurance program, including liability for losses caused by the buyer's default in payments.[13]

Liability on a refinance

However, the veteran who is released by the VA is not necessarily released by the lender from further liabilities for the loan. For instance, the veteran who **refinances** their property with a VA-insured loan has liability under the loan (as well as to the VA) for any deficiency in the property value to cover the loan.

The veteran exposed to refinancing liability is best served by entering into a **novation agreement** with the lender. The agreement relieves the seller

9 38 USC §§3713(a); 3714(a)(1)
10 38 USC §3729(b)
11 38 CFR §36.4312(e)(2)
12 38 CFR §36.4312(d)(8)
13 38 CFR §36.4323(h)

of liability for a potential deficiency. Liability to a lender for a loan used to refinance a property is different from the mortgage insurance liability the veteran has with the VA.

A *novation agreement* requires the consent by three parties — the buyer, seller and lender — to release the seller from further liability to the lender when the seller is released from mortgage insurance liability by the VA under a *substitution of liability*.

If the lender refuses to allow the buyer to assume the loan, the VA is to review the findings and determine whether the buyer is entitled to assume the loan.

If the veteran is unable to make payments on their VA-insured loan, but finds a qualified buyer to assume the loan, the VA is to require the lender to agree to the loan assumption since it is in the best interest of the VA.[14]

However, neither the lender nor the VA is required to release the seller from liability on the loan when the assumption is granted to avoid foreclosure.[15]

If the VA refuses to allow the buyer to assume the loan, and the veteran borrower sells the property nonetheless, the lender is to call the loan and demand payment of the remaining principal and interest without prior approval from the VA.[16]

Also, the lender is to call the VA loan if the veteran borrower sells their personal residence and fails to notify the lender of the sale.[17]

However, when a lender becomes aware the veteran borrower sold the property secured by a VA loan and the lender fails to notify the VA, then the lender, not the seller, is liable for any VA losses on the loan.[18]

14 38 USC §3714(a)(4)(B)
15 38 CFR §36.4323(h)
16 38 USC §3714(a)(4)(C)
17 38 USC §3714(b)
18 38 USC §3714(c)(1), (2)

Chapter 15 Summary

The Federal Housing Administration (FHA) insures lenders against loss for the full amount of a mortgage. FHA-insured mortgages permit small cash down payments and higher loan-to-value ratio (LTV) requirements than mortgages originated by conventional lenders.

The VA mortgage guarantee program assists qualified veterans or their surviving spouses to buy a home with zero down payment.

EP investor-owners generally have a high default rate compared to owner-occupants of single family residences (SFRs). Thus, the Department of Housing and Urban Development (HUD) discourages equity purchase (EP) investors from taking over FHA-insured loans. HUD has the right to call the loan if taken over by anyone other than an owner-occupant buyer. However, in spite of the HUD due-on enforcement policy, the servicing lender is permitted to call the loan on a subject-to transfer to an EP investor only with HUD's prior approval. However, as a matter of practice, HUD has not authorized a call when an EP investor acquires the property, unless the EP investor defaults on loan payments.

The VA loan assumption policy is entirely different from the HUD/FHA assumption policy. A buyer of property secured by a VA-guaranteed loan takes over the loan if:

- the loan is current;
- the buyer assumes the loan; and
- the buyer is creditworthy.

For a buyer to assume a VA loan, a fee of 0.5% of the loan balance is to be paid to the VA by the buyer.

Chapter 15 Key Terms

Chapter 16

Assumptions: formal and subject-to

Learning Objectives

After reading this chapter, you will be able to:

- understand how existing financing encumbering a property may remain of record and be taken over by an equity purchase (EP) investor;
- distinguish conditions by which an EP investor takes over a mortgage on acquiring ownership under a subject-to transfer, subject-to assumption, formal assumption or a novation agreement;
- determine when a lender can enforce its due-on clause and call the mortgage on its discovery of a sale;
- structure a subject-to transaction under a purchase agreement provision applying the existing mortgage balance taken over by the investor as part of the purchase price paid for the property; and
- understand how a novation agreement on the investor's assumption of the mortgage releases the seller from liability on the mortgage.

Key Terms

assumption agreement	**novation**
beneficiary statement	**recourse mortgage**
due-on clause	**subject-to transaction**
nonrecourse mortgage	**waste**

Mortgage takeover by an EP investor

On an owner's sale of real estate encumbered with a mortgage, a buyer may take over the mortgage obligations with the mortgage remaining on title. Here, the principal balance remaining unpaid on the mortgage is applied toward the price the buyer pays for the property, the balance of the price typically paid in cash.

When an owner-occupant of a one-to-four unit residential property in foreclosure is selling the property, an equity purchase (EP) investor as the buyer acquires title to ownership and takes over the owner's mortgage under one of four procedures:

- a **subject-to transfer** of ownership to the EP investor without an assumption agreement of any type;
- a **subject-to assumption agreement** between the seller and EP investor, the lender being the third-party beneficiary;
- a **formal assumption agreement** between the lender and EP investor, the seller being a third-party beneficiary; or
- a **novation agreement** between the lender, seller and EP investor.

The subject-to take over

Consider a seller of their personal residence that is encumbered by a first trust deed mortgage in foreclosure. The seller enters into an equity purchase (EP) agreement and escrow instructions with an investor on terms calling for the investor to **take title subject-to** the existing mortgage. [See **first tuesday** Form 156 §5]

The investor plans to close escrow on the transfer without entering into a formal assumption agreement with the lender. The investor intends to negotiate with the lender after closing, before they bring the mortgage current, to determine whether the lender will call the mortgage or demand a modification of mortgage terms to consent to the transfer of ownership.

If negotiations are unsuccessful, the EP investor will refinance with another lender, sell the property or let it be sold in foreclosure, the investor's economic decision.

The interest rate on the seller's existing mortgage is at or above current market levels. The experience of the investor and their agent indicates the lender will not call the mortgage and demand a payoff or assumption under current economic cycle circumstances. If the mortgage is called (requiring a separate notice of default (NOD) filing if not paid in full), the investor reasons the lender will lose either its servicing fees or its higher-than-market portfolio yield on the mortgage, and will still have an outstanding NOD for the prior uncured delinquency.

Request for a beneficiary statement

A **beneficiary statement** is requested from the lender by escrow. The lender complies with the request by sending a statement of the mortgage condition to escrow within 21 days of its receipt of the request.[1] [See Chapter 20; see **first tuesday** Form 415]

However, the lender unilaterally **instructs escrow** not to close until the investor has been approved by the lender and has assumed the mortgage since the lender's trust deed contains a due-on clause.

1 Calif. Civil Code §2943(e)(3)

Can the lender interfere with the closing of a subject-to transaction by issuing instructions to escrow when the seller's and buyer's instructions to escrow do not call for lender approval or a formal assumption?

No! Escrow instructions for the sale of property subject to the existing mortgage are solely between the investor, seller, and escrow. The lender has no legal right to interfere with the transaction to prevent the closing since the lender is not a party to the escrow. [See **first tuesday** Form 401]

More importantly, escrow has no authority from its principals to follow any lender instructions attached to the beneficiary statement. The lender's remedy is limited to calling the mortgage under its due-on clause in the trust deed (or accepting payments) after the subject-to transaction is closed.[2]

beneficiary statement
A document issued by a mortgage holder on request noting future payment schedules, interest rates and balances on a mortgage. [See **ft** Form 415]

The subject-to transaction

A **subject-to transaction** is initially structured by use of a financing provision in a purchase agreement. The provision calls for the amount of an existing mortgage to be part of the purchase price the EP investor is to pay for the property. The financing provision further states the EP investor is to take title to the property *subject to* the existing mortgage. [See **first tuesday** Form 156 §§5 and 6]

The seller's representation of the terms and condition of the mortgage is confirmed by the EP investor during escrow on escrow's demand and receipt of the lender's *beneficiary statement*. [See **first tuesday** Form 415]

The EP investor relies on the *beneficiary statement* for future payment schedules, interest rates and the principal balance on the mortgage they are taking over from the seller.

subject-to transaction
A sale of mortgaged property calling for the buyer to take title subject to the mortgage, the principal balance being credited toward the purchase price paid. Compare with formal assumption. [See **ft** Form 156 §5]

Unrecorded sales documents

Some EP investors acquire their ownership rights under **unrecorded sales documents**, such as:

- a lease-option agreement;
- land sales contract; or
- other installment sales arrangements for payment of the agreed price and conveyance of title.

This effort is undertaken to avoid detection of a change in ownership by the lender and county assessor.

Thus, the seller and investor defer the conveyances, escrow, title insurance, and other customary transfer activities until the investor originates new financing or negotiates an assumption of the existing mortgage.

These unrecorded sales transactions do, however, trigger **due-on clauses** and **reassessments**. They also create risks of loss inherent in an unrecorded transaction losing priority. These are *masked security devices* and they leave much room for misunderstandings about ownership.

due-on clause
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

2 **Moss** v. **Minor Properties, Inc.** (1968) 262 CA2d 847

Market rates motivate

On handling a transparent *subject-to transaction* when mortgage rates charged are comparable to or lower than the note rate on the seller's existing mortgage:

- a beneficiary statement is ordered to *confirm the mortgage amount* and its terms;
- the change of ownership conveyance is *recorded and insured*; and
- the conveyance is promptly brought to the *lender's attention* so when they accept payments they may not later call the mortgage when rates rise, claiming the transfer went undisclosed.

Conversely, when market interest rates are higher than the note rate on the existing mortgage, the lender might not be notified of a subject-to sales transaction by either the seller or the buyer. Notice of the transaction allows the lender to gain financially from a call or recast of the mortgage at the expense of the seller and investor.

nonrecourse mortgage
A debt secured by real estate for which the holder's sole source of recovery of amounts owed is the value of the mortgaged property, no money judgment permitted for a deficiency in the value of the mortgaged property on foreclosure or short payoff to fully satisfy the debt.

However, the lender can enforce its due-on clause and call the mortgage on its **future discovery** of any sale. This is the case regardless of how the sale was structured.

On a later discovery of an unconsented to transfer, neither the investor nor the seller are liable to the lender for any **retroactive interest differential (RID)** lost by the lender based on market rates higher than the mortgage note rate at the time of the transfer.

However, brokers, attorneys or accountants whose *primary objective* in negotiating the sales transaction was to induce the investor and seller into avoiding the due-on clause may be liable for the lender's RID losses.

Liability for due-on avoidance

The concern of the seller on either a subject-to or an assumption of the seller's mortgage is whether personal liability exists on the mortgage. Mortgage liability depends on whether the mortgage is:

- a **recourse mortgage**, meaning the lender may pursue the seller for a loss due to a deficiency in the value of the secured property, but only if the lender forecloses judicially; or
- a **nonrecourse mortgage**, meaning the lender may not pursue the seller for a loss on the mortgage when the property has insufficient value to satisfy the outstanding debt.

Nonrecourse mortgage debt

A seller is not liable for a deficiency in the value of mortgaged property to cover the mortgage debt on the foreclosure of a *nonrecourse mortgage* taken over by the buyer.

Nonrecourse mortgages include:

- seller carryback financing on the sale of any type of real estate which becomes the sole security for the carryback note;

- a mortgage which funded the purchase of an owner-occupied, one-to-four unit residential property;[3] and
- a mortgage made for the construction of an owner-occupied, single family residence (SFR).

A lender as the holder of a purchase-money mortgage has no recourse to the borrower on a default. As nonrecourse debt, the lender is limited to foreclosing and selling the secured property as the sole source of recovery for any amounts remaining unpaid on the mortgage.[4]

Even if the secured property has insufficient value to satisfy the balance of the purchase-money mortgage, the lender cannot hold the original borrower or a subsequent assuming investor personally liable on the *nonrecourse* note for the deficiency in the property value.

waste
The intentional destruction or neglect of property which diminishes its value. [See **ft** Form 550 §6.8 and 552 §7.4]

*Editor's note – The lender may only recover from an owner who inflicts **waste** on the property.*

On the take-over of a purchase-money mortgage by an investor for the purpose of converting the property to an income producing rental investment, the mortgage retains its original nonrecourse purchase-money characteristic, regardless of whether the investor takes title subject-to or assumes the mortgage.[5]

Thus, a non-occupying investor who takes over a purchase-money mortgage under any procedure and puts the property to any legal use is entitled to *anti-deficiency protection*. In contrast, purchase-assist mortgage financing originated by a non-occupying investor of any type of residential property, including one-to-four unit residential property, is a recourse mortgage.

However, if the mortgage is insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA), the FHA or the VA have recourse to the borrower under government guarantee programs for losses on a foreclosure and resale of the property.

Recourse real estate mortgages

Recourse mortgages are all mortgages not classified as purchase-money mortgages, as reviewed above.

When property is sold and title is conveyed to an investor subject-to an existing *recourse mortgage*, the seller remains liable for any deficiency on the recourse mortgage if the investor fails to pay and the lender forecloses.[6]

recourse mortgage
A mortgage debt in which a lender may pursue collection from a property owner for a loss due to a deficiency in the value of the secured property to fully satisfy the debt if the lender forecloses judicially.

Further, unless the investor enters into an *assumption agreement* with either the seller or the lender, a subject-to investor is not liable to either the seller or the lender for a drop in the property's value below the mortgage balance, unless the investor commits *waste*.[7]

3 Calif. Code of Civil Procedure §580b
4 CCP §580b
5 **Jackson** v. **Taylor** (1969) 272 CA2d 1
6 **Braun** v. **Crew** (1920) 183 C 728
7 **Cornelison** v. **Kornbluth** (1975) 15 C3d 590; CC §2929

However, when the investor and lender enter into an assumption agreement which significantly modifies the terms of the recourse mortgage without the seller's consent, the seller is no longer liable for the mortgage.[8]

Investor-seller assumption

A seller can take steps to reduce their risk of loss on an investor's takeover of a recourse mortgage. To do so, the seller includes a provision in the purchase agreement requiring the investor to enter into an **assumption agreement** with the seller.

assumption agreement
A promise given by the equity purchase (EP) investor to the seller or a lender to perform all the terms of the mortgage taken over by the investor on the sale. [See **ft** Form 431 and 432]

An *investor-seller assumption agreement* is not to be confused with a so-called *formal assumption* between the investor and a lender.

The investor-seller assumption agreement is a promise given by the investor to the seller to perform all the terms of the mortgage taken over by the investor on the sale. It is agreed to in the purchase agreement and prepared in escrow. [See Form 431 accompanying this chapter]

The assumption agreement gives the seller the right to collect from the investor the amount of any deficiency judgment a recourse lender might be awarded against the seller in a judicial foreclosure. To be enforceable, the assumption agreement must be in writing.[9]

Although the investor's promise to pay the mortgage under an investor-seller assumption agreement is given to the seller, the investor also becomes liable under the agreement to the recourse lender under the legal doctrine of **equitable subrogation**.[10] [See Form 431 §6]

Even though the investor takes over the primary responsibility for the recourse mortgage, the seller remains *secondarily liable* to the lender. The seller's risk of loss arises when:

- the investor fails to pay the recourse mortgage; and
- the property's market value is or becomes insufficient to cover the mortgage amount.[11]

Idemnified for losses

Unlike the subject-to seller, the seller under the investor-seller assumption agreement is entitled to be **indemnified**. In effect, the seller is held harmless by the investor for any losses the seller later incurs due to their continued liability on the mortgage taken over by the investor.

Sales negotiations calling for the investor to enter into an assumption agreement with the seller may also call for the investor to secure the assumption agreement by a **performance trust deed** carried back by the seller as a lien on the property sold. [See **first tuesday** Form 432 and 451]

8 Braun, *supra*; CC §2819
9 CC §1624
10 Braun, *supra*
11 **Everts** v. **Matteson** (1942) 21 C2d 437

Form 431

Assumption Agreement

ASSUMPTION AGREEMENT
Unsecured and Subrogated

Prepared by: Agent ______________ **Phone** ______________
Broker ______________ **Email** ______________

DATE: ______________, 20______, at ______________, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This assumption agreement is entered into by
   1.1 ______________, as the Buyer,
   1.2 and ______________, as the Seller,
   1.3 regarding Buyer's acquisition of real estate referred to as ______________
   ______________.
2. **FIRST TRUST DEED NOTE:**
   2.1 Buyer is acquiring title to the real estate subject to a first trust deed dated ______________,
   2.2 executed by ______________, as the Trustor,
   2.3 in which ______________ is the Beneficiary,
   2.4 recorded on ______________, as Instrument No.______________, in the Official Records of ______________ County, California, and
   2.5 given to secure a promissory note of the same date for the principal sum of $______________.
3. **SECOND TRUST DEED NOTE:**
   3.1 Buyer is acquiring title to the real estate subject to a second trust deed dated ______________,
   3.2 executed by ______________, as the Trustor,
   3.3 in which ______________ is the Beneficiary,
   3.4 recorded on ______________, as Instrument No.______________, in the Official Records of ______________ County, California, and
   3.5 given to secure a promissory note of the same date for the principal sum of $______________.

AGREEMENT:

4. Seller hereby assigns and delegates to Buyer all rights and obligations in the above note(s) and trust deed(s).
5. Buyer hereby assumes and agrees to timely pay the debt evidenced by the above promissory note(s) and to perform all of Trustor's obligations under the trust deed(s) securing the note(s).
6. This agreement is made for the benefit of the Beneficiary(ies) of the trust deed(s) securing the note(s).
7. Should Buyer or Buyer's successors default in the performance of this agreement, the whole sum of the principal and interest on the assumed indebtedness(es) shall become immediately due at the option of the holder of this assumption agreement.
   7.1 On default, Seller shall become subrogated to the interest of Beneficiary under the defaulted note and trust deed.
8. In any action to enforce this agreement, the prevailing party shall receive attorney fees.

I agree to the terms stated above.	I agree to the terms stated above.
Date:______________, 20______	Date:______________, 20______
Seller: ______________	Buyer: ______________
Seller: ______________	Buyer: ______________

FORM 431 03-11 ©2011 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

With a recorded trust deed held by the seller to secure the investor's promise to pay the lender as agreed in the assumption agreement, any default by the investor allows the seller to:

- demand the investor to tender the entire balance remaining due on the assumed mortgage, subject to the investor's right to reinstate the delinquencies; and

- proceed with foreclosure under the performance trust deed to recover the property and cure the default on the mortgage assumed by the investor.

An investor-seller assumption, like a subject-to transaction, does not alter the lender's right to enforce its due-on clause on discovery of the conveyances. An exception exists when the lender waives its due-on rights by failing to promptly call the mortgage after acquiring knowledge of the transfer of ownership.

Novation

Consider an EP investor who will cash out a seller-in-foreclosure's equity and assume an existing recourse mortgage with a lender. However, the seller is unwilling to sell the property and remain liable for the mortgage after closing when they no longer have an interest in the property and are unable to protect themselves.

Can the sale be closed without the seller remaining liable on the recourse mortgage assumed by the investor?

novation
An agreement entered into by a lender, equity purchase (EP) investor and seller shifting responsibility for a mortgage obligation to the investor (an assumption) and releasing the seller of liability .

Yes! A lender may enter into an agreement with both the investor and the seller for the investor's *assumption* of the mortgage and a *release* of the seller's liability by the lender. In exchange, the lender charges a fee together with a demand for a modification of mortgage interest rate and terms of repayment. This agreement is called a **novation** or **substitution of liability**.

On an investor-lender assumption of a mortgage secured by an owner-occupied, one-to-four unit residential property, the lender, as part of the assumption arrangements, is required to *release the seller from liability* for the mortgage assumed by the investor.[12]

A *novation agreement* is comparable to the existing lender originating a new mortgage with the investor, except the trust deed executed by the seller remains of record and the note remains unpaid.

Thus, the lender under a novation agreement or assumption will review the investor's credit status, seek a modification of the interest rate to current levels, and charge an assumption fee. These are benefits a lender regularly receives on an origination of a new mortgage made to the investor.

However, any payment of assumption fees or modification increasing the interest rate and payment amounts on the mortgage defeats the advantages an investor and seller have when taking title subject to an existing mortgage.

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12 12 Code of Federal Regulations §591.5(b)(4)

Chapter 16 Summary

On an owner's sale of real estate encumbered with a mortgage, a buyer may take over the mortgage obligations with the mortgage remaining on title. Here, the principal balance remaining unpaid on the mortgage is applied toward the price the buyer pays for the property.

When an owner-occupant of a one-to-four unit residential property in foreclosure is selling the property, an equity purchase (EP) investor as the buyer acquires title to ownership and takes over the owner's mortgage under one of four procedures:

- a subject-to transfer of ownership to the EP investor without an assumption agreement of any type;
- a subject-to assumption agreement between the seller and EP investor, the lender being the third-party beneficiary;
- a formal assumption agreement between the lender and EP investor, the seller being a third-party beneficiary; or
- a novation agreement between the lender, seller and EP investor.

A subject-to transaction is structured by a provision in a purchase agreement calling for the principal amount of an existing mortgage to be part of the purchase price paid for the property. The lender may enforce its due-on clause by calling the mortgage on its later discovery of the sale, regardless of how the sales transaction is structured.

A seller is not liable for a deficiency in property value to satisfy the mortgage on foreclosure of a nonrecourse purchase-money debt taken over under any procedure by the investor. On a recourse mortgage, the seller can reduce their risk of loss on an investor's takeover of the mortgage by negotiating for the investor to enter into an assumption agreement with the seller.

An investor-seller assumption does not alter the lender's right to enforce its due-on clause on discovery but does give the seller the right to recover from the investor any losses they may have incurred due to the lender's losses on a default and foreclosure.

The lender can enter into an agreement with both the investor and seller for the investor's assumption of the mortgage and a release of the seller's liability on the mortgage, called a novation. A novation agreement is comparable to the existing lender originating a new mortgage with the investor, except the trust deed executed by the seller remains of record and the note remains unpaid.

Chapter 16 Key Terms

due-on clause .... **pg. 175**
nonrecourse mortgage .... **pg. 176**
novation .... **pg. 180**
recourse mortgage .... **pg. 177**
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Chapter 17

Escrow, the way to perform

Learning Objectives

After reading this chapter, you will be able to:

- appreciate the tandem effect of the purchase agreement and the escrow instructions to create and close a transaction;
- recognize how agents ensure the escrow instructions conform to the purchase agreement and the intent of the seller-in-foreclosure and equity purchase (EP) investor;
- understand the steps escrow takes to facilitate the closing of a real estate sale;
- distinguish the various services rendered by escrow and the duties of an escrow officer;
- calculate prorations and adjustments for the investor and the seller in a transaction; and
- advise on who has the right to receive the investor's funds held in escrow when escrow fails to close.

Key Terms

escrow	**good faith deposit**
escrow instructions	**proration**
escrow officer	**Statute of Frauds**

The performance of a purchase agreement

Escrow is a process employing an independent agent, typically a licensed escrow company, to manage and coordinate the closing of a real estate transaction. The escrow company does so by handling the exchange of documents and money between two parties, such as an equity purchase (EP) investor and seller-in-foreclosure. *Escrow* activities are typically based on a primary agreement, such as a written *purchase agreement*, though one need not exist.[1] [See **first tuesday** Form 156]

1 Calif. Financial Code §17003(a)

escrow
The depository process employed to facilitate the gathering of instruments and funds for use to transfer real estate interests between two persons.

In mortgage servicing situations, the word *escrow* has a different application for an arrangement called **impounds**. The mortgage holder manages as an *escrow account* their receipt and disbursement of funds received from the property owner for payment by the lender of annual property taxes and insurance premiums (TI) owed by the owner of the secured property. Typically, these funds are collected monthly with the regular principal and interest (PI) payment. Collectively, the mortgage principal, interest, property taxes and insurance premiums are referred to as **PITI**.

Escrow activity employed to close a real estate transaction consists of:

- *one person*, such as a seller-in-foreclosure or EP investor of real estate, who delivers written documents or money, called **instruments**, to an escrow company for the purpose of fully performing their *obligations owed another person* under an agreement previously entered into for a sale, a mortgage origination or lease of real estate; and
- *the escrow company***,** who receives and delivers documents and money *to another person***,** such as the investor, seller or third parties, on the occurrence of an specified event or the performance of prescribed conditions, such as the receipt of reports, further approvals or the issuance of a title insurance policy.[2]

Escrow companies and escrow officers

escrow officer
An individual licensed and employed as an agent of an escrow company to perform escrow services.

An individual engaged in the business of acting as an *escrow agent* is called an **escrow officer**. The officer is employed by an **escrow company** and needs to be licensed. Likewise, the *escrow company* is licensed by the California Department of Corporations (DOC), unless exempt.[3]

Individuals exempt from the escrow licensing requirements include:

- a licensed real estate broker, either individual or corporate, who represents a person in a real estate transaction in which the broker will also perform escrow services;
- a licensed attorney who does not hold themselves out as an escrow agent;
- a bank, trust company, savings and loan association or insurance company; and
- a title insurance company whose principal business is preparing abstracts or making searches of title used for issuing title insurance policies.[4]

The services rendered by escrow officer typically include:

escrow instructions
Directives an escrow officer undertakes as given by a seller-in-foreclosure and an investor to coordinate a closing on a purchase agreement. [See **ft** Form 401]

- receiving funds and collecting necessary documents, such as property reports, disclosure statements and title reports called for in the **escrow instructions** [See **first tuesday** Form 401];
- preparing documents necessary for conveyancing and mortgaging a property required for escrow to close;

2 Fin C §17003(a)
3 Fin C §17200
4 Fin C §17006

- calculating prorations and adjustments; and
- disbursing funds and transferring documents when all conditions for their release have been met.[5]

The specific duties of the escrow officer, outlined in the *escrow instructions*, vary according to expectations held in local real estate transactions. [See **first tuesday** Form 401]

Escrow basics

Consider an EP investor and seller-in-foreclosure who enter into a purchase agreement for the sale of the seller's one-to-four unit residence. As provided in the purchase agreement, escrow is opened to handle the closing of the transaction. [See **first tuesday** Form 156 §13.1]

In modern real estate practice, *opening escrow* simply means establishing a depository for the **instruments** (deeds, money and other items) with accompanying instructions for their use. Escrow instructions are signed by all necessary persons (the investor and seller), each authorizing escrow to transfer or hand their instruments to the other person or third parties on closing.[6]

Before accepting any instruments as an escrow holder for a transaction, an agent of the investor or seller *dictates instructions* to the escrow officer. The purpose for this communication is to establish precisely when and under what circumstances the documents and monies deposited with escrow are to change hands.

When receiving instructions from an agent, the escrow officer prepares a "**take sheet."** On it, the officer notes all the tasks they are to undertake to handle and close escrow. When drafting escrow instructions, the officer relies on the *take sheet* as a checklist to determine the contents of the instructions.

Increasingly, agents simply email a copy of the purchase agreement to the named escrow company. The escrow officer then drafts escrow instructions as needed for the investor and seller to comply with their obligations under the purchase agreement. When prepared, the officer sends the written instructions to the agent to verify they conform to the intent of the persons in the transaction.

As a checklist used by an agent for "going to escrow," a worksheet helps the investor's agent organize the collection of facts and supporting papers the escrow officer needs to draw instructions, clear title conditions and close escrow. [See **first tuesday** Form 403]

Escrow instructions

An escrow officer will perform only as instructed. Typically, *escrow instructions* are prepared by the escrow officer based on information received from the seller's or buyer's agent about the transaction. However, agents, like many builders, may include instructions as an addendum to a purchase agreement.[7] [See **first tuesday** Form 401]

5 Fin C §17003(a)

6 **Montgomery** v. **Bank of America National Trust & Savings Association** (1948) 85 CA2d 550

7 **Moss** v. **Minor Properties, Inc.** (1968) 262 CA2d 847

In practice, the escrow officer prepares the instructions on forms adopted for this use. Once completed, the instructions are forwarded to the agents of the persons in the transaction for their signatures and return to escrow. When returned, escrow is then *open* for the person who signed and returned the instructions.

Two types of escrow instructions are used in California:

- **bilateral**; and
- **unilateral** instructions.

Throughout most of California, escrow instructions used in real estate sales transactions are *bilateral* in nature. As bilateral escrow instructions, they are entered into by both the investor and seller. Each signs a copy of the same instructions and hands them to escrow. [See **first tuesday** Form 401]

In some areas of Northern California, separate sets of *unilateral* escrow instructions are prepared, usually waiting until the transaction is ready to close to be prepared and signed. Each set of instructions contain only the activities to be performed by or on behalf of one person; one set being the investor's instructions, the other set the seller's instructions.

When an escrow officer operating under conditions of unilateral instructions determines they have all documents necessary to call for funding and closing the transaction, the officer prepares the separate instructions for signatures of the respective investors and sellers.

The documents work together

Most modern real estate sales transactions depend on both the purchase agreement and the escrow instructions working in tandem to close a transaction. Thus, the trend needs to be toward the agent preparing both at the same time as separate agreements, one attached to the other — saving time and massive amounts of energy. [See **first tuesday** Form 156 §13.1 (a), (b)]

Both the purchase agreement and the escrow instructions are *contracts* regarding interests in real estate. Both documents must be in writing to be enforceable under the **Statute of Frauds**.[8]

Statute of Frauds
A rule of contract law requiring specific real estate transactions to be reduced to a signed writing to be enforceable.

A *purchase agreement* sets forth the:

- sales price;
- terms of payment; and
- conditions to be met before closing. [See **first tuesday** Form 156]

Escrow instructions constitute an additional agreement entered into by the investor and seller with an escrow company. Under the instructions, escrow facilitates the completion of the performance required of the investor and seller in the underlying purchase agreement.

8 Calif. Civil Code §1624

Escrow instructions do not replace the purchase agreement. Instead, the instructions function separately from purchase agreements, as directives an escrow officer undertakes to coordinate a closing intended by the terms of the purchase agreement.9

Escrow instructions occasionally add exactness and completeness, providing the enforceability sometimes lacking in purchase agreements prepared by brokers or their agents.

Purchase agreement is primary

A written and signed purchase agreement typically is the primary underlying document in a real estate sales transaction. All further agreements, including the escrow instructions, must conform to the primary document, unless the parties *intend to modify* the terms of that original agreement. The document making the change needs to note a modification is involved.

The agents negotiating a transaction are responsible for ensuring the escrow instructions conform to the purchase agreement. This is done by reviewing the instructions prepared by the escrow officer to ensure the intentions of the investor and seller are clear. Thus, the escrow instructions are reviewed by the both agents prior to submitting them to their clients for their review and signatures.

In some instances, the investor and seller orally negotiate the sale and go directly to escrow, without first memorializing their understandings in a written purchase agreement. In this instance, there is no underlying written purchase agreement generated prior to opening escrow.

Here, the investor and seller intend the escrow instructions to function as the binding contract documenting the sale (an enforceable contract arising when all contingencies have been removed). In this situation, in addition to providing closing instructions, the escrow instructions constitute a binding contract between the investor and seller, satisfying the *Statute of Frauds*.[10]

Escrow checklist ensures a timely closing

To provide for a timely closing, the agent dictating instructions collects and hands to the escrow officer all of the information necessary to prepare the instructions and documents.

Less diligent agents leave the job of tracking down documents to the escrow officer, limiting the agent's involvement to simply forwarding a copy of the purchase agreement to the named escrow company. However, to enhance the likelihood of a successful closing without surprises, the agent prepares a *checklist* of items and information to gather for the escrow officer. [See **first tuesday** Form 403]

Leaving it up to the escrow officer to glean what needs to be accomplished from the purchase agreement imprudently threatens a timely closing.

9 **Claussen** v. **First American Title Guaranty Co.** (1986) 186 CA3d 429
10 **Amen** v. **Merced County Title Co.** (1962) 58 C2d 528

Generally, the agents in a transaction know more about potential issues which may interfere with closing than the escrow officer at the time instructions are dictated.

As another consideration by agents, an escrow officer does not have an obligation to notify the investor or seller of any suspicious fact or circumstance observed by the officer before the close of escrow, unless the *fact affects closing*.

However, an agent best serves their client by selecting escrow officers who promptly alert the agent to potential problems outside the escrow instructions which become known to the escrow officer.[11]

Modifying escrow instructions

If a dispute between the investor and seller arises over a point not addressed in the underlying purchase agreement or escrow instructions, the agents need to mediate an agreeable solution.

The negotiated resolution then needs to be added to the escrow instructions by amendment and signed by the investor and the seller. Signed amended instructions bind the investor and seller to the terms agreed to in the amended instructions as part of their contractual obligations in the transaction.[12]

Escrow instructions which **modify** the intentions stated or implied in the purchase agreement need to be *written, signed and returned* to escrow by both the investor and seller. Proposed modifications signed by some but not all parties are not binding on a party who has not agreed to the modifications.[13]

Need for clarification

The purchase agreement and escrow instructions work together to ensure the original expectations of the investor and seller are met when the transaction closes.

Before closing escrow, an agent may discover an aspect of the escrow instructions which conflict with the purchase agreement or the expectations of the investor or seller. Here, the agent is duty-bound to immediately bring these discrepancies to the attention of the escrow officer and their client for resolution between the parties.[14]

On notification of an error in the instructions or a need for clarification, the escrow officer holds up the close of escrow until the discrepancy is clarified and corrected escrow instructions have been prepared, signed by the investor and seller, and returned to escrow.[15]

The **amended instructions** reference the purchase agreement as being modified. Once the investor and seller agree on the terms, escrow can proceed toward closing.

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11 **Lee** v. **Title Insurance and Trust Company** (1968) 264 CA2d 160

12 **U.S. Hertz, Inc.** v. **Niobrara Farms** (1974) 41 CA3d 68

13 **Louisan** v. **Vohanan** (1981) 117 CA3d 258

14 **Claussen** v. **First American Title Guaranty Co.** (1986) 186 CA3d 429

15 **Diaz** v. **United California Bank** (1977) 71 CA3d 161

Required escrow disclosures

All written escrow instructions signed by an investor or seller must include:

- the escrow agent's name; and
- the name of the California state agency issuing the license or granting the authority under which the escrow agent is operating.[16] [See **first tuesday** Form 401]

In addition, all escrow transactions for the purchase of real estate where a policy of title insurance will not be issued are to include an **advisory notice** prepared in a separate document and signed by the investor. The notice states:

> "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." [CC §1057.6; see **first tuesday** Form 401-1]

Finally, escrow has a duty to advise the investor in writing of the *Franchise Tax Board (FTB)* requirements for withholding 3 1/3% of the price paid the seller, unless the seller certifies they are exempt from state income tax withholding.[17]

Prorations

On the close of escrow, investors and sellers receive a credit or a charge (debit) for their proportionate share of past due or prepaid income or expenses involved in the ownership or operations of the property being conveyed, called **prorations.**

Prorations are usually calculated based on the date escrow closes. However, they may be set based on any date agreed to by the investor and seller. For calculating prorations based on the date of closing, the entire day of closing is the first day of the investor's ownership, unless the escrow instructions specify otherwise.

proration
Provisions entitling the seller to a credit for the portion of prepaid sums which have not accrued on obligations the investor assumes on the day escrow closes, or entitling the investor to credit for amounts assumed which accrued unpaid through the day prior to the close of escrow. [See **ft** Form 401 §10]

Items which the investor takes over and are prorated include:

- property taxes;
- interest on loans/bonds assumed;
- rent; and
- service contracts assumed by the investor.

Items to be prorated are initially agreed to in the purchase agreement. Proration provisions entitle the seller to a credit for the portion of prepaid sums which have not fully accrued on the day before closing on items the investor takes over or receives on the sale.

16 CC §1057.7
17 Calif. Revenue and Taxation Code §18662(e)(3)(B)

Conversely, the investor receives a credit for unpaid amounts assumed by the investor which accrued through the day prior to the close of escrow. [See **first tuesday** Form 156 §13.7]

For example, property taxes are levied for the fiscal year which begins July 1st and ends June 30th of the following calendar year. To prorate property taxes, the beginning of the fiscal year – July 1st – is the starting point for accrual.

Prorations are based on a 30-day month or a 360-day year.

Property taxes are paid in one or two installments. The first installment is payable no later than December 10th for the first half of the fiscal year. The second payment is due no later than April 10th for the second half of the fiscal year.

For interest on mortgages, improvement district bonds or other debts assumed by the investor, the seller is charged and the investor receives a credit for the interest accrued and unpaid during the seller's ownership of the property through the day before the close of escrow.

Prorations on the purchase of income property

On the purchase of income property, the investor is entitled to a credit for the **prepaid rents** collected by the seller which have not accrued for the remaining days of the month beginning with the day of the close of escrow.

All **security deposits** held by the seller are credited to the investor as a lump sum adjustment, not a proration. After closing, the investor is responsible to account to the tenants for the deposits on termination of their tenancies. [See **first tuesday** Form 585]

The seller is credited for any delinquent unpaid rents which have accrued prior to closing and are to be collected by the investor, unless otherwise agreed in the purchase agreement and escrow is so instructed.

Funds held in escrow on cancellation

good faith deposit
A deposit made by an investor to evidence their good faith intent to buy when making their offer. Also known as earnest money. [See **ft** Form 401 §1.1]

When escrow fails to close, an investor's **good faith deposit** toward the payment of the purchase price of a one-to-four unit residential property is disbursed within 30 days after the person entitled to the funds demands them. If disputed by the other party, the issue becomes who has the right to receive the funds deposited in escrow.[18]

A seller or investor who wrongfully refuses to release the investor's good faith escrow deposit is liable for a money penalty of three times the amount wrongfully withheld, called **treble damages**. *Treble damages* will be greater than $100 but less than $1,000, plus attorney's fees.[19]

Usually the dispute arises on the seller's claim they are entitled to the deposit under a *forfeiture-of-deposit* provision contained in some outdated purchase agreement. However, the seller is not entitled to any of the investor's funds unless the seller has suffered **out-of-pocket money losses** due to a breach by the investor, much different from a forfeiture.

18 CC §1057.3
19 CC §1057.3

Thus, the fully performing seller needs to release the escrowed deposit to a breaching investor, less any out-of-pocket money losses the seller actually incurred due to the investor's breach.

Unless escrow receives mutual instructions to disburse the funds held in escrow when escrow fails to close, the escrow company merely deposits the funds with the court. This relieves escrow of any further responsibility to account for the funds, called an **interpleader**. Thus, escrow can close out its trust account on this escrow file.[20]

Good faith dispute over deposits

Release of deposited funds is not required if a legitimate **good faith dispute** exists between the investor and the seller over entitlement to the funds.[21]

Neither the investor nor seller will be entitled to any penalty or statutory attorney's fees on resolution of a *good faith dispute*.

However, the good faith standard for an individual's refusal to release escrowed funds requires a *reasonable belief* by the individual of their right to the funds.[22]

20 Calif. Code of Civil Procedure §386; **Security Trust & Savings Bank** v. **Carlsen** (1928) 205 C 309
21 CC §1057.3(f)(2)
22 CC §1057.3(c)

Chapter 17 Summary

Escrow is a process employed to facilitate the closing of a transfer of real estate interests by two parties. Escrow activity consists of:

- one person, such as a seller or investor of real estate, who delivers written documents or money to an escrow company for the purpose of fully performing their obligations owed another person under an agreement; and
- the escrow company, who delivers the documents and money to the other person, such as the investor or seller, on the occurrence of an specified event or the performance of prescribed conditions.

The services rendered by escrow agents typically include:

- receiving funds and gathering necessary documents, called instruments;
- preparing documents necessary for conveyancing and mortgaging a property required for escrow to close;
- calculating prorations and adjustments; and
- disbursing funds and transferring documents when all conditions for their release have been met.

Most modern real estate sales transactions depend on both the purchase agreement and the escrow instructions working in tandem to close a transaction. Both the purchase agreement and the escrow instructions must be in writing to be enforceable under the Statute of Frauds.

Agents negotiating a transaction are responsible for ensuring the escrow instructions conform to the purchase agreement and the intent of the parties.

On the close of escrow, investors and sellers receive a credit or a charge for their proportionate share of income or expenses, called prorations. Proration provisions entitle the seller to a credit for the portion of prepaid sums which have not accrued by the day of closing on items the investor takes over or receives on the sale. Conversely, the investor receives a credit for unpaid amounts assumed by the investor which accrued through the day prior to the close of escrow.

When escrow fails to close, a seller or investor who wrongfully refuses to release the investor's good faith escrow deposit is liable for a money penalty of three times the amount wrongfully withheld. Release of deposited funds is not required if a legitimate good faith dispute exists between the investor and the seller over entitlement to the funds.

Chapter 17 Key Terms

Chapter 18

Contracting to assign or double escrow the resale transaction

Learning Objectives

After reading this chapter, you will be able to:

- advise on the assignment of an equity purchase (EP) investor's purchase rights in a property to a substitute buyer, such as an LLC investment group formed by the EP investor;
- help the EP investor structure a concurrent resale by grant deed;
- determine the property disclosures an EP investor is required to provide to a substitute buyer in escrow on the resale of a property in foreclosure; and
- use a release and substitution agreement on an assignment of purchase rights to limit the seller's enforcement of the purchase agreement to performance by the substitute buyer.

Key Terms

double escrow **novation**

Two different methods to contract a flip

An undercapitalized equity purchase (EP) investor locates a residence suitable to buy with the intent to fix it up and immediately locate a buyer and resell the property. However, the investor is not financially able to buy, rehabilitate and carry the costs of ownership until a resale of the property can be closed.

When the investor enters into an agreement to buy the property, they will sell and transfer their right to buy the property to:

- a user who will pay cash to acquire the investor's rights to purchase the property — called **flipping** — and become a *substitute buyer*; or

- a limited liability company (LLC), formed by the EP investor to obtain cash from other investors, to fund the purchase price and carrying costs of ongoing ownership with the intent to close escrow and later resell the property — a capitalization plan called **syndication**.

On the resale of the property to a third-party buyer (not by assignment to their syndicated group), the investor will either:

- **assign** their contract right to purchase the real estate to the **substitute buyer**, also known as the *assignee*, by entering into supplemental escrow instructions with escrow closing in the name of the substitute buyer (as is also accomplished by **syndication**) [See Form 401-2 accompanying this chapter]; or
- transfer their ownership interest using a **grant deed** by entering into a separate purchase agreement and escrow instructions with their buyer and close concurrent with (or after) the closing of the investor's purchase escrow with the seller, a process called **double escrowing** which allows the investor to avoid putting up more money than their **good-faith deposit**. [See Chapter 19]

double escrow
An (EP) investor resale arrangement used to flip a property prior to closing their purchase escrow and acquiring title, by which the investor opens a second escrow for the resale of the property to another buyer.

Assignment provision and vesting

All purchase rights an EP investor holds as a buyer under a purchase agreement entered into with a seller-in-foreclosure can be assigned, unless restricted by a provision in the purchase agreement.

Further, an assignment is barred when any personal performance promised by the investor under the purchase agreement will differ if it is to be performed by the substitute buyer (the assignee). This occurs with **carryback financing arrangements** requiring the buyer to meet the same standards of creditworthiness and care of property the seller can reasonable expect of the investor.[1]

Nor may a seller refuse to cooperate with an investor's assignment of their purchase rights to a title *warehousing agent* so the investor can complete a reverse Internal Revenue Code §1031 transaction, called a *parking transaction* by the Internal Revenue Service (IRS). The warehousing agent is not a substitute buyer, but a middleman or straw man who holds title and will deed the property to the investor at a later date.[2]

Further, when the purchase agreement states the investor's purchase rights are assignable, the seller cannot require the original buyer — the investor — to close escrow and take title in their name instead of in the name of a substitute buyer by assignment.

To put the seller on notice of the investor's right to assign their purchase rights to a substitute buyer who will close escrow under the purchase agreement, the vesting provisions in the purchase agreement call for the conveyance of title by the seller to be insured in the name of the *buyer or assignee*. [See **first tuesday** Form 156 §13.5]

1 Calif. Civil Code §1457; **Masterson** v. **Sine** (1968) 68 C2d 222
2 **Nicholson** v. **Barab** (1991) 233 CA3d 1671

Form 401-2

Assignment of Purchase Rights

Page 1 of 2

ASSIGNMENT OF PURCHASE RIGHTS

Supplemental Escrow Instructions

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

DATE: ________, 20____, at ________________________, California.

Items left blank or unchecked are not applicable.

TO: ________________________
(Escrow holder)
____
(Address)
____

1. This assignment, assumption and supplemental instructions pertain to
   - 1.1 your escrow number ________________________,
   - 1.2 entered into by ________________________, as the Seller, and ________________________, as the Buyer
   - 1.3 dated ________, 20____, at ________________________, California,
   - 1.4 regarding real estate referred to as ________________________ ________________________.
2. Buyer ________________________, as the Assignor, hereby assigns to ________________________, as the Assignee, all of Assignor's interest in the following:
   - 2.1 the property referenced above;
   - 2.2 the above referenced escrow and any funds deposited by Assignor in escrow; and
   - 2.3 An underlying agreement pertaining to Assignor's acquisition of the property entitled: ☐ Purchase agreement, ☐ Purchase option, ☐ Exchange agreement, ☐ ____________,
     - a. dated ________, 20____, at ________________________, California,
     - b. entered into by ________________________, as the ____________, and ________________________, as the ____________.
3. Assignor, as consideration for this assignment, is to receive the sum of ________________________.
   - 3.1 Consideration is to be delivered ☐ outside of escrow, or ☐ through this escrow on the occurrence of (enter condition for payment) ________________________ ________________________.
4. Assignee hereby assumes and agrees to perform all obligations of Buyer acquiring the property under your instructions and the above referenced underlying agreement for the acquisition of the property.
5. Assignee acknowledges receipt of the following items:
   - 5.1 your escrow instructions consisting of (identify each separate instruction signed by Buyer): ________________________ ________________________;
   - 5.2 the underlying acquisition agreement referenced above;
   - 5.3 property disclosures, delivered to Assignor by the owner of the property, consisting of (identify each by its name and date): ________________________ ________________________;
   - 5.4 property disclosures prepared by Assignor or third parties for Assignor consisting of (identify each by its name and date): ________________________ ________________________.

—— PAGE ONE OF TWO — FORM 401-2 ——

Having agreed in the purchase agreement that title may be vested by assignment in the name of a substitute buyer, the seller is obligated to cooperate in good faith by signing closing instructions and transfer documents so title can be conveyed to and escrow closed in the name of the substitute buyer.

Form 401-2

Assignment of Purchase Rights

Page 2 of 2

PAGE TWO OF TWO — FORM 401-2

6. You are authorized and instructed to:
   6.1 Prepare a grant deed from ______________________________,
   showing the grantee vesting as ______________________________.
   6.2 Other ______________________________

I agree to the terms stated above.
☐ See attached Signature Page Addendum. [ft Form 251]
Date: ____________, 20_____
Assignor's name: ______________________________
Signature: ______________________________
Assignor's name: ______________________________
Signature: ______________________________

I agree to the terms stated above.
☐ See attached Signature Page Addendum. [ft Form 251]
Date: ____________, 20_____
Assignee's name: ______________________________
Signature: ______________________________
Assignee's name: ______________________________
Signature: ______________________________

7. Seller hereby releases the original buyer(s) from all obligation under the escrow instructions and underlying acquisition agreement.
8. Seller consents to this assignment and accepts Assignee as the substitute buyer in these instructions and underlying acquisition agreement.

I agree to the terms stated above.
☐ See attached Signature Page Addendum. [ft Form 251]
Date: ____________, 20_____
Seller's name: ______________________________
Signature: ______________________________
Seller's name: ______________________________
Signature: ______________________________

FORM 401-2 03-11

Having entered into a purchase agreement with a provision that imposes a duty on the seller to cooperate in an assignment, the investor then:

- seeks out and locates a substitute buyer;
- negotiates the amount he is to be paid for the sale of their right to purchase the property; and
- enters into an agreement to sell and assign their right to buy the property under the purchase agreement and escrow instructions they entered into with the seller.

The resale by assignment

Documentation of the investor's **assignment** of their contract right to purchase a property is best handled through escrow as supplemental escrow instructions. [See Form 401-2]

An investor, by an *assignment*, transfers all of their purchase rights to the substitute buyer, called the **assignee.** The assignment is given in exchange for a promise to pay the investor a sum of money due on entering into the assignment or at the time escrow closes. [See Form 401-2§2]

The substitute buyer accepting the assignment agrees to fully perform all of the investor's obligations under the purchase agreement and escrow instructions. By the assignment, the substitute buyer takes legal responsibility for the investor's contract obligations delegated to the substitute buyer, an activity called an **assumption**. [See Form 401-2§4]

By the investor assigning their purchase rights, the substitute buyer "steps into the shoes" of the investor and becomes the buyer. Having been assigned all the rights to purchase the property, the substitute buyer may enforce the purchase agreement in their name and require the seller to close escrow by conveying the property to the substitute buyer.[3]

Obligations assumed

The substitute buyer, on accepting the assignment in escrow, **assumes** all of the investor's obligations under the purchase agreement and escrow instructions. On elimination of all contingencies, approval of disclosures and waiver of other rights to cancel, the substitute buyer needs to perform by paying the purchase price and closing escrow on the transaction. If not, they are liable for any money losses incurred by the seller for wrongfully failing to close escrow.[4]

The substitute buyer who fails to close escrow without legal excuse or justification, called a **breach**, is also liable to the investor under the assumption provisions in the assignment for losses the investor may incur due to the breach.

The investor may incur money losses if the seller pursues the investor for money losses or specific performance on the breach, unless a release of liability was entered into by the seller and the investor at the time of the assignment. This **release and substitution agreement** requires the seller to look solely to the substitute buyer for performance of the purchase agreement and escrow, an arrangement called a **novation**.[5] [See Form 401-2 §7 and 8]

novation
An agreement entered into by a mortgage holder, equity purchase (EP) investor and seller to shift responsibility for a mortgage obligation to the investor by an assumption and release the seller of liability.

To comply with escrow instructions after the assignment of the investor's purchase rights, escrow prepares all closing documents in the name of the substitute buyer. Closing documents include:

- deeds;
- carryback notes and trust deeds;
- closing instructions and statements;
- approvals and assumptions of any existing loans;
- title insurance; and
- clearance of any other items necessary for escrow to close.

3 **San Francisco Hotel Co.** v. **Baior** (1961) 189 CA2d 206
4 **Fanning** v. **Yoland Productions, Inc.** (1957) 150 CA2d 444; CC §1589
5 **Bank of America National Trust and Savings Assoc.** v. **McLaughlin** (1957) 152 CA2d Supp. 911; **Gates** v. **Quong** (1906) 3 CA 443

A separate resale by grant deed

An investor flipping a property may not want to disclose to a substitute buyer the purchase price the investor is paying for the property and thus their earnings on the flip. Also, the seller might refuse (wrongfully) to cooperate and allow escrow to close in the name of the substitute buyer when asked to comply with the investor's assignment of their purchase rights. Worse, the seller may feel they are entitled to the investor's quick profit.

Instead of **assigning** their purchase rights under the purchase agreement and escrow instructions to a substitute buyer the investor has located, the investor can simply **resell** the real estate, whether or not the investor has acquired title in their name. In some counties, the resale will be additionally taxed on recording the second grant deed, a tax the assignment avoids. Also, there is the issue of the Franchise Tax Board (FTB) withholding 3% of the price on the resale, which causes investors to incorporate and report as an "S" corporation to avoid FTB withholding on the resale.

On the investor's resale of the property, the investor and their perspective buyer will enter into an entirely **new purchase agreement** and set of escrow instructions, separate from the investor's contracts with the seller.

In the context of a resale, the investor undertakes the duties a seller owes a buyer to make all the **disclosures** required of a seller of real estate. The investor may use the disclosures they received from the seller, noting any additional or contrary information known to them.[6]

New purchase agreement; separate escrow

A **separate escrow** will be opened for the resale that will be funded by the resale buyer and any purchase-assist mortgage lender. The escrow company handling the investor's purchase is typically also used to escrow the resale for convenience and reduced escrow charges, and if a concurrent closing, the transfer of funds.

The investor's purchase escrow with the seller and the separate resale escrow opened with the substitute buyer may close concurrently, or the closings may be separated in time. The closing of the resale escrow needs to be contingent on the close of the investor's purchase escrow with the seller. The investor's **net sales proceeds** from their resale escrow will be the source of the funds they will use to close their purchase escrow if both escrows are to close concurrently.

Through this legitimate *double-escrow process*, two grant deeds will be recorded — one from the seller to the investor who, in turn, will further convey the property by grant deed to the resale buyer in this variety of a flip.

Only one **title insurance** policy will be issued if the closings are concurrent, and one set of loan assumptions or loan origination documents will be completed — all in the name of the substitute buyer. If the investor's purchase escrow closes first, a *binder* form title policy needs to be purchased at a 10% premium. Under a **binder**, a policy of title insurance will be issued in the name of the **substitute** buyer when the resale escrow on the flip is closed.

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6 **Shapiro** v. **Sutherland** (1998) CA4th 1534

A **seller-in-foreclosure** has a two-year right of rescission when investor misconduct exists under the EP statutes. On an **assignment** of the investor's purchase rights, the seller retains their **rescission rights** against the substitute buyer since the right to rescind arose under the contract taken over by the substitute buyer. [See Chapter 4]

However, if the investor conveys the real estate to a third-party buyer flipping it in a separate *arms-length* resale, the buyer is a **bona fide purchaser (BFP)** exempt from the seller's two-year right of rescission under EP law — even if the resale buyer knows the property is in foreclosure.

Disclosures on a resale

The EP investor offering to sell a one-to-four unit residential property makes a full disclosure of:

- the property's physical, operating, and title conditions; and
- the natural and environmental hazards on or surrounding the property. [See **first tuesday** Form 304 and 314]

The substitute buyer on an assignment of the EP investor's right to buy the property receives copies of:

- the purchase agreement;
- escrow instructions; and
- all disclosures received by the EP investor from their seller.

On agreeing to the assignment, the substitute buyer acknowledges receipt of the documents delivered to them by the EP investor. [See Form 401-2 §5]

Who is liable for the TDS?

Consider the seller of a one-to-four unit residential property who agrees to sell the property to an investor. The investor intends to flip the property by:

- selling and assigning their contract position in escrow; or
- selling the further deeding the property in a separately escrowed sales transaction. [See **first tuesday** Form 156 §13.5]

The seller hands the EP investor a **transfer disclosure statement (TDS)**, also known as a *condition of property disclosure*. The TDS does not disclose night-time noise conditions known to the seller, but not the EP investor. [See **first tuesday** Form 304]

The EP investor locates a buyer prior to closing. The buyer is handed the seller's condition of property disclosure statement, along with all the property disclosures the EP investor has received.

On closing escrow and occupying the residence, the buyer discovers the undisclosed noise condition. Due to the noise, the price paid for the property exceeds its value, a loss suffered by the buyer.

The buyer makes a demand on the seller who prepared and signed the TDS for the loss, not the EP investor who assigned their purchase rights.

The buyer claims they are entitled to recover the loss from the seller since the seller intended, by including an assignment provision in their purchase agreement with the EP investor, that their TDS be relied on by a buyer other than the EP investor.

The seller claims they owed no duty to the EP investor's buyer since the seller did not contract to sell the property to the buyer, only to the EP investor.

However, the seller contracted with the EP investor without restricting the EP investor's right to assign the purchase rights created by entering into the purchase agreement. Thus, the seller is liable for the buyer's lost value due to the seller's nondisclosure of the noise in the TDS. The seller *knew or ought to have known* the TDS was to be relied on by a buyer the EP investor located and who acquired the EP investor's purchase rights by an assignment or by grant deed.[7]

Carryback transactions

Consider an EP agreement that calls for the seller-in-foreclosure to carry back a portion of their equity in a note and trust deed.

The agreement provides for an assignment noting title is to be vested in the buyer or "assignee." [See **first tuesday** Form 156 §13.5]

Prior to the close of escrow, the EP investor assigns their right to purchase the real estate to a substitute buyer. However, the seller refuses to carry back a note and trust deed to be executed and paid by the substitute buyer.

Is the seller obligated to extend credit to the substitute buyer in the form of a carryback note and trust deed?

Maybe not! A standard of reasonableness applies to any refusal of the seller to cooperate with the EP investor's assignment of their purchase rights to a substitute buyer unless it has been agreed the carryback trust deed includes a due-on clause.

The seller is at liberty to refuse to permit the substitute buyer to undertake the **personal obligation** of executing and performing on a carryback note and trust deed if the substitute buyer:

- is not equally or more creditworthy than the EP investor; or
- is potentially a person who might mismanage the property under their ownership.[8]

Same standard of creditworthiness and maintenance

The carryback seller may require the substitute buyer to meet the same standards of creditworthiness (performance on the note) and property maintenance (performance under the trust deed) required of the EP investor who was accepted as the buyer on entering into the purchase agreement.

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7 **Shapiro** v. **Sutherland** (1998) 64 CA4th 1534

8 **Madison** v. **Moon** (1957) 148 CA2d 135

When a purchase agreement imposes obligations on the buyer to only perform activities of a *non-personal nature*, an assignment of acquisition rights may be enforced by the substitute buyer.

For example, a purchase agreement provides for the buyer to pay cash for the seller's equity in a property. The balance of the price is to be paid by a loan assumption or funded by a purchase-assist loan taken out by the EP investor. Here, an assignment of the buyer's purchase rights may be enforced by the substitute buyer without the seller's consent.[9]

Also, a seller is required to cooperate in the investor's assignment of their purchase rights to a title warehousing agent employed to facilitate a reverse IRC §1031 transaction, called a **parking transaction** by the IRS. The warehousing agent is not a substitute buyer, but a middleman who merely holds title and deeds the property on to the EP investor at a later date.[10]

Release of liability

When obtaining the seller's consent on assigning the purchase rights and obligations under an EP agreement to a substitute buyer, the EP investor needs to also ask for a *release* from the seller of the EP investor's obligations under the EP agreement and escrow instructions.[11]

A **release and substitution agreement** requires the seller to look solely to the substitute buyer for performance of the purchase agreement and escrow, an arrangement called a **novation**.[12]

9 **King** v. **Stanley** (1948) 32 C2d 584
10 **Nicholson** v. **Barab** (1991) 233 CA3d 1671
11 CC **§1530; see Form 401-2 §§7 and 8**
12 **Gates** v. **Quong** (1906) 3 CA 443

Chapter 18 Summary

An equity purchase (EP) investor is able to sell or exchange their purchase rights to:

- a user who will pay cash to acquire the investor's rights to purchase the property and become a substitute buyer, called flipping; or
- a limited liability company (LLC), formed by the EP Investor to obtain cash from investors, to fund the purchase price and carrying costs of ongoing ownership with the intent to close escrow and later resell the property, called syndication.

When the purchase agreement states the buyer's purchase rights are assignable, no limitation exists allowing the seller to require the original buyer to close escrow in their name without assignment.

To put the seller on notice of the EP investor's right to assign their purchase rights to a substitute buyer who is committed to perform under the purchase agreement and close escrow, the vesting provisions in the purchase agreement call for the conveyance of title by the seller to be insured in the name of the buyer or assignee.

Alternatively, instead of assigning their purchase rights under the EP agreement and escrow instructions to a substitute buyer, the EP investor is able to simply resell the real estate. On the EP investor's resale of the property, the EP investor and their prospective buyer enter into an entirely new purchase agreement and escrow instructions, separate from the EP investor's contract with the seller.

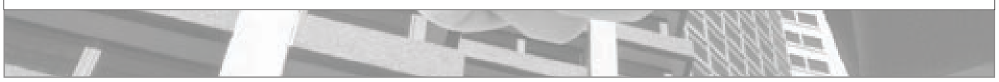
When an EP agreement that calls for the seller-in-foreclosure to carry back a portion of their equity in a note and trust deed, the seller is at liberty to refuse to permit the substitute buyer to undertake the personal obligation of executing and performing on a carryback note and trust deed if the substitute buyer:

- is not equally or more creditworthy than the EP investor; or
- is potentially a person who might mismanage the property under their ownership.

Chapter 18 Key Terms

Chapter 19

Syndicating the equity purchase



Learning Objectives

After reading this chapter, you will be able to:

- distinguish between syndicated activities containing a security risk and those that only present an economic marketplace risk;
- recognize a blind pool investment program as a securities risk when syndicating the acquisition of yet-to-be-located real estate;
- comply with the nonpublic exemption rules when forming a group investment to avoid regulatory activity governing corporate securities; and
- exercise the additional contributions provision in the limited liability company (LLC) operating agreement to request funds from each member to cover deficits in cash flow and reserves.

Key Terms

additional contributions provision

blind pool investment program

syndicator

Blind pool funding and property selection

The purchase of a seller-occupied residence in foreclosure is typically negotiated in mere hours and closed within days. Thus, the availability of purchase funds is needed at the outset of negotiations.

Consider a **syndicator,** typically a broker or agent, who forms small investment groups to buy property.

The syndicator solicits commitments for cash contribution or receives funds from investors before locating the real estate their funds will be used to acquire. This arrangement is called a **blind pool investment program**. The syndicator is given what is essentially a "blank check" by the investors to later locate, analyze, and disburse their funds to acquire property the syndicator deems suitable for the group.

syndicator
An individual who solicits cash contributions from investors to fund a limited liability company to acquire real estate for investment purposes.

Before the syndicator accept funds promised to be contributed by investors in the venture, the syndicator forms a **limited liability company (LLC)** entity naming the syndicator as the managing member. Bank accounts are opened in the name of the LLC and the LLC-1 formation document is recorded in the county.

Once funds have been gathered and deposited in the LLC's bank account, the syndicator locates a seller-occupied one-to-four unit residential property in foreclosure which conforms to the syndicator's investment purposes. An **equity purchase (EP) agreement** is entered into with the seller in the name of the syndicator as the buyer. [See **first tuesday** Form 156]

Escrow is opened on expiration of the seller's five-business-day cancellation period, the seller not having exercised their right to cancel the transaction.

The syndicator concurrently *assigns* their purchase rights created as a buyer under the purchase agreement to the LLC holding the investor's funds. The LLC becomes the **substitute buyer** in escrow under the assignment from the syndicator to the LLC, the syndicator no longer being the buyer. [See Chapter 18; and **first tuesday** Form 370]

Typically, after locating property, negotiating the EP purchase agreement and prior to closing, the syndicator does not have sufficient time to complete all steps needed to eliminate security risks before soliciting funds to acquire the selected real estate, activities such as:

- creating an investment circular;
- preparing the LLC documents;
- locating investors; and
- funding acquisition of the investment.

Creating a securities risk

In a *blind pool investment program*, after some or all of the group members fund the LLC, the syndicator:

- locates and selects the property to be acquired;
- negotiates the terms for purchase of the property;
- arranges mortgage financing;
- uses investor LLC contributions to fund the close of escrow; and
- rehabilitates and manages the property for immediate resale or as a rental.

blind pool investment program
The solicitation or receipt of investor contributions in a group investment program before the syndicator identifies and discloses the real estate the investors' funds will be used to acquire.

Here, the investors hand over their capital to the syndicator before the investment property is selected. In this instance, the *risk of loss* they are exposed to is controlled by the securities law, not the economics of the real estate market. The investors on funding the investment program take on the securities risk of loss when they rely entirely on the investment expertise of the syndicator to later select a suitable property of sufficient value and quality for the placement of their investment funds. Thus, a **corporate securities risk** has been created.[1]

Having created a **securities risk** in the form of a blind pool investment program, the syndicator's conduct is controlled by the securities laws and the syndicator needs to:

- avoid the creation of a *public offering*; and
- *minimize the risk of loss* by undertaking the duty to make a full disclosure of the investment when the property selected for investment is acquired. [See Form 365 accompanying this chapter]

A closely knit group

The **blind pool** syndicator, having created a securities risk, avoids California regulatory activity governing corporate securities by refraining from offering the investment program to the public, called a **nonpublic exemption** or **private offering exemption**.

To comply with the *nonpublic exemption* rules when forming a group investment presenting a securities risk, the program is to:

- include no more than 35 members (a husband and wife being one member);
- acquire only members who have a deep-rooted, **pre-existing** personal or business relationship with the syndicator, or be **sophisticated investors** with prior experience in similar investments;
- require each member to agree they are purchasing their interest in the LLC for their own account and not for resale; and
- solicit no member from the public by *advertisement*.[2]

The blind pool syndicator who fails to comply with all elements of the *private offering exemption* needs to qualify and obtain a securities permit from the Department of Corporation before accepting funds from members — no matter how the members are solicited.[3]

Assessable LLC interests

In an EP investment program, the property acquired is often intended to be held for immediate resale, the flip situation with the purpose of a quick profit. However, if the *price-to-income ratios* for the property are fundamentally sound, the property, as an alternative to flipping, might be retained as a rental for long-term investment.

If intended for immediate resale, the members of the EP investment program do not expect to receive spendable income from any rental operations during the short period of ownership and maintenance prior to flipping it to another buyer. Specifically, the members need to expect a **negative cash flow** situation until the property acquired is resold. For this contingency, cash reserves are maintained in the LLC account.

1 **Underhill** v. **Royal** (1985) 769 F2d 1426
2 Calif. Corporations Code §25102(f)
3 **People** v. **Humphreys** (1970) 4 CA3d 693

Figure 1

Excerpt from Form 372-2

Operating Agreement

2. CAPITAL CONTRIBUTIONS AND DISTRIBUTIONS OF FUNDS:
   2.1 Capital Contributions: The Limited Liability Company's capital shall be: ________________________________ dollars ($______________) as set forth in Exhibit "A".
   a. Use of Contributions and Dissolution: The LLC will be funded prior to the selection and purchase of the property. Should the LLC be unsuccessful in acquiring property, the Manager may refund the capital contributed, less any expenditures made by the LLC toward the unsuccessful acquisition of property.
   b. Additional Contributions: Additional contributions in the aggregate sum not to exceed $______________ may be required from time to time of the Class "A" member(s) on thirty (30) days' written notice from the Manager. If a member does not deliver up his share of the additional contribution within thirty (30) days of receipt of the notice, the Manager may elect to terminate the member under Section 6 of this agreement.

additional contributions provision
A provision in the limited liability company (LLC) operating agreement authorizing the member manager to request additional capital contributions from the contributing members when operating conditions produce a cash operating deficit. [See **ft** Form 372-2 §2.1b]

Further, an EP investment program has the potential to incur unforeseen *rehabilitation expenses* or *carrying costs* beyond those anticipated by the syndicator. These expenses can quickly exhaust the reserve fund initially established for ongoing LLC ownership and operating expenses.

To provide for the continuing solvency of the investment program, an **additional contributions provision** is included in the LLC operating agreement. The *additional contributions provision* enables the syndicator to periodically request additional capital contributions from the members if the EP investment program is confronted with a deficit cash flow during the ownership of the property.

Use of the additional contributions provision

The EP syndicator exercises their authority to raise money under an additional contributions provision by giving written notice to the members of the amount of funds each member is to additionally contribute to cover deficits in cash flow and reserves. The members may either comply with the request or face the agreed-to termination or participation limitations for failure to meet the call. [See Figure 1 accompanying this chapter]

Thus, the financial sanctions encourage members to make additional contributions to keep the LLC solvent.

The members have the option of rejecting the contribution request and accepting the sanctions as a consequence. The EP syndicator on a call for funds may not force non-contributing members to advance the additional contributions.

Each member is to make a sober business decision — whether to subject their interest to termination or limitations, or to invest more to carry on with their original investment. This is sometimes considered a "good-money-after-bad-money" analysis. Essentially, the LLC is being recapitalized to stay solvent.

But the dilemma, while troublesome, does not affect the member's limited liability status.

The additional contributions provision, triggered by the EP syndicator's call for funds, is not a promise to pay. The member has already contributed the amount required to become a member. Each member now has a choice to make. The member is left to either:

- increase the amount of their original contribution to the LLC; or

ESTIMATED PROFIT ON RESALE

Property Acquired for Immediate Disposition

Prepared by: Agent________________ | Phone________________
Broker________________ | Email________________

DATE: ____________ 20_____, prepared by ________________________________,

Property description ____

Title to be acquired on ____________, 20_____. Date of anticipated resale ____________, 20_____.

ESTIMATES:

1. Fair Market Value (estimated as of date of purchase) . . . . $____________
2. Encumbrances:
   - 2.1 First trust deed . . . . $____________
   - 2.2 Second trust deed . . . . $____________
   - 2.3 Other liens/encumbrances . . . . $____________
   - 2.4 **TOTAL encumbrances** $0.00
3. Acquisition/Fix-up Costs:
   - 3.1 Cash to Seller . . . . $____________
   - 3.2 Loan reinstatement . . . . $____________
   - 3.3 Loan assumption fees . . . . $____________
   - 3.4 Broker's fees . . . . $____________
   - 3.5 Legal fees . . . . $____________
   - 3.6 Escrow closing costs . . . . $____________
   - 3.7 Fix-up/rehabilitation costs . . . . $____________
   - 3.8 Other ________________ . . . $____________
   - 3.9 **TOTAL acquisition costs** . . . . $ 0.00
4. Carrying Costs (until anticipated resale date):
   - 4.1 Loan payments . . . . $____________ for ______ months.
   - 4.2 HOA assessments . . . . $____________ for ______ months.
   - 4.3 Property taxes due . . . . $____________
   - 4.4 Hazard/bond insurance premium . . . . $____________
   - 4.5 Utilities . . . . $____________
   - 4.6 Accounting/legal fees . . . . $____________
   - 4.7 Management fees . . . . $____________
   - 4.8 Maintenance/upkeep . . . . $____________
   - 4.9 Repair/replacements . . . . $____________
   - 4.10 Lawn/gardening . . . . $____________
   - 4.11 Other ________________ . . . $____________
   - 4.12 **TOTAL carrying costs** . . . . $ 0.00
5. Resale Expenses:
   - 5.1 Title insurance . . . . $____________
   - 5.2 Escrow fees/charges . . . . $____________
   - 5.3 Documentary stamps . . . . $____________
   - 5.4 Termite inspection/repairs . . . . $____________
   - 5.5 Loan prepayment penalty . . . . $____________
   - 5.6 Loan reconveyance fee . . . . $____________
   - 5.7 Beneficiary statement . . . . $____________
   - 5.8 Points (FHA-VA) _____% . . . . $____________
   - 5.9 Broker's fees _____% . . . . $____________
   - 5.10 **TOTAL resale expenses** $0.00
6. **Expenditure to buy, own and sell** (Sum of lines 2,3,4 and 5) $0.00
7. **Estimated net resale profit** (Line 1 minus line 6) $0.00

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Form 365

Estimated Profit on Resale

- risk the buy-out consequences or limitations for refusing to meet the call.

Thus, a member does not breach the LLC operating agreement by failing to contribute the additional money — the member simply exercises their **option** not to make **future contributions** as agreed in the operating agreement. [See Figure 1]

Provisions for EP syndication

The EP syndicator discloses the existence and risks of the blind pool funding through provisions in the:

- LLC *operating agreement* [See **first tuesday** Form 372]; and
- *investment circular* (marketing package). [See **first tuesday** Form 371]

The EP provisions are designed for use in California. However, no two sets of syndication circumstances are identical. The formulas and arrangements members agree to will, by necessity, vary from transaction to transaction.

Accordingly, **legal counsel** is recommended to advise on the necessary adjustments to wording in the operating agreement so it conforms to the specific facts of each EP syndicator's program. Advisors lend the experience they develop advising others on syndication programs. A template of an operating agreement accompanies the **Forming Real Estate Syndicates** text published by **first tuesday.** It is intended for use as a basis for seeking personal advice from the reader's legal counsel.

*Editor's note – **first tuesday** publishes a customizable and editable version of the LLC operating agreement and investment circular, Form 372-1 and 371-1, respectively.*

Chapter 19 Summary

A syndicator is an individual who solicits cash contributions from investors to fund a limited liability company (LLC) with cash to acquire real estate for investment purposes. An equity purchase (EP) agreement is entered into with the seller in the name of the syndicator as the buyer.

The syndicator concurrently assigns their purchase rights created as a buyer under the purchase agreement to the LLC holding the investor's funds.

In a blind pool investment program, after some or all of the group members fund the LLC, the syndicator:

- locates and selects the property to be acquired;
- negotiates the terms for purchase of the property;
- arranges financing;
- uses investor contributions to fund the close of escrow; and
- rehabilitates and manages the property for immediate resale or as a rental.

An EP investment program potentially incurs unforeseen rehabilitation expenses or carrying costs beyond those anticipated by the syndicator.

To provide for the solvency of the investment program, an additional contributions provision is included in the LLC operating agreement. The additional contributions provision enables the syndicator to periodically request additional capital contributions from the members if the EP investment program faces a deficit cash flow during the ownership of the property.

Chapter 19 Key Terms

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Chapter 20

Beneficiary statements and payoff demands

Learning Objectives

After reading this chapter, you will be able to:

- use beneficiary statements and payoff demands in sales transactions and mortgage originations;
- understand the procedures and timelines for a mortgage holder's delivery of a requested beneficiary statement or payoff demand based on the characteristics of the mortgage; and
- explain the remedies available when a mortgage holder makes an error in the preparation of a beneficiary statement or payoff demand.

Key Terms

beneficiary statement
guarantor
nonrecourse mortgage
novation
payoff demand statement
unsecured debt

Confirming loan conditions

A **beneficiary statement** is a written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a note. In a mortgage, the debt is secured by a trust deed lien on real estate described in the trust deed. [See Form 415 accompanying this chapter]

A complete *beneficiary statement* includes information and data regarding:

- the amount of the *unpaid balance*;
- the *interest rate* of the debt;
- the total of all *overdue payments* of principal and/or interest;
- the amounts of any *periodic payments*;
- the *due date* for final/balloon payoff of the debt;

beneficiary statement
A document issued by a mortgage holder on request noting future payment schedules, interest rates and balances on a mortgage. [See **ft** Form 415]

- the date to which *real estate taxes* and special assessments have been paid, if known;
- the amount of *hazard insurance* and its term and premium, if known;
- any *impound* balance reserve for the payment of taxes and insurance;
- the amount of any *additional charges* incurred by the beneficiary that have become part of the mortgage; and
- whether it is possible for the mortgage to be *assumed* by a new owner (added following federal deregulation of lenders in 1982).[1]

On **adjustable rate mortgages (ARMs)**, the beneficiary statement is to list the **note rate** as variable. The statement will further reference and attach a copy of the note containing the formula for adjustments in interest and payments.

Adjustable rate **consumer mortgages,** those consumer-purpose loans secured by the borrower's principal residence, require extensive disclosures of rate adjustment formulas, schedules and maximum periodic and lifetime increases. These disclosures are separate from any beneficiary statement requested by a borrower or successor.[2]

Assumption by buyer-occupant

Additionally, in the event of the **assumption** of a consumer mortgage by a buyer-occupant, **Regulation Z (Reg Z)** requires the mortgage holder to make new disclosures to the assuming buyer based on the remaining unpaid mortgage balance. These disclosures are to include:

- the unpaid mortgage balance being assumed;
- the total amount of any charges assessed by the mortgage holder as a condition to the assumption;
- the original annual percentage rate; and
- the repayment schedule and total payment amounts due on the remaining balance.[3]

Formulas for ARM adjustments and payment options vary extensively from mortgage to mortgage. Thus, the seller or buyer relying on the beneficiary statement for an ARM needs greater detail than the current interest rate and payment amount. To that end the mortgage holder *attaches a copy* of the ARM note to the beneficiary statement for full disclosure of the index used to calculate the periodic adjustments with the margin which comprises the note rate.

Lender response time to a request

A written request for a beneficiary statement needs to be made by an **entitled person** before the mortgage holder is required to respond. An *entitled person* includes:

- the **original borrower** (property owner) on the mortgage;

1 Calif. Civil Code §2943(a)(2)
2 12 Code of Federal Regulations §1026.19(b)
3 12 CFR §1026.20(b)(1)-(5)

- the **successor-in-interest** (new property owner) to the original borrower; or
- an **authorized agent** of either, such as a real estate broker, attorney or escrow agent.[4]

The holder of any type of mortgage is required to prepare and deliver a beneficiary statement within 21 days of the receipt of the written request from an entitled person.[5]

The mortgage holder's *intentional failure* to send the statement within 21 days of receipt of request results in the mortgage holder's $300 forfeiture to the person making the request. Also, the mortgage holder is liable for all money losses resulting from its intentional failure to comply.[6]

However, the mortgage holder's failure to timely deliver the statement must be proven to be an intentional failure without legal excuse before the entitled person making the request may recover a penalty — a difficult task.

Editor's note — Before deregulation, mere administrative failure to send the beneficiary statement within the 21-day period resulted in an automatic forfeiture of $300 by the mortgage holder.[7]

The request for a beneficiary statement may be made before or up to two months after a *Notice of Default (NOD)* is recorded.[8]

The mortgage holder is permitted to charge no more than $30 for each beneficiary statement requested, with the exception of mortgages insured by the **Federal Housing Administration (FHA)** or the **Department of Veterans Affairs (VA)**. Occasionally, the mortgage terms state a lesser amount that controls the beneficiary statement charge.[9]

Payoff demand

A **payoff demand statement** is a mortgage beneficiary's written claim for the total dollar amount remaining on the date of preparation to pay off the mortgage and record a reconveyance of the property from the trust deed lien.

The *payoff demand statement* also includes information and formulas for escrow to calculate the total payoff amount due after the date the demand is prepared, to include **per diem interest** accruing until payoff funds are received. The statement is valid for up to 30 days unless the mortgage terms change, such as occurs with ARMs.[10]

payoff demand statement
A written demand, prepared by a mortgage holder, for the total dollar amount required on the date of preparation to pay off the mortgage as a requisite for recording a reconveyance of their trust deed lien on a property.

Unlike beneficiary statements, which are required to be delivered within 21 days of receipt of a request from an entitled person, delivery timelines for payoff statements vary depending on the type of mortgage. For **business**

4 CC §2943(a)(4)
5 CC §§2943(b)(1), 2943(e)(6)
6 CC §2943(e)(4)
7 **Anderson** v. **Heart Federal Savings** (1989) 208 CA3d 202
8 CC §2943(b)(2)
9 CC §2943(e)(6)
10 CC §2943(a)(5)

mortgages, the payoff demand—like the beneficiary statement—is required to be delivered *within 21 days of receipt* of a written request from an entitled person.[11]

For **consumer mortgages** other than *Section 32 high-cost mortgages*, the maximum timeframe for delivery is *within seven days of receipt* of a written request from either:

- the borrower; or
- a person acting on behalf of the borrower, such as an attorney, consumer credit counselor or refinancing lender.[12]

If the consumer mortgage is a **Section 32 high-cost mortgage**, the payoff statement delivery timeframe is limited to *five business days*.[13]

Again, as with the beneficiary statement, the charge for the preparation and delivery of a payoff demand is limited to $30, unless the loan is insured by the FHA or VA. Additionally, a Section 32 mortgage holder is not permitted to charge a fee for the payoff statement, but is permitted to charge a *processing fee* to pay for fax or courier delivery as long as it is disclosed to the borrower that a no-fee delivery is also available.[14]

As with the beneficiary statement, the mortgage holder's intentional failure to timely reply without legal excuse results in the forfeiture of $300 and liability to the person making the request for any resulting money losses.[15]

The request for a statement

Unless an entitled person, such as an **owner-in-foreclosure**, *specifically requests* a beneficiary statement by name, a mortgage holder only needs to send a payoff demand statement.[16]

The request for either statement is written and sent to the mortgage holder at the address given in the payment notice or payment book.[17]

Before delivering the beneficiary statement or payoff demand, the mortgage holder is permitted to require proof the request is being made by an entitled person. For example, the mortgage holder is entitled to require:

- evidence of ownership; or
- written authority as an agent of the owner.

The written request by escrow needs to be accompanied by the escrow's written authorization from the owner to order out a beneficiary statement.[18]

If a request for either a beneficiary statement or a payoff demand includes a request for a copy of the trust deed, the mortgage holder is to supply a copy

11 CC §2943 (b)(1)
12 12 CFR §1026.36(c)(3); Supplement I to §1026.36(c)(3)
13 12 CFR §1026.34(a)(9)(i), (ii), (v)
14 CC §§2943(c); 2943(e)(6); 12 CFR §1026.34(a)(9)(v)
15 CC §2943(e)(4)
16 CC §2943(e)(1)
17 CC §2943(e)(5)
18 CC §2943(e)(3)

of the document at no extra charge. Inconsistently, the statutory scheme for beneficiary statements does *not* require that a payoff demand include delivery of a copy of the note on request.[19]

The mortgage holder may issue either the beneficiary statement or the payoff demand statement to set forth the amounts necessary to pay a loan in full.[20]

Any **oral amendment** to either statement given by the mortgage holder is to be followed by their delivery of a **written amendment** by the next business day.[21]

In addition to a beneficiary statement or a payoff demand, an entitled person may also rely on amended statements to establish payoff amounts.[22]

An erroneous statement or demand

Any error in the mortgage holder's statements regarding the amount owed on a mortgage becomes an **unsecured debt** of the original borrower after the close of escrow. If the mortgage holder amends its loan statement prior to the close of escrow, the amount listed in the amended statement replaces the original amount.[23]

unsecured debt
A mortgage balance remaining unpaid following reconveyance of property subject to a trust deed, exhaustion of the security by foreclosure of a prior lien or errors in the principal amount of a mortgage debt in a beneficiary statement or payoff demand.

For example, consider a borrower who funds the payoff of a mortgage by obtaining **refinancing** from a new lender. The payoff demand for the existing mortgage erroneously understates the amount due. The new lender funds the amount stated in the payoff demand and the existing trust deed is reconveyed.

Later, the paid-off lender realizes the mistake in the amount of the payoff and seeks to recover the underpayment. The paid-off lender makes a demand on the new lender for the remaining unpaid amount claiming they are liable for the **deficiency** since they funded the payoff.

The new lender claims the owner who signed the note is liable for any unpaid amount since amounts remaining unpaid on reconveyance are only recoverable, if at all, from the borrower obligated on the note.

Here, the mortgage holder issuing an erroneous payoff demand is only able to recover amounts remaining unpaid from the *original borrower*. The named borrower on the note is the sole source of recovery for amounts understated in the payoff demand.[24]

Nonrecourse debt payoff errors

A holder of a purchase-assist mortgage made to a buyer of a one-to-four unit residential property they intend to occupy as their principal residence is barred from obtaining a **money judgment** for any deficiency in the value of the property to fully satisfy the loan on any type of foreclosure. These mortgages are classified as **nonrecourse mortgages.**[25]

19 CC §2943(e)(2)
20 CC §2943(d)(1)
21 CC §2943(d)(2)
22 CC §2943(d)(1)
23 CC §§2943(d)(3)(A), 2943(d)(3)(B)
24 **Freedom Financial Thrift & Loan** v. **Golden Pacific Bank** (1993) 20 CA4th 1305
25 Calif. Code of Civil Procedure §580b(a)

Form 415

Beneficiary Statement

BENEFICIARY STATEMENT
(California Civil Code §2943)

NOTE: This form is used by an escrow officer when, on behalf of an authorized person, escrow requests information from the holder of a mortgage on a property in sale or loan escrow to confirm the terms and conditions of the debt owed on the mortgage.

DATE: ____________, 20______, at ____, California.
TO: ____
(Name and address of party requesting statement)
____

Loan No. ____
We are the holder(s) of a promissory note for $______________, dated ______________,
made by ____,
and secured by a Trust Deed recorded on ____________________, as Instrument No. ______________,
in ____ County, California,
as a lien on property referred to as ____
____.

1. Present principal balance...$ __________
  1.1 Additional charges, costs or expenses advanced by Lender under its lien..........$ __________
2. Balance in impound/escrow accounts.......................................$ __________
3. Rate of interest:
  3.1 Annual fixed rate of interest is ______%
  3.2 Present note rate of interest adjustable per the note is ______%
  ☐ Attached is a copy of the note containing adjustment formulas.
4. Interest is paid through ______________, 20______.
5. Taxes and special assessments are paid through ______________, 20______.
  5.1 Taxes and special assessments for the fiscal year of ______ and ______ were..........$ __________
6. Payments are delinquent for the months of ________________________.
  6.1 Total amount of delinquencies to bring the loan current is ....$ __________
  which includes any late charges and foreclosure costs.
7. Monthly payments are due on the ______________ day of each month.
  7.1 Monthly payments are comprised of:
  Interest only..$ __________
  Principal and interest...$ __________
  Tax impounds of ....$ __________
  Hazard insurance premium impounds....................................$ __________
  TOTAL monthly payments...$ 0.00
  The taxes and premiums are subject to change.
8. The principal balance is all due and payable on ______________, in the amount of $______________.
9. Hazard insurance is described as follows:
  Insurance Company ____________________ Expiration Date ______________, 20______.
  Insurance Agent ____________________ Policy Term from ______________ to ______________
  Policy Number ____________________ Amount of Premium $______________
  Amount of Coverage $______________
10. ☐ The Trust Deed securing the note contains a due-on-sale clause requiring Lender's consent and approval on any transfer of an interest in the secured real estate.
11. ☐ As requested, a copy of the Trust Deed securing this note is attached.
12. ____
____

Date: ______________, 20______

Beneficiary: ____

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nonrecourse mortgage
A debt secured by real estate for which the holder's sole source of recovery of amounts owed is the value of the mortgaged property, no money judgment permitted for a deficiency in the value of the mortgaged property on foreclosure or short payoff to fully satisfy the debt.

Likewise, carryback mortgages secured only by the property sold are classified as nonrecourse debt. Refinances of nonrecourse debt also remain nonrecourse, exclusive of any new principal advance (such as in a cash-out refinance).[26]

Further, those trust deed investors holding a *nonrecourse mortgage* by an **assignment** are also barred from obtaining a money judgment for any deficiency in property value.

26 CCP §580b(b)

The mortgage holder who makes a mistake in the amount of a payoff demand or beneficiary statement issued on a *nonrecourse debt* is always limited in its recovery to the value of the property – set at the time of the erroneous payoff demand.

Initially, the amount of a negative error on payoff becomes an *unsecured debt* of the original borrower. The amount unpaid and now unsecured remains a nonrecourse debt. The character of the unpaid debt does not change; the debt simply became unsecured on reconveyance of the trust deed.[27]

Logically, the holder of a nonrecourse mortgage is limited in its recovery of the error to the difference between the amount received on payoff and any greater market value of the property at the time of the erroneously calculated payoff.[28]

Recourse debtor payoff error

The amount of a negative error made in a beneficiary statement or payoff demand for a **recourse debt** also becomes an *unsecured obligation*. However, recovery on a mortgage classified as recourse debt is not limited to the value of the property on the date of the payoff in the same way it is for a nonrecourse debt.[29]

A mortgage holder who demands and is paid an erroneous amount on payoff and reconveyance of a *recourse mortgage* may proceed directly to a **money judgment** against the borrower for the uncollected amount, regardless of the value of the real estate securing the debt.

Thus, sellers of property encumbered by a recourse mortgage expose themselves to a continuing liability for mortgage debts they owed as original or assuming borrowers when the property is sold subject to the existing mortgage.

When a buyer assumes a seller's recourse mortgage the seller is considered a **guarantor**, secondarily liable for payment if their buyer fails to pay, unless the buyer's **assumption** of the mortgage included a significant modification in its terms and the seller did not consent to the modifications.[30]

> **guarantor**
> A person who agrees to pay a money obligation owed by another to a mortgage holder or a landlord under a lease agreement on a default in the obligation and demand for the sums remaining unpaid. [See **ft** From 439 and 553-1]

Consider a buyer who acquires a mortgaged property and enters into a written assumption agreement with the mortgage holder. The buyer later resells the property. On the resale, the mortgage holder makes a mistake in a payoff demand (or beneficiary statement), which results in an underpayment to the mortgage holder on reconveyance.

Here, the *seller* who originally borrowed the funds is a *guarantor* of payment on the mortgage and is liable to the mortgage holder for the mortgage holder's error.

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27 CC §2943(d)(3)

28 **Ghirardo** v. **Antonioli** (1996) 14 C4th 39

29 Calif. Code of Civil Procedure §726(b)

30 **Braun** v. **Crew** (1920) 183 C 728

Thus, when a buyer assumes a seller's mortgage, the seller will likely feel compelled to condition the closing of the sale on a *release of liability* from the mortgage holder, called a **novation**.

novation
An agreement entered into by a mortgage holder, equity purchase (EP) investor and seller to shift responsibility for a mortgage obligation to the investor by an assumption and release the seller of liability.

The release of liability eliminates the seller's risk of "original borrower liability" for a potential future error by the mortgage holder in payoff demands or beneficiary statements.[31]

In a *novation*, as with an assumption, the buyer promises to perform the duties of the original borrower (the seller in this arrangement). Distinct from an assumption, the mortgage holder who agrees to a novation releases the seller from all future liability for the mortgage debt. [See Chapter 16]

31 CC §1531

Chapter 20 Summary

A beneficiary statement is a written disclosure made by a mortgage holder regarding the condition of a debt owed them, usually evidenced by a note.

To obtain a beneficiary statement, an entitled person submits a written request to the mortgage holder. An entitled person is:

- the original borrower or property owner;
- a successor-in-interest, or new property owner; or
- an authorized agent of either.

Mortgage holders are required to deliver the beneficiary statement within 21 days of receipt of a written request from an entitled person. Intentional failure to do so results in the mortgage holder's forfeiture of $300 to the requesting person, as well as liability for any related money losses. Mortgage holders are permitted to charge no more than $30 for each beneficiary statement, with the exception of FHA- or VA-insured mortgages.

A payoff demand statement is a mortgage beneficiary's written claim for the total dollar amount remaining on the date of preparation to pay off the mortgage. Unlike beneficiary statements, delivery timelines for payoff statements vary depending on the type of mortgage.

Payoff demand statements for business mortgages are required to be delivered by the mortgage holder within 21 days of receipt of a request from an entitled person. On consumer mortgages, the statement is due within seven days of receipt of request. On Section 32 high-cost consumer mortgages, that limit is five business days. The maximum charge for preparing a payoff demand statement is also $30, unless the mortgage is VA- or FHA-insured.

Any error in the mortgage holder's statements regarding the amount owed on a mortgage becomes an unsecured obligation of the original borrower after the close of escrow. The named borrower on the note is the sole source of recovery for amounts understated in the payoff demand. On a nonrecourse debt, the mortgage holder's recovery is limited to the value of the property at the time of the payoff demand.

Recovery on a mortgage classified as recourse debt is not limited to the value of the property on the date of the payoff in the same way it is for a nonrecourse debt. Sellers of property encumbered by a recourse mortgage expose themselves to a continuing liability for mortgage debts when the property is sold subject to the existing mortgage. To avoid this continuing liability, the seller conditions the closing of the sale on a release of liability from the mortgage holder, called a novation.

Chapter 20 Key Terms

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Chapter 21

Equity purchase: sale-leaseback, no option

Learning Objectives

After reading this chapter, you will be able to:

- understand a sale-leaseback arrangement coupled with a repurchase option is recharacterized for its legal and tax consequences; and
- identify the loss of ownership benefits when an equity purchase (EP) investor grants an option to repurchase the property to the seller.

Key Terms

holdover tenancy	**reinstatement**
mortgage-in-fact	**reverse lease-option**

A mortgage or tenancy on breach?

Consider a homeowner who defaults on their mortgage secured by a trust deed on their home. The lender begins foreclosure proceedings by recording a Notice of Default (NOD).

The NOD recording is picked up by a foreclosure reporting service. The service's subscribers are in turn advised of the NOD. An EP investor tracking NOD recordings as a subscriber contacts the homeowner, intending to investigate the property for suitability and acquisition.

An offer to purchase the residence is prepared and submitted to the homeowner on an EP agreement form as mandated by state law.

However, the homeowner queries the EP investor about their desire to retain possession of the residence with the intent to buy back the property when their personal financial situation improves.

Sale/lease-option

As an alternative to the EP investor's offer, the homeowner proposes a *sale/lease-option* arrangement in which:

- the investor acquires title to the property by investing only the funds needed by the owner to cure the delinquent mortgage payments and property taxes, and pay the annual property insurance premium and foreclosure costs;
- the seller-in-foreclosure remains in possession under a lease with sufficient rental payments to cover the investor's costs of ownership; and
- the owner is given an *option to repurchase* the residence at a price to include a profit for the investor.

The EP investor refuses. The investor claims the grant of a purchase option to the owner will:

- transform the investor's intended purchase into a disguised mortgage transaction;
- bar the investor from conveying title or encumbering the property at any time without the owner's further consent; and
- deprive the investor of the investment and tax benefits of owning real estate.

As a result, the investor and the owner reach a compromise. They enter into an EP agreement that provides the owner with a six-month *holdover tenancy* — no repurchase option included.

mortgage-in-fact
A grant deed given by an owner for the sole purpose of securing the performance of an obligation owed a creditor, such as payment of a debt.

Has the EP investor correctly represented the mortgage and tax consequences of holding title subject to a repurchase option as a loan, called a **mortgage-in-fact**?

Yes! A sale-leaseback and purchase option arrangement is a *mortgage*. Thus, the EP investor will have made a loan, not a purchase of ownership of the property. When an owner occupying a one-to-four unit residential property as their principal residence conveys title in exchange for money to cure delinquencies and the right to retain possession with an *option to repurchase* the property, a mortgage has been negotiated, not a sale.

Mortgage in disguise

The financial arrangement of the lease-option sale contains all the elements of a mortgage:

- a yield (interest and principal paid as rent); and
- a due date (final/balloon payment of principal and further earnings on exercise of option) as a condition for returning (reconveying) title.

Thus, the investor becomes a lender holding title as security for repayment of a debt, not a buyer receiving the possessory rights and economic risks and benefits of a true owner.[1]

1 Calif. Civil Code §1695.12

As a lender, the EP investor is not able to take depreciation or other *tax benefits* available to an owner of rental property.[2]

An investor who takes title to property while allowing the owner the right to remain in the property and the right to repurchase the property under an *option to buy* does not own the property. The grant deed the investor receives merely conveys title as security for repayment of a debt, a *mortgage-in-fact*.

Despite any additional set of agreements or circumstances (even using EP agreements and fully complying with right to cancel notices), the investor taking title may not give the owner-in-foreclosure an option to recover title to the property.

However, the investor taking title who does grant an option to buy to the owner must later obtain written permission from the owner before the investor may:

- encumber the property; or
- grant any interest in the property to another person.[3]

Thus, when the owner defaults on the lease and vacates the property, the investor who granted a purchase option is left with naked title, unable to refinance the property, convey title to another person or create a leasehold interest under a rental or lease agreement with a tenant since they are a lender— without the owner's prior approval.[4]

Equity mortgage during foreclosure

Consider an owner whose home is in foreclosure due to a default under a trust deed lien on their home. The owner asks a friend to make them a mortgage loan.

The friend advances all funds necessary to cure the default under the trust deed and take the property out of foreclosure, called **reinstatement**.

reinstatement
The curing of monetary defaults and terminating the foreclosure process on a mortgage by a property owner or junior lienholder prior to expiration of the reinstatement period applicable to the trustee's or judicial foreclosure by paying the delinquent amounts and foreclosure charges.

As security for repayment of the friend's advance of funds, the homeowner conveys title to the friend. As part of the arrangements, the owner remains in possession under a *net lease agreement* and is granted an option to recover title to the residence on a final/balloon payment made to the friend.

Later, the owner defaults on the rent and voluntarily vacates. The friend locates a buyer, enters into a purchase agreement and conveys title to the buyer.

The vacated owner seeks to recover the value of their lost equity from their (former) friend. The owner claims an investor who takes title and grants an option to the owner to repurchase the property must first obtain the owner's consent before the investor may convey any interest in the property to another since the transaction was entered into while the home was in foreclosure.

2 **Haggard** v. **Commissioner** (9th Cir. 1956) 241 F2d 288
3 CC §1695.6(e)
4 CC §1695.12

The friend claims EP law does not apply to them since they are not in the business of lending money, much less buying homes in foreclosure.

However, EP law applies to all persons whose conduct constitutes that of an EP investor, regardless of the number of EP transactions the person completes.

The friend, cast as an investor, conveyed title to the property without first obtaining written consent from the owner, in violation of equity purchase law.[5]

Even though the investor held title, the EP investor's failure to obtain the owner's written permission prior to conveyance on the property's resale imposes liability on the EP investor for breach of the owner's redemption rights when a mortgage-in-fact is involved. The money losses collectible by the owner are based on the value of the property at the time the EP investor first transferred the property without the owner's consent.[6]

No exemptions for court-ordered sales

Consider an owner-in-foreclosure who is in bankruptcy and conveys their property to an EP investor at a price lower than its market value.

The transaction is structured as a grant deed conveyance to the investor with a leaseback agreement and the grant of a repurchase option to the owner. Mandatory equity purchase forms with the required right of rescission are not entered into by the owner and the investor.

The transaction is approved as a sale of the property by a trustee acting on behalf of the bankruptcy court.

The owner-in-foreclosure is not able to repurchase the property on expiration of the repurchase option. A notice to vacate is served by the owner.

The owner seeks to quiet title to the property in their name, claiming the sale-leaseback agreement violated of the *Home Equity Sales Contract Act (HESCA)* EP law since the investor, knowing the home was in foreclosure, acquired title to the property without complying with the EP notice requirements.

The investor claims the sale was authorized by the equivalent of a court order, and thus exempt from equity purchase laws, since the sale was approved by a bankruptcy trustee acting on behalf of the court.[7]

Here, the sale by the owner-in-foreclosure to the investor was subject to EP law since the exemption for court-ordered sales does not apply to sales of property approved by a mere bankruptcy trustee.[8]

---

5 CC §1695.6

6 Segura, *supra*

7 CC §1695.1(a)(5)

8 **Spencer** v. **Marshall** (2008) 168 CA4th 783

Continued occupancy by the seller-in-foreclosure

Any leaseback agreement negotiated with an owner-in-foreclosure is to be reduced to a written addendum as part of the EP agreement. Alternatively, it may be documented by amendment to the EP agreement prior to funding by the EP investor and conveyance of title by the seller.[9]

The owner-in-foreclosure and EP investor structuring a transaction may consider one of several occupancy arrangements for the owner:

- a sale-leaseback, typically a **holdover tenancy** for a fixed time period at which point the owner is to vacate [See **first tuesday** Form 272];
- a sale-leaseback with an option to purchase as an addendum (which is a mortgage-in-fact), sometimes called a **reverse lease-option** [See **first tuesday** Forms 161 and 550]; or
- an unexecuted purchase agreement coupled with a lease-option agreement with the seller, a variation on the prior arrangement that does not call for immediate conveyance. [See **first tuesday** Form 163]

holdover tenant
A tenant who retains possession of a rented premises after their right of possession has been terminated.

reverse lease-option
A sale-leaseback agreement with an option to purchase as an addendum.

In a straightforward lease arrangement, a security deposit and the first month's rent are payable to the EP investor at the closing of an EP sale since the seller will holdover for a specified time period. The seller usually prepays rent and a security deposit through escrow from their net sales proceeds. So long as the EP laws calling for the use of special Equity Purchase agreements and right-of-rescission notices are complied with, the sale-leaseback arrangement does not violate the EP laws. [See **first tuesday** Form 156]

It is the *repurchase option* given under any circumstances which sets the investor up for a future violation of the EP law.

Sale-leaseback recharacterized

Inherent in an EP sale-leaseback and option to repurchase the property is the risk the mortgage transaction will be misinterpreted by the local assessor, the existing lender and the Internal Revenue Service (IRS).

Reassessment of the property occurs on execution of a sale-leaseback.[10]

However, if the "two-step" financing scheme is brought to the attention of the assessor, a sale-leaseback intertwined with an option to repurchase is correctly recharacterized by all agencies (and the seller) as a single financing arrangement, rather than two consecutive sale and repurchase transactions. Thus, no change of ownership occurs, even though the vesting of title is altered, and no reassessment takes place.[11]

Existing lenders view a sale-leaseback, with or without a repurchase option, as an opportunity to *call or recast* a mortgage under their **due-on clause** — if they become aware of the transaction. An EP investor needs to consider including a contingency in the EP agreement calling for a *due-on waiver* to be negotiated with the existing lender prior to closing to avoid a call or recast of the loan.

---

9 CC §1695.3(f)

10 **Pacific Southwest Realty Company** v. **County of Los Angeles** (1991) 1 C4th 155

11 Calif. Revenue & Taxation Code §62(c)

An existing lender usually will not demand a modification or call its mortgage unless the current market rates are high, allowing the lender to increase its portfolio yield through points or an increased interest rate, either by mortgage modification or a payoff and reinvestment in a new mortgage.

Federal tax consequences

The *IRS* also treats sale-leasebacks as mortgage transactions, not a sale or a purchase, when the seller remains in possession and is given an option to repurchase title to the property.

Taxwise, the sale-leaseback is considered a financing arrangement when:

- rental payments under a long-term lease equal an amortization of the fair market value (FMV) over the term of the lease when title is to be reconveyed to the seller/tenant; or
- the final/balloon payment required to exercise a repurchase option equals principal and accrued interest that will be financially similar to the due-date payoff under a mortgage.[12]

The EP investor's tax consequences on recharacterization of a sale-leaseback and purchase option as a financing arrangement include:

- denial of any depreciation deductions;
- imputing of interest income reportable at 110% of the applicable federal rate (AFR);[13]
- reporting of potential rental income as investment/portfolio category interest income on a mortgage; and
- denial of any rental operating expenses (impound for taxes and insurance premiums belonging to the seller), since the transaction is a mortgage loan.

For the EP investor to receive the tax benefits of owning real estate, they need to limit the leaseback to a:

- periodic tenancy, such as a month-to-month [See **first tuesday** Form 551]; or
- a tenancy with a set date requiring the tenant to vacate the premises (a fixed-term lease agreement). [See **first tuesday** Form 550]

Under either structuring, no repurchase option is granted to the owner.

No repurchase options granted

An EP investor structuring a sale-leaseback, which does not include a repurchase option, eliminates the risk the transaction will be recharacterized as a financing arrangement if:

- the seller-in-foreclosure is given the lease in full or part exchange for their equity (or for their payment of rent); or
- the rent charged is the current fair market rate; and

12 **M & W Gear Co.** v. **Commissioner** (7th Cir. 1971) 446 F2d 841

13 Internal Revenue Code §1274(e)

- the leaseback agreement sets a "fixed" time period for the lease to terminate and possession to be transferred to the EP investor.[14]

If the seller-in-foreclosure is not given a repurchase option and remains in possession of the property after the lease expires, the EP investor may begin an **unlawful detainer (UD)** action against the seller without prior notice to the seller to vacate.[15]

As in any lease, the leaseback agreement needs to provide for payment of increased rent if the seller-in-foreclosure does not vacate upon either:

- the expiration of the lease; or
- a notice to vacate used to terminate the tenancy under a month-to-month rental agreement. [See **first tuesday** Form 569]

A reminder: The seller-in-foreclosure has previously defaulted on home payments. Thus, the seller-in-foreclosure poses a serious adverse credit risk as a tenant for the EP investor.

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14 **Camp** v. **Matich** (1948) 87 CA2d 660
15 **Ryland** v. **Appelbaum** (1924) 70 CA 268

Chapter 21 Summary

An investor who takes title to property while allowing the owner the right to remain in the property and the right to repurchase the property under an option to buy does not own the property. The grant deed the investor receives merely conveys title as security for repayment of a debt, a mortgage-in-fact.

The Internal Revenue Service (IRS) also treats sale-leasebacks as mortgage transactions, not a sale or a purchase, when the seller remains in possession and is given an option to repurchase title to the property.

For the EP investor to receive the tax benefits of owning real estate, they need to limit the leaseback to a:

- periodic tenancy, such as a month-to-month; or
- a tenancy with a set date requiring the tenant to vacate the premises (a fixed-term lease agreement).

Chapter 21 Key Terms


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Chapter 22

Short payoffs on loans in foreclosure

Learning Objectives

After reading this chapter, you will be able to:

- understand how a distressed seller qualifies for a short sale;
- negotiate a short sale with a first and second lien holder;
- provide mortgage holders with a broker price opinion (BPO);
- get your seller qualified for a HAMP and HAFA short sale; and
- counsel a seller on the tax implications of a short sale.

Key Terms

broker price opinion (BPO)
hardship letter
Home Affordable Foreclosure Alternatives (HAFA)
loss mitigation
nonrecourse mortgage
recourse mortgage
short sale

The new and present normal, sort of

The **short sale**, also known as a **short payoff,** resurfaced during the recovery from the Great Recession of 2008. Until the recovery is complete, *short sales* will remain a commonplace though waning feature of the home resale market.

The dire job environment left in the wake of the Millennium Boom and subsequent Great Recession and Financial Crisis of 2008 combined to bring short sales back for the first time since the early 1990s recession.

Roughly 25% of multiple listing service (MLS) sales transactions statewide were short sales during the recessionary period, declining to 20% by 2012 and 8% by the end of 2013.

short sale
A sale in which the lender accepts the net proceeds at closing in full satisfaction of a greater amount of mortgage debt. Also known as a short payoff.

Short sales were the result of the financial fallout from:

- the massively inflated real estate prices of the past decade; and
- the current lack of job opportunities for *unemployed* or *underemployed* homeowners.

These unemployed and underemployed casualties of the Great Recession most often view a short sale of their home as the respectable alternative to losing their home through a *foreclosure* sale. To meet their short sale objective to rid themselves of their home and debt, they fully expect even an inexperienced agent with a "short sale training" seminar under their belt to properly structure the listing and purchase offers. They also expect these agents to successfully negotiate with their lender on their behalf to cure their real estate problems.

An uphill battle and a formidable adversary

Negotiating with a mortgage holder for a short sale is not a straightforward or routine task.

Any agent facilitating short sale negotiations with the seller's lender needs to first thoroughly understand:

- *California anti-deficiency law* barring mortgage holder collection of property value deficiencies which generate a loss on a recourse mortgage debt [See Chapter 23];
- the *trust deed foreclosure process* and documentation, as well as time periods for reinstatement and redemption prior to the trustee's sale and elimination of ownership;
- complications over clearing the title of any *junior financing* encumbering the property in situations where the amount of the first mortgage is either less or more than the short sale net proceeds;
- the **Home Affordable Foreclosure Alternatives (HAFA)** application process if the seller is eligible to receive government-funded relocation funds; and
- the seller's income and net worth financial situations.

Home Affordable Foreclosure Alternatives (HAFA)
A government program aimed at assisting homeowners to avoid foreclosures by offering incentives for homeowners and lenders to complete short sales.

This knowledge, combined with first-hand experience directly negotiating short sales with a mortgage holder, is the true pedigree of a "short sale specialist."

The seller's agent comes prepared

The mortgage holder's consent to a discounted payoff on a short sale is based on **facts readily available** to the seller's agent at the time the listing is being negotiated. Thus, an agent's forward-oriented investigation can anticipate mortgage holder approval or rejection before taking the listing. This conserves the agent's time, talent, reputation and money.

For agents, a basic litmus test to discern which short sale listings are worth the time begins by asking the following questions:

1. *Is the mortgage's loan-to-value ratio (LTV) ratio more or less than 94%?*

If a seller owes less than the home is worth (the LTV is less than 94%), the issue of a short sale is non-existent. The net sales proceeds are sufficient to pay the loan in full.

The agent arrives at the LTV by first developing their **broker price opinion (BPO)** to establish the property's fair market value (FMV). The agent calculates a *BPO* using data available by downloading a *property profile* (title condition) on the home and a printout of recent sales in the surrounding area from a title company website. This is the agent's first step in any seller counseling and listing effort, be it a short sale or conventional sale.

broker price opinion (BPO)
An agent's opinion of a property's fair market value (FMV) based on comparable sales.

2. *How many liens are on the property?*

If any *junior liens* encumber the property, each mortgage holder needs to be dealt with to clear title of their trust deed lien before a short sale can close.

Occasionally, the same mortgage holder holds both the first and second mortgage on a home, the now prohibited piggyback financing common during the *Millennium Boom*.

If the answers to the above are promising, the seller and agent enter into a listing agreement employing the agent's broker to both:

- locate a buyer (whether a buyer-occupant or equity purchase (EP) investor); and
- negotiate a discount on the existing mortgage(s).

To this *listing agreement*, the agent adds a provision stating:

> "*The owner will first qualify with the mortgage holder for a discounted payoff of the loan and reconveyance of the trust deed on a sale of the home. When qualified by the lender, the agent will begin marketing the property in search of a buyer.*" [See **first tuesday** Form 102-1]

On taking the listing, the agent instructs the seller to contact their mortgage holder and discuss how to proceed with a short sale.

If the mortgage holder qualifies the seller for a short sale, the mortgage holder indicates they will accept the net sales proceeds in full settlement of the mortgage debt(s).

Qualifying for a short sale

On contacting the mortgage holder, the seller is referred to the mortgage holder's **loss mitigation** specialist, sometimes called a **negotiator**. In response, the seller is sent a short sale information packet, requesting they deliver the following to the lender:

- *Authorization to release information to an agent.* This document signed by the seller gives the mortgage holder permission to deal with and furnish information about the mortgage to the seller's agent. Without this critical authority, mortgage holders will not communicate with anyone acting on behalf of the seller. [See **first tuesday** Form 124]

loss mitigation
A lender strategy to lessen the amount of their loss due to a default on a mortgage.

hardship letter
A statement detailing a distressed homeowner's financial situation, delivered to the lender to determine if the homeowner qualifies for a short sale. [See **ft** Form 217-1]

- A **hardship letter**. The mortgage holder first determines whether or not the seller is financially qualified to make payments on the mortgage. For this, the seller prepares a letter detailing their current personal and financial situation. Here, the seller explains their inadequate sources of income or other financial hardships they are experiencing. The seller also discloses whether they are the only wage earner in their household. [See **first tuesday** Form 217-1]
- *The seller's most recent pay stubs, bank statements and tax returns*. The mortgage holder wants to confirm the seller is purchasing only necessities in lieu of making mortgage payments (i.e. groceries, car repairs and school supplies). Tax returns are used to verify annual income. The mortgage holder optionally requires the seller to fill out a *financial statement* (equivalent to an application for a mortgage). With it, the mortgage holder determines whether the seller has other assets available as a source of funds to voluntarily pay off the mortgage without a discount (i.e. cash on hand, equity in other property, stocks/bonds, etc.).
- *Proof of occupancy*. The seller provides the mortgage holder with a utility bill in the seller's name delivered to the property address to prove they occupy the residence and don't rent it to others.

*Editor's note —When a buyer's agent finds a property listed as a short sale, the first question the agent needs to ask the seller's agent is **"Have you qualified your seller for a short sale with the lender?"***

A buyer's agent needs to protect their buyer, along with everyone's time and energy, by being assured the seller has been qualified for a short sale before spending additional time and talent putting together an offer to be submitted by their buyer.

A different lender holds a second

If a mortgage holder second mortgage exists, one of two payoff situations face the agents:

- the net sales proceeds satisfy the first mortgage, but not the second; or
- the net sales proceeds do not satisfy the first mortgage, and by extension do not satisfy the second.

In the first situation, the net sales proceeds are more than sufficient to fully satisfy the first mortgage on closing. Here, the seller's agent negotiates solely with the junior lienholder in the second position. The junior lienholder needs to consent to the balance of the net proceeds remaining after payoff of the first mortgage in exchange for a full reconveyance of their junior mortgage.

Here, the second mortgage is initially contacted when taking the listing. If the second concludes the seller qualifies for a discounted payoff in a short sale, then the purchase agreement entered into by the seller and a buyer is submitted to the second lienholder for its consent.

At that point, the second lienholder orders out the appraisal, determines the property value and reviews the appropriateness of the net sales proceeds. Only then does the second lienholder allow the short sale to close by discounting the amount owed to them.

Net sales proceeds do not satisfy the first or second

When the second payoff situation exists and the net sales proceeds do not satisfy the first mortgage, and by extension the second, the situation becomes traumatic for everyone involved in clearing title.

Here, the seller's agent has to deal with both mortgage holders. The second lienholder will demand some amount of money from the net sales proceeds before they will consent to cancel their debt and reconvey their mortgage.

As a result, the seller's agent needs to be sufficiently innovative at the outset of negotiations. Initially, the agent knows the second needs to be dealt with before the first can be paid off and a sale closed. Thus, the first mortgage holder needs to agree to let the second participate in some of the net sales proceeds, say a few thousand dollars.

Negotiations with the junior lienholder need to keep the holder of the first mortgage from being so greedy as to kill the transaction. At all times, agents need to resist any requests by the mortgage holders for the brokers to cut their fees agreed to in the purchase agreement. The broker offering services to help the financially distressed owner and lender is paid to resolve a bad situation not of the broker's making. Likewise, the title company or escrow providing services in a short sale will not discount their fees because the mortgage holder or owner find themselves in financial straits. [See **first tuesday** Form 150-1]

Keep an eye on your frustrated buyer

The processing times on the mortgage holders' end vary widely. The typical short sale takes three to five months. However, any one of many factors involved can deny the seller's agent success.

Frequently, the mortgage holder demands more net proceeds at time of closing, and thus bid for the buyer to pay a higher price than agreed to with the seller. This conduct parallels engrained lender interest rate bumps on mortgage orgination at the time of closing.

*Editor's note —EP investors who do not plan to occupy the property-in foreclosure they purchase in a short sale are to use an equity purchase agreement with a short sale provision. [See **first tuesday** Form 156-1]*

On the other end of the deal, the length and uncertainty of a short sale transaction often triggers a buyer's decision to withdraw their offer. Too often the seller's agent leaves the buyers and buyer's agents out of the loop of the short sale process.

To keep the deal alive, buyers need to be given *frequent updates* to ensure the process is on the right track and moving. To accomplish this level of communication, buyer's agents need to stay in contact with the seller's agent, at least weekly, for status updates to be passed on to the buyer.

Further, frustrated buyers often locate and purchase other property, cancelling or abandoning their purchase agreements during the approval process. Loss of the buyer nullifies all the work done by the mortgage orignator. Once the seller accepts another buyer's purchase offer and submits documentation to the lender for approval, the loss mitigation specialist assigned to the file starts the approval and appraisal process all over again.

Further delayed for HAFA benefits

The short sale process is often delayed by yet another monkey wrench — *Home Affordable Foreclosure Alternatives (HAFA)* money for the seller.

The HAFA program is designed to help homeowners avoid foreclosure by providing short sale incentives. It is a supplement to the **Home Affordable Modification Program (HAMP)** launched in 2009.

HAFA provides incentives for sellers, mortgage holders and agents to consider a short sale rather than a foreclosure sale. Sellers participating in a HAFA short sale receive:

- $3,000 to help cover their cost of relocation;
- full release from future deficiency liability for the first mortgage (cash contributions by sellers are not allowed in a HAFA transaction); and
- standardized timeframes for each step of the process.

Mortgage holders participating in a HAFA short sale receive:

- $1,500 to cover administrative costs; and
- up to $2,000 subsidy for allowing a total of $6,000 in net sales proceeds to be distributed to junior lienholders.

Agents representing a seller in a HAFA short sale receive:

- fee protection since mortgage holders are prohibited from requiring a reduction of a real estate fee agreed to in the listing agreement (up to 6%).

HAFA eligibility

In order for a seller to be eligible for HAFA:

- the property needs to be the seller's principal residence;
- the mortgage needs to be a first lien originated before January 1, 2009;
- the mortgage needs to be delinquent or at imminent risk of default;
- the current unpaid principal balance needs to be equal to or less than $729,750;
- the seller's total monthly mortgage payment needs to exceed 31% of their gross income; and

- the seller needs to first apply for a loan modification through HAMP.

Mortgage holders need to consider a HAMP seller for HAFA within 30 calendar days after the seller:

- fails to successfully complete a trial period under a HAMP modification;
- misses at least two consecutive payments after a HAMP modification; or
- requests a short sale or deed-in-lieu of foreclosure.

HAFA qualified

After all HAFA qualifications have been met, the seller requests short sale consent from their mortgage holder. In turn, the mortgage holder sends them a ***HAFA* Short Sale Agreement (SSA)** to be signed by the seller and the seller's agent within *14 calendar days* of receipt. The SSA is then returned by the agent to the lender's loss mitigation specialist. [See HAFA Form 184]

The mortgage holder gives the seller an initial period of *120 calendar days* to sell their home after receipt of the signed SSA, which can be extended up to 12 months (during which time the seller is making no payments.

Once an offer to purchase the home by a buyer-occupant or EP investor is accepted, the seller (or their agent) submits a **Request for Approval of Short Sale (RASS)** to the mortgage holder within three business days after executing a purchase agreement. The *RASS* includes:

- a copy of the purchase agreement and all addenda;
- buyer documentation of funds or pre-approval from a mortgage holder; and
- information on the status of subordinate liens and any negotiations with subordinate lienholders. [See HAFA Form 185]

After receiving the RASS, the mortgage holder approves or denies the request within ten business days.

This separate HAFA application, documentation and processing time is completed before the mortgage holder even begins its own short sale approval process. Thus, there is another delay of approximately three months for mortgage holder approval.

If the mortgage holder refuses to approve the short payoff after HAFA approves the seller, the transaction with the buyer is terminated, unless it is somehow revived by negotiations to resolve the mortgage holder's reasons for disapproving the short sale.

If the sale is terminated, the HAFA process starts all over again for this seller (and the seller's agent) when the next buyer's short sale purchase offer is accepted.

Tax aspects of the short payoff

Tax wise, the two most significant consequences of the short sale on a **nonrecourse** loan (which includes an owner-occupied one-to-four unit residential property encumbered by a purchase-assist mortgage, improvement loan or *refinance* on a purchase-assist mortgage) are:

- the short sale does not trigger tax reporting of ordinary income for the discounted and discharged portion of the mortgage for homes sold and closed escrow before 2014; and
- the discount on a short payoff produces a capital loss that is unavailable for reducing taxable income.

nonrecourse mortgage
A debt secured by real estate for which the holder's sole source of recovery of amounts owed is the value of the mortgaged property, no money judgment permitted for a deficiency in the value of the mortgaged property on foreclosure or short payoff to fully satisfy the debt.

*Editor's note: The Mortgage Forgiveness Debt Relief Act expired at the end of 2013 after a previous extension. However, losing this Act will not hamper Californians with **nonrecourse** mortgages. A property owner is not personally liable for a nonrecourse mortgage.*[1]

*Further, on January 1st 2011, California expanded anti-deficiency-nonrecourse protection to **discharge-of-indebtedness income** from a first mortgage on a short sale — for both nonrecourse and recourse mortgages, i.e., refinances.*

Then, in July 2011, the state further expanded anti-deficiency protection to include discharge-of-indebtedness income from any mortgage on a short sale, provided a short sale agreement exists between the seller and participating mortgage holders.

No discharge-of-indebtedness income

The discount on a short payoff is not reported by the seller as taxable *discharge-of-indebtedness income*, though the mortgage holder automatically files such an erroneous statement with the Internal Revenue Service (IRS). Instead, the discount produces a *personal loss* (capital loss) on the sale which the seller may not write off to reduce taxable income.

In a conflicting filing, the mortgage holder reports to the IRS on a 1099C indicating the discount occurred. This action reports the discount as debt relief that is taxable personal income. However, the negative equity home sales rule and the IRS regulation on nonrecourse loan discounts are an exception the seller has to exercise when filing their return.[2]

recourse mortgage
A mortgage debt in which a lender may pursue collection from a property owner for a loss due to a deficiency in the value of the secured property to fully satisfy the debt if the lender forecloses judicially.

A second mortgage complicates the liability analysis. Second mortgages other than piggyback mortgages are generally **recourse**, unless the second lienholder consents in writing to a short sale which converts them to a nonrecourse debt.

1 26 Code of Federal Regulations §1.1001-2(a)
2 Internal Revenue Code §108(e)

Chapter 22 Summary

A short sale, also known as a short payoff, is a sale in which the mortgage holder accepts the net proceeds at closing in full satisfaction of a greater amount of mortgage debt. An agent facilitating short sale negotiations with the seller's lender needs to understand:

- California anti-deficiency law;
- the trust deed foreclosure process and documentation;
- complications over clearing the title of any junior financing encumbering the property in situations where the amount of the first mortgage is either less or more than the short sale net proceeds; and
- the seller's income and net worth financial situations.

When a seller seeking a short sale has more than one lien encumbering their property, all mortgage holders are required to consent to the short payoff.

Seller's agents need to keep an eye on short sale buyers and keep the buyer's agent in the loop. If a frustrated buyer walks away from the deal, the approval process starts all over again.

The government Home Affordable Foreclosure Alternatives (HAFA) program provides cash incentives to the seller, mortgage holder and agent to complete a short sale.

Anti-deficiency protection includes discharge-of-indebtedness income from any mortgage on a short sale, provided a short sale agreement exists between the seller and participating mortgage holders.

Chapter 22 Key Terms

Chapter 23

Anti-deficiency: past, present and future

Learning Objectives

After reading this chapter, you will be able to:

- understand the history and purpose of California anti-deficiency statutes;
- analyze options lenders and carryback sellers have to recover unpaid debts secured by real estate; and
- identify the protections and defenses buyers have against lenders seeking to recover debt not satisfied through foreclosure.

Key Terms

anti-deficiency	**letter of credit**
cramdown	**nonrecourse mortgage**
deficiency	**purchase-assist funding**
discharge-of-indebtedness income	**put option**
exculpatory clause	**recourse mortgage**
guarantee agreement	**right of redemption**
	subordination

The trade-off: real estate as security

A buyer of real estate encumbers the property with a **mortgage** to secure a debt.

The *mortgage*, in favor of either a lender or a carryback seller, is an agreement to pay the dollar amount owed.

Securing the debt by a mortgage lien on real estate does not abolish the buyer's **personal obligation** under their promise to pay. However, the inclusion of real estate as security places the enforcement of the debt under *mortgage law*, with dramatically different results from commercial law for all involved. If the debt had been unsecured, the buyer's promise to pay is enforced under *commercial law*.

put option
A provision in all trust deeds which, in tandem with anti-deficiency laws, grants the owner of mortgaged real estate the right to default and force the mortgage holder to first sell the property through foreclosure.

In accepting a mortgage on real estate as security for the repayment of a debt, a lender or carryback seller alters their ability to force the borrower to pay on that promise. When held as security, the real estate, not the borrower, becomes the primary source of the lender's **recovery** in the event the borrower defaults. Under mortgage law, a trade-off occurs for accepting real estate as security for a debt.

To satisfy an unpaid mortgage debt on a default, the mortgage holder is forced to **foreclose**. Thus, the mortgage holder first sells the real estate before attempting any other method of collection, called **exhausting the security**.

A default is the borrower's act of exercising the **put option** contained in the provisions of all mortgages. On default, the mortgage holder is forced to sell the secured property through a foreclosure sale to satisfy the amounts owed.[1]

Limits to recovery

Mortgage holders are limited in their ability to recover losses incurred when a foreclosed property's value is insufficient to satisfy the mortgage debt. This protected class of mortgage debt is called **nonrecourse debt** or **purchase-money debt.** *Nonrecourse debt,* also known as **antideficiency debt**, includes:

nonrecourse mortgage
A debt secured by real estate for which the holder's sole source of recovery of amounts owed is the value of the mortgaged property, no money judgment permitted for a deficiency in the value of the mortgaged property on foreclosure or short payoff to fully satisfy the debt.

- the *purchase-assist funding* by a mortgage lender of a one-to-four unit residential property to be occupied by the buyer;
- *carryback mortgages* evidencing the installment sale of any type of property; and
- *refinanced* purchase-money mortgages, to the extent the funding is applied to obligations under the replaced purchase money mortgage (including fees and costs associated with the refinance transaction).[2]

Editor's note — Purchase-money debt does not include purchase-assist loans which fund the purchase of property other than buyer-occupied one-to-four residential units.

purchase-assist funding
The use of proceeds from a mortgage to fund the price paid by the borrower to acquire real estate.

Occasionally, the **fair market value (FMV)** of the secured real estate is insufficient to satisfy the debt at the time of a foreclosure sale. Yet the buyer, as the borrower on the mortgage, is still *personally responsible* for the deficiency remaining.

However, getting a court judgment to collect money losses from a deficiency in the secured property's value to fully satisfy the debt requires the debt to be **recourse** in nature and the foreclosure to be processed judicially.

Thus, the mortgage holder needs to have structured the transaction and the foreclosure sale to deprive the buyer of an anti-deficiency defense.

1 Calif. Code of Civil Procedure §726

2 CCP 580b

Until the 1930s, the signer of a mortgage evidencing any type of debt secured by any type of real estate remained *personally liable* for any deficiency in value remaining after any type foreclosure sale. Thus, the signer was subject to an award of a *money judgment* after either a judicial or nonjudicial (trustee's) foreclosure sale on the property.

deficiency
Losses experienced by a mortgage holder at a foreclosure sale due to insufficient value of the secured property to satisfy the mortgage debt.

For example, consider a lender in 1929 who holds a mortgage evidencing a loan secured by a mortgage lien on the owner's principal residence.

The owner defaults on the mortgage. The lender forecloses through a trustee's sale and recovers the property at a price below its FMV by bidding less than the dollar amount of the secured debt, called an **underbid**.

Prior to the mid-1930s, the lender was able to obtain an award of money losses for the difference between the amount of the *underbid* and the amount due on the mortgage, regardless of the value of the property the lender held as security.

After the payment of the money judgment, the owner was not entitled to recover the property. Foreclosure by a trustee's sale barred any later *redemption* or *recovery* of the real estate by the wiped-out owner and was not a defense in court to avoid a money judgment.

Thus, in addition to losing the secured real estate, the owner also remained burdened with the responsibility of paying off the balance of a debt they incurred to buy property they no longer owned.

This disconnect came to an end in California in the late-1930s.

Recovery of deficiencies eliminated as against public policy

In the 1920s, the economy was booming. Real estate values were high and rising, and real estate prices and public confidence in the future were even higher. It was like the giddy **Millennium Boom** era of the mid-2000s, but with the added post-WWI fervor.

However, the 1930s ushered in an economic depression which, due in part to the abrasive foreclosure practices of lenders and carryback sellers (as well as a penurious Federal Reserve), decimated values in the real estate market.

Outsized real estate values plunged along with the solvency of banks and the health of the general economy. Foreclosure sales were rampant and the loss of homeownership escalated out of control.

With the additional burden of personal liability of owners for their property's deficient value, the chances of financial recovery for most owners who lost property through a trustee's foreclosure were slim. The easiest way to escape a **deficiency judgment** was to move to another state.

The drastic increase in foreclosures and the resulting money judgments and displacement of owners was a further drag on the region's economy.

anti-deficiency
A limitation placed on a mortgage holder barring recovery of losses on a default resulting when the mortgaged property's value is insufficient to satisfy a nonrecourse mortgage debt, and a recourse mortgage debt if nonjudicially foreclosed.

To curb those negative impacts, the California legislature enacted **anti-deficiency laws** which:

- limited the amount recoverable in a money judgment for mortgage debts to the difference between the amount due on the mortgage and a court-established FMV of the secured property at the time of a judicial foreclosure sale;[3]
- prohibited deficiency judgments on either type of foreclosure by limiting recovery to the value of the secured property when:
    - the mortgage funded the purchase and was secured by a one-to-four unit residential property occupied by the buyer as their principal residence, including refinanced purchase-money mortgages to the extent the funding is applied to payoff obligations under the purchase money mortgage; or
    - the mortgage evidenced the installment sale of any type of real estate and the property sold was the sole security for the debt;[4] and
- barred a deficiency judgment for any mortgage holder on completion of a **trustee's sale**.[5]

The risk of drop in market value

Anti-deficiency laws shift the **risk of loss** on a mortgage signed by the owner in favor of a *purchase-money* lender or carryback seller. The *risk of loss* shifts from the owner to the lender when the value of the secured real estate becomes inadequate to fully satisfy the debt, a condition called **negative equity**.

The value of the real estate securing a *purchase-money debt* may become deficient to cover the mortgage debt when real estate values fall due to a local or general economic downturn.

Here, anti-deficiency laws ensure an economic downturn is not aggravated beyond the usual cyclical increase in foreclosure sales. Thus, as a matter of public policy to avoid exacerbating a recession and stalling a recovery, buyers of any type of real estate on an installment sale are not held personally liable for those debts in the event of default.[6]

Consider a homebuyer who obtains a 30-year purchase-assist mortgage to fund their purchase of a one-to-four unit residential property to be occupied as their **principal residence**.

Later, changes in the local economy cause the property's FMV to drop below the mortgage balance. The buyer defaults and the lender acquires title to the *negative equity* property at a foreclosure sale.

Is the lender who funded the purchase-assist mortgage secured by the buyer-occupied one-to-four unit residential property able to enforce collection of the remaining unpaid mortgage balance?

3 CCP §580a
4 CCP §580b
5 CCP §580d
6 **Roseleaf Corporation** v. **Chierighino** (1963) 59 C2d 35

No! The lender is barred from obtaining a deficiency judgment in any amount regardless of the type of foreclosure. The purchase-assist mortgage is classified as *nonrecourse* since it funded the purchase of the property and was secured by a one-to-four unit residence occupied by the buyer.[7]

Overinflated prices for profit, and a carryback risk

Consider a seller of real estate who locates a buyer willing to pay an inflated price for the property. To help finance the buyer's purchase, the seller carries back a portion of the sales price in an *installment sale* as a mortgage secured solely by the property sold.

Realizing the property is **over-encumbered,** the buyer later defaults on the carryback mortgage. The seller forecloses and the property is sold at a foreclosure sale for less than the amount owed on the mortgage. The seller seeks to recover their loss on the mortgage due to the property's deficient value.

Here, *anti-deficiency laws* bar the carryback seller from enforcing collection of any deficiency at the time of the foreclosure sale, regardless of the foreclosure method employed. The property sold was the sole security for the mortgage, evidenced by an installment sale.[8]

Thus, the carryback seller whose property's sales price is inflated, or whose property declines in value after it is sold, will not benefit beyond the price received at the foreclosure sale.

Deficiency and other security

Now consider a seller who carries back two separate mortgage amounts on the sale of a single parcel of real estate after the buyer makes a 5% down payment, sometimes called **piggyback financing**. Two notes evidence separate amounts due the seller, totaling 95% of the property's total sales price.

One note is in an amount equal to an 80% **loan-to-value (LTV)** ratio and is secured by the property sold. The other note for 15% of the sales price is secured by other property owned by the buyer. A default on one note does not constitute a default on the other. [See **first tuesday** Form 154 §4]

The buyer defaults on both notes.

The seller completes a trustee's foreclosure sale under the carryback mortgage for the debt encumbering the property sold to the buyer. A judicial foreclosure is later initiated against the buyer's other property under the separate mortgage in an effort to recover what will be a deficiency in the other property's value to fully satisfy the debt at the time of the judicial foreclose sale.

The buyer claims the judicial foreclosure on the other property violates anti-deficiency law since the second foreclosure is an attempt to recover a deficiency on the price the buyer paid for the first property the seller recovered through a trustee's sale.

7 CCP §580b

8 CCP §580b

Sidebar

Shift in Risk of Loss

When a buyer uses anti-deficiency rules to defend against liability for the unpaid balance on a purchase-money mortgage, the risk of loss shifts from the buyer to the lender or carryback seller holding that mortgage.

*In the event the value of real estate securing a purchase-money mortgage falls, the mortgage holder's potential for loss increases. On a default, mortgage holders often minimize their loss through pre-foreclosure workouts. Mortgage holders often accept the net proceeds from the owner's sale of the secured property in exchange for cancelling the unpaid mortgage balance, called a **short payoff** or **short sale**.*

By accepting a short payoff, the lender or carryback seller avoids the costs of both:

- *foreclosure; and*
- *its REO acquisition of the property by foreclosure.*

Anti-deficiency laws protect buyers and prompt mortgage holders to minimize their potential losses, balancing the risk of losses during times of economic reversal.

*Taxwise, a buyer who participates in a short payoff on a nonrecourse mortgage incurs no reportable **discharge-of-indebtedness income** when the original purchase price of the secured property is greater than the principal remaining on the debt prior to the payoff. [**Commissioner of Internal Revenue** v. **Tufts** (1983) 461 US 300]*

discharge-of-indebtedness income
Reportable income resulting from a mortgage holder's discount on a payoff of a mortgage debt. Called a short pay.

recourse mortgage
A mortgage debt in which a lender may pursue collection from a property owner for a loss due to a deficiency in the value of the secured property to fully satisfy the debt if the lender forecloses judicially.

Is the seller able to foreclose on the buyer's other property under the separate mortgage and obtain a money judgment for any deficiency?

Yes! The foreclosure on the other property does not violate anti-deficiency law. A carryback debt secured by property other than the property sold is not subject to anti-deficiency law.[9]

In this example, the buyer, when negotiating to secure the carryback mortgage with a lien on other property in addition to the property purchased, needs to be advised by their agent to negotiate the inclusion of an **exculpatory clause** in the mortgage note. An *exculpatory clause* converts **recourse debt** into nonrecourse debt by eliminating personal liability for any deficiency in the value of the secured property. [See **first tuesday** Form 418-5]

Anti-deficiency waiver barred

exculpatory clause
A provision in a note secured by a trust deed which converts a recourse debt into nonrecourse debt to bar recovery by a money judgment against the borrower. [See **ft** Form 418-5]

Consider a seller of unencumbered property who carries back two mortgages evidencing separate portions of the sales price remaining to be paid. The mortgages are separately secured by first and second trust deeds on the real estate sold, an 80-10-10 piggyback financing arrangement.

Later, the buyer arranges for a lender to refinance the balance due on the carryback seller's first mortgage.

However, as a condition for recording the refinancing, the seller is required to **subordinate** their second mortgage to the lender's new mortgage. Thus, the refinancing will have priority as a first mortgage lien on the property.

9 **Hodges** v. **Mark** (1996) 49 CA4th 651

The carryback seller agrees to reconvey the first mortgage and subordinate the second mortgage to the refinancing, if the buyer:

- **personally guarantees** the seller's second mortgage; and
- signs a **written waiver** of any anti-deficiency protection against payment of the second mortgage.

subordination
The rearrangement of mortgage lien priorities on title in which a mortgage lien takes a lesser or junior position to another mortgage lien on a property.

The buyer agrees and enters into a **guarantee agreement** and a modification of the second mortgage. The seller enters into a **subordination agreement** allowing their original second mortgage to remain junior in priority to the new mortgage. The lender's trust deed and the subordination agreement are recorded on closing the mortgage escrow.

The buyer defaults. The first mortgage holder forecloses on the property, wiping out the carryback seller's second mortgage. The carryback seller seeks to recover the balance due on the second mortgage, since the foreclosure on the first mortgage exhausted the security interest in the property.

Only a third party guarantor is personally liable

Continuing our previous example, the carryback seller claims they are entitled to a deficiency judgment from the buyer since the buyer personally guaranteed the debt and waived their anti-deficiency protection in consideration for the seller subordinating their interest to new financing.

The buyer claims the personal guarantee and the waiver of anti-deficiency protection are *unenforceable* attempts by the seller to circumvent anti-deficiency law on the carryback debt.

Is the carryback seller able to enforce collection on the mortgage or the personal guarantee for the balance due on the mortgage?

No! The buyer is not liable on the mortgage or their guarantee. The seller's carryback debt remained secured by a mortgage on the property sold, with no additional property involved as security, and thus subject to the buyer's anti-deficiency defenses. Any agreement which purports to waive the buyer's anti-deficiency protection without a substitution of property as security is unenforceable as against **public policy**.[10]

As for the *guarantee agreement*, only a third party (not the person who signs the mortgage) can become personally liable for amounts due on another's debt. [See **first tuesday** Form 439]

guarantee agreement
An agreement entered into by a person who is not the borrower obligating that person as the guarantor to pay a mortgage holder in full if the borrower defaults. [See **ft** Form 439]

Now consider a seller who carries back a second mortgage on property they sell. Later, during a real estate recession, the buyer of the property defaults and is unable to sell the property or borrow funds to pay off the mortgage. The seller commences foreclosure by recording a **notice of default (NOD)**.

Prior to the trustee's sale, the buyer and seller modify the terms of the mortgage. A provision is included stating the buyer waives their anti-deficiency protection in exchange for cancellation of the *NOD*.

10 **Palm** v. **Schilling** (1988) 199 CA3d 63

The first mortgage holder forecloses, wiping out the seller's second mortgage. The carryback seller seeks to recover the amount owed on their mortgage since the first mortgage lienholder's foreclosure exhausted their security interest under the second mortgage lien.

The buyer claims the carryback seller is barred from any recovery on the mortgage since enforcement of debt created in an installment sale of real estate is subject to anti-deficiency protection, which, as a matter of public policy, cannot be waived.

The seller claims the buyer waived their anti-deficiency protection in a written agreement which modified the mortgage in exchange for the seller's cancellation of the NOD.

Is the seller able to recover on the carryback mortgage based on the modification and waiver agreement?

No! Recovery on the modified mortgage, which evidences a carryback debt secured at all times only by the property sold, is barred by anti-deficiency rules. Even though the buyer waived their anti-deficiency protection, any waiver of that protection while the carryback debt remains secured solely by the property sold is unenforceable as against public policy.[11]

Deficiency judgment and one year redemption

The public policy objective behind anti-deficiency legislation is to protect property owners and dissipate the "debtor's prison" effect on these owners.[12]

A lender holding a *recourse mortgage* is able to foreclose judicially and obtain a deficiency judgment if the FMV of the secured property at the time of the judicial foreclosure sale has fallen below the amount of the debt.

right of redemption
A property owner's or junior lienholder's right to clear a property's title of a mortgage lien prior to the completion of the trustee's sale by paying all amounts due on the mortgage, including foreclosure charges.

However, when a deficiency judgment is awarded to the lender, the property owner has the **right to redeem** the property within one year after the judicial foreclosure sale by paying the amount of the successful bid (plus interest).

If the money judgment remains unsatisfied, it is a separate debt. The judgment is unconnected to the *right to redeem* the property for the price bid at the foreclosure sale, even when the lender is both the successful bidder and judgment creditor.[13]

As in most litigation, a **judicial foreclosure** is costly to the lender both in time and money. Also, the lender who acquires the property at the foreclosure sale faces the risk of a further decline in the property's value during the one-year redemption period after the foreclosure sale, as well as the risk of being unable to recover a money award.

In contrast, a mortgage holder of either a recourse or nonrecourse mortgage is able to foreclose quickly and inexpensively through the trustee's sale procedure. On completion of the trustee's sale, the owner's right of redemption is terminated.

11 **DeBerard Properties, Ltd.** v. **Lim** (1999) 20 C4th 659; CCP §580d
12 Palm, *supra*
13 CCP §729.030

To counterbalance the recourse lender's right to a swift foreclosure through a trustee's sale, the recourse lender is barred from obtaining a deficiency judgment after foreclosing non-judicially by a trustee's sale. A buyer has no right to redeem the property after a trustee's sale, but is protected from a money judgment in favor of the lender for any deficient value.[14]

The reemergence of anti-deficiency law

When faced with an economic downturn, mortgaged property owners need the protection of anti-deficiency laws to shield them from mortgage holders if they are to continue live in California and contribute to the state's economy. This was the exact economic scenario during the **2008 Great Recession**, the echo of which we are still coping presently.

But signs of erosion are seen in the long-standing public policy behind the anti-deficiency defense. The California legislature passed laws to the benefit of mortgage holders in 1994, and **cramdown** authority on single family residences (SFRs) was removed by federal bankruptcy reform in 2005.[15]

cramdown
The reduction of the principal balance of a mortgage debt to the value of the mortgaged real estate.

Lenders are very good at lending too much money when profits remain **privatized** and then later lobbying governments to cover their errors in judgment by **socializing** their losses.

As a result, mortgage holders are able to circumvent California's anti-deficiency protections by requiring buyers to provide a **letter of credit** as a condition for financing (with the exception of purchase-money financing for buyer-occupied one-to-four unit residential property). The buyer is ultimately liable for repayment of any amounts the lender or carryback sellers draws on the *letter of credit*.[16]

letter of credit
A commitment made by a bank to a mortgage holder assuring payment of a stated amount on presentation to the bank, used by mortgage holders as a supplemental security device to avoid anti-deficiency laws.

Following the 1994 legislation, mortgage holders are no longer barred from drawing on letters of credit either before or after completing a trustee's sale to recover any deficiency in property value to fully pay off the mortgage balance. This procedure is quicker than the alternative of judicial foreclosure, appraisals, money judgment awards and redemption periods in pursuit of collection.

Additionally, the letter of credit has been legislatively re-classified. It is no longer legally considered a **guarantee** or additional security, although enforcing a letter of credit has the same economic function as the enforcement of a guarantee or pursuit of the additional security.

The issuer of a letter of credit (usually a lender) does not receive the same protection as a guarantor signing a guarantee. A guarantor is entitled to a **notice of foreclosure** and an opportunity to purchase the guaranteed mortgage before the completion of a foreclosure on the property, unless the guarantor waives this right to a notice in writing or fail to record a request for notice of NOD. [See **first tuesday** Form 439]

14 CCP §580d

15 CCP §580b; Calif. Commercial Code §5114; Pub.L. 109-8 (Bankruptcy Abuse Prevention and Consumer Protection Act of 2005)

16 CCP §§580.5; 580.7

Further, unlike additional security, a mortgage holder is able to draw on a letter of credit before completing a judicial foreclosure. This does not then bar the foreclosure for having enforced collection without first foreclosing on the secured property, which is known as the **one-action rule**.

Currently protected from the letter of credit device are:

- homebuyers;
- owner-occupants of one-to-four unit residential properties; and
- buyers who refuse to provide a letter of credit on which the mortgage holder is able to draw at any time.

A letter of credit is now legally considered a **source of payment**, not a form of security. It may be used by a mortgage holder at any time. Thus, a buyer defaulting on any debt secured by real estate and accompanied by a letter of credit (excluding an owner-occupied, one-to- four unit residence) has lost the much-needed protection that anti-deficiency law provides against reckless lending, boom-time mentality and dramatic declines in the real estate economy.

Chapter 23 Summary

Securing a debt by a mortgage on real estate places the enforcement of the debt under mortgage law. When held as security, the real estate, not the borrower, becomes the primary source of the mortgage holder's recovery in the event the borrower defaults.

Thus, to satisfy an unpaid debt on a default, the holder of a mortgage secured by real estate is forced to first foreclose, selling the real estate before attempting any other method of collection.

Mortgage holders are further limited in their ability to recover losses incurred when a foreclosed property's value is insufficient to satisfy the underlying debt. This protected class of debt is called purchase-money debt and includes carryback mortgages on any type of property sold, the purchase-assist funding of a one-to-four unit residential property occupied by the buyer and the refinance of a purchase-money debt for the purchase of an owner-occupied, one-to-four unit residential property.

The value of the real estate securing a purchase-money mortgage may become deficient as real estate values fall due to a local or general economic downturn. Anti-deficiency laws ensure an economic downturn is not aggravated beyond the usual cyclical increase in foreclosure sales.

A carryback debt secured by a property other than the property sold is not subject to anti-deficiency law. When negotiating to secure the carryback mortgage with a note on other property in addition to the property purchased, a buyer is advised to arrange for the inclusion of an exculpatory clause in the mortgage to eliminate personal liability for any deficiency.

Any guarantee or agreement under which the buyer purports to waive anti-deficiency protection without a substitution of property as security is unenforceable as against public policy.

Mortgage holders are able to circumvent California's anti-deficiency protections by (other than on buyer-occupied one-to-four residential units) requiring buyers to provide a letter of credit as a condition for financing in which the buyer is personally liable for repayment of any amounts the lender or carryback sellers draws on the letter of credit. A letter of credit is not a guarantee or additional security, although enforcing a letter of credit has the same economic function.

Chapter 23 Key Terms

Glossary

A

abstract of judgment 131, 140
A condensed written summary of the essential holdings of a court judgment.

abstract of title 111, 116
An accurate, factual representation of title to the property being acquired, encumbered or leased.

acceleration 56, 153
A demand on an owner of property by a mortgage holder for immediate payment of all amounts remaining unpaid on a mortgage. Also known as a call.

additional contributions provision............................... 206
A provision in the limited liability company (LLC) operating agreement authorizing the member manager to request additional capital contributions from the contributing members when operating conditions produce a cash operating deficit. [See **ft** Form 372-2 §2.1b]

Alquist-Priolo Maps...95
Maps which identify earthquake fault areas available from the State Mining and Geology Board and the city or county planning department. [See **ft** Form 314 §5]

anti-deficiency 242
A limitation placed on a mortgage holder barring recovery of losses on a default resulting when the mortgaged property's value is insufficient to satisfy a nonrecourse mortgage debt, and a recourse mortgage debt if nonjudicially foreclosed.

"as-is" clause 67
An unenforceable provision stating the buyer accepts the property without a full disclosure of known conditions. Properties are sold "as-disclosed," never "as-is."

assumption agreement.. 178
A promise given by the equity purchase (EP) investor to the seller or an existing mortgage holder to perform all the terms of the mortgage taken over by the investor on the sale. [See **ft** Form 431 and 432]

automatic homestead 141
The dollar amount of equity in a homeowner's principal dwelling the homeowner is automatically qualified to exempt from creditor seizure. Also known as a statutory homestead exemption.

B

beneficiary statement...175, 211
A document issued by a mortgage holder on request noting future payment schedules, interest rates and balances on a mortgage. [See **ft** Form 415]

blind pool investment program................................. 204
The solicitation or receipt of investor contributions in a group investment program before the syndicator identifies and discloses the real estate the investors' funds will be used to acquire.

bona fide purchaser (BFP)....................................... 10, 50
A buyer other than the mortgage holder who purchases a property for value at a trustee's sale without notice of title or trustee's sale defects.

broker price opinion (BPO)....................................... 231
An agent's opinion of a property's fair market value (FMV) based on comparable sales.

C

California Home Energy Rating System (HERS) 78
California state system used to create a standard rating for energy efficiency and certify professional raters. [See **ft** Form 156 §12.1h]

comparable market analysis (CMA)................................45
A worksheet used by an agent to prepare an estimate for review with an equity purchase (EP) investor of the value of property for sale based on the price recently paid for similar properties.

cramdown... 247
The reduction of the principal balance of a mortgage debt to the value of the mortgaged real estate.

D

date-down search 111
A further search of the public records performed immediately prior to closing an equity purchase (EP) transaction and issuance of a policy of title insurance.

declaration of homestead.................................. 133 , 139
A document signed by a homeowner and filed with the county recorder's office to protect the owner-occupant's homestead equity from seizure by creditors. [See **ft** Form 465]

deficiency 241
Losses experienced by a mortgage holder at a foreclosure sale due to insufficient value of the mortgaged property to satisfy the mortgage debt.

discharge-of-indebtedness income 244
Reportable income resulting from a mortgage holder's discount on a payoff of a mortgage debt. Called a short pay.

double escrow.. 194
An (EP) investor resale arrangement used to flip a property prior to closing their purchase escrow and acquiring title, by which the investor opens a second escrow for the resale of the property to another buyer.

due-on clause 151, 175
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

E

encumbrance.. 113
A claim or lien on a parcel of real estate, such as trust deeds, CC&Rs, easements, taxes or assessments.

equity purchase investor 2
A person who acquires title to a seller-occupied, one-to-four unit residential property in foreclosure for dealer, investment or security purposes.

equity purchase transaction 1, 11
A property transaction in which a one-to-four unit residential property in foreclosure, occupied by the owner as their principal residence, is acquired for dealer, investment or security purposes by an investor. [See **ft** Form 156]

escrow 184
The depository process employed to facilitate the gathering of instruments and funds for use to transfer real estate interests between two persons.

escrow instructions 184
Directives an escrow officer undertakes as given by a seller-in-foreclosure and an investor to coordinate a closing on a purchase agreement. [See ft Form 401]

escrow officer 184
An individual licensed and employed as an agent of an escrow company to perform escrow services.

exception 118
Any encumbrances affecting title and any observable on-site activities which are listed as risks agreed to and assumed by the insured and not covered by a policy of title insurance.

exclusion 117
Risks of loss not covered under a policy of title insurance, comprised of encumbrances arising after the transfer or known to or brought about by the insured.

exculpatory clause 244
A provision in a note secured by a trust deed which converts a recourse debt into nonrecourse debt to bar recovery by a money judgment against the borrower. [See **ft** Form 418-5]

F

Federal Housing Administration (FHA)-insured mortgage 166
A mortgage originated by a lender and insured by the FHA, characterized by a small down payment requirement, high loan-to-value (LTV) ratio and high mortgage insurance premiums (MIPs), typically made to first-time homebuyers.

federal tax lien 133
A lien recorded against the title of property owned by a taxpayer who owes the Internal Revenue Service (IRS) outstanding taxes.

five-business-day right to cancel 3
An owner-occupant seller of a one-to-four unit residential property in foreclosure on entering into a purchase agreement with an investor is entitled to cancel the agreement during a five-business-day period commencing on receipt of notice of the right to cancel. [See **ft** Form 156, page 6]

foreclosure consultant 35
A person who, for a fee from a seller-in-foreclosure, agrees to stop or postpone the foreclosure sale, prevent lienholders from enforcing or accelerating their note, help the seller reinstate the loan or negotiate an extension of the reinstatement period, advance funds to the seller or arrange a loan for the seller.

future advances clause..........62
A trust deed provision authorizing a mortgage holder to advance funds for payment of conditions impairing the mortgage holder's security interest in the mortgaged property, such as delinquent property taxes, assessments, improvement bonds, mortgage insurance premiums or elimination of waste. [See **ft** Form 450 §2.5]

G

Garn-St. Germain Federal Depository Institutions Act of 1982 153
Federal legislation which preempts state-level limitations on a mortgage holder's enforcement of the due-on clause contained in mortgages.

good faith deposit 190
A deposit made by an investor to evidence their good faith intent to buy when making their offer. Also known as earnest money. [See **ft** Form 401 §1.1]

guarantee agreement 245
An agreement entered into by a person who is not the borrower obligating that person as the guarantor to pay a mortgage holder in full if the borrower defaults. [See **ft** Form 439]

guarantor.......... 216
A person who agrees to pay a money obligation owed by another to a mortgage holder or a landlord under a lease agreement on a default in the obligation and demand for the sums remaining unpaid. [See **ft** From 439 and 553-1]

H

hardship letter 232
A statement detailing a distressed homeowner's financial situation, delivered to the lender to determine if the homeowner qualifies for a short sale. [See **ft** Form 217-1]

holdover tenant.......... 225
A tenant who retains possession of a rented premises after their right of possession has been terminated.

Home Affordable Foreclosure Alternatives (HAFA) 230
A government program aimed at assisting homeowners to avoid foreclosures by offering incentives for homeowners and lenders to complete short sales.

home energy audit..........77
An audit conducted by a Home Energy Rater evaluating the energy efficiency of the home. [See **ft** Form 156 §12.1h]

Home Equity Sales Contract Act (HESCA) 31
An equity purchase (EP) scheme established to protect homeowners whose residence is in foreclosure from deception and unfair dealing by investors.

home inspection report 68, 74
A report prepared by a home inspector disclosing defects in improvements on a property and used by the seller's agent to assure prospective buyers about actual property conditions. [See **ft** Form 130]

home inspector 75
A professional employed by a home inspection company to inspect and advise on the physical condition of property improvements in a home inspection report for reliance by the seller, the seller's agents and the buyer as a warranty of the condition of improvements.

homestead **130**
Dollar amount of equity in a homeowner's principal dwelling the homeowner qualifies to exempt from creditor seizure. [See **ft** Form 465]

I

inter vivos trust **161**
A title holding arrangement used as a vesting by a property owner for probate avoidance on death. Also known as a living trust. [See **ft** Form 463]

J

judgment lien **129**
A money judgment against a property owner that is recorded as an abstract and attaches to the title of their properties.

L

letter of credit **247**
A commitment made by a bank to a mortgage holder assuring payment of a stated amount on presentation to the bank, used by mortgage holders as a supplemental security device to avoid anti-deficiency laws.

loss mitigation **231**
A lender strategy to lessen the amount of their loss due to a default on a mortgage.

M

material defect **79**
Information about a property which might affect the price and terms a prudent buyer is willing to pay for a property.

mortgage-in-fact **222**
A grant deed given by an owner for the sole purpose of securing the performance of an obligation owed a creditor, such as payment of a debt.

N

Natural Hazard Disclosure (NHD) Statement **84**
A report provided by a local agency or NHD vendor and used by sellers and seller's agents to disclose natural hazards which exist on a property held out for sale. [See **ft** Form 314]

natural hazards **83**
Risks to life and property which exist in nature due to a property's location.

net operating income (NOI) **106**
The net revenue generated by an income producing property as the return on capital, calculated as the sum of a property's gross operating income less the property's operating expenses. [See **ft** Form 352 §4]

no-investor policy **169**
HUD policy which restricts a defaulting seller from selling their FHA-insured single family residence (SFR) to an investor.

nonrecourse mortgage **176, 216, 236, 240**
A debt secured by real estate for which the holder's sole source of recovery

of amounts owed is the value of the mortgaged property, no money judgment permitted for a deficiency in the value of the mortgaged property on foreclosure or short payoff to fully satisfy the debt.

notice of rescission **50**
Notice given by a seller-in-foreclosure to an equity purchase (EP) investor to exercise the seller's two-year right to rescind the sale and be restored to title of the property sold.

novation **157, 180, 197, 218**
An agreement entered into by a mortgage holder, equity purchase (EP) investor and seller to shift responsibility for a mortgage obligation to the investor by an assumption and release the seller of liability.

O

operating expenses **101**
The total annual cost incurred to maintain and operate a property for one year. [See ft Form 352 §3.21]

oppression **48**
When negotiations between an equity purchase (EP) investor and a seller-in-foreclosure are not realistic due to a "take it or leave it" environment created by the EP investor's abuse of inequality in bargaining power.

P

payoff demand statement **213**
A written demand, prepared by a mortgage holder, for the total dollar amount required on the date of preparation to pay off the mortgage as a requisite for recording a reconveyance of their trust deed lien on a property.

post-closing surprise **48**
The post-closing discovery of detrimental conditions hidden in the wording of an equity purchase (EP) agreement or escrow instructions.

power-of-sale provision **56**
A provision contained in a trust deed or other security device granting the holder the ability to nonjudicially foreclose by a trustee's sale of the secured real estate.

preliminary title report **109, 116**
A report constituting a revocable offer by a title insurer to issue a policy of title insurance used by a buyer and escrow to initially establish the current vesting and encumbrances attached to title of a property as reflected by public record.

proof-of-loss statement **126**
A statement submitted to the title insurance company by the insured referencing the encumbrance discovered after the policy was issued, the amount of the loss and the basis for calculating the loss.

property operating data **100**
The actual costs of operating a property for its intended use. [See **ft** Form 306 and 352]

proration **189**
Provisions entitling the seller to a credit for the portion of prepaid sums which have not accrued on obligations the investor assumes on the day escrow closes, or entitling the investor to credit for amounts assumed which accrued unpaid through the day prior to the close of escrow. [See **ft** Form 401 §10]

purchase-assist funding 240
The use of proceeds from a mortgage to fund the price paid by the borrower to acquire real estate.

put option 38, 240
A provision in all trust deeds which, in tandem with anti-deficiency laws, grants the owner of mortgaged real estate the right to default and force the mortgage holder to first sell the property through foreclosure.

Q

quiet title 140
A court action to establish title to a property or remove a cloud from title.

R

recourse mortgage 177, 236, 244
A mortgage debt in which a lender may pursue collection from a property owner for a loss due to a deficiency in the value of the secured property to fully satisfy the debt if the lender forecloses judicially.

redeem 57
The clearing of title to a parcel of real estate of a monetary lien, such as a mortgage, through payment of the debt in full as is required during a redemption period to avoid loss of the property either at a trustee's foreclosure sale or following a judicial foreclosure sale.

reinstatement 57, 223
The curing of monetary defaults and terminating the foreclosure process on a mortgage by a property owner or junior lienholder prior to expiration of the reinstatement period applicable to the trustee's or judicial foreclosure by paying the delinquent amounts and foreclosure charges.

rent skimming 167
When a speculator purchases a single family residence (SFR), and collects and keeps rent without making payments on the underlying loan.

restoration 85
The return of funds and documents on a rescission of a purchase agreement sufficient to place all the parties in the position they held before entering into the agreement.

reverse lease-option 225
A sale-leaseback agreement with the option to purchase as an addendum.

right of redemption 246
A property owner's or junior lienholder's right to clear a property's title of a mortgage lien prior to the completion of the trustee's sale by paying all amounts due on the mortgage, including foreclosure charges.

S

Schedule A 117
Identification of the property interest the insured acquired, the legal description of the insured property, the date and time coverage began, the premium paid for the policy, and the maximum total dollar amount to be paid for all claims settled.

Schedule B 118
Itemization of title insurance policy exemptions and items which need to be complete before escrow may close and title insurance is issued.

short sale **229**
A sale in which the lender accepts the net proceeds at closing in full satisfaction of a greater amount of mortgage debt. Also known as a short payoff.

Statute of Frauds **186**
A rule of contract law requiring specific real estate transactions to be reduced to a signed writing to be enforceable.

subject-to transaction **175**
A sale of mortgaged property calling for the buyer to take title subject to the mortgage, the principal balance being credited toward the purchase price paid. Compare with formal assumption. [See **ft** Form 156 §5]

subordination **245**
The rearrangement of mortgage lien priorities on title in which a mortgage lien takes a lesser or junior position to another mortgage lien on a property.

syndicator **203**
An individual who solicits cash contributions from investors to fund a limited liability company to acquire real estate for investment purposes.

T

termination **85**
The cancellation of a transaction before escrow has closed. [See **ft** Form 183]

title insurance **114**
A form of indemnity insurance by which a title insurance company holds harmless a person who acquires an interest in real estate against a monetary loss caused by an encumbrance on title that is not listed in the policy and the insured was unaware of when the policy was issued.

transfer disclosure statement (TDS) **66**
A mandatory disclosure prepared by a seller-in-foreclosure and given to prospective buyers setting forth any property defects known or suspected to exist by the seller, generically called a condition of property disclosure. [See **ft** Form 304]

two-year right of recission **12**
A seller-in-foreclosure's right to rescind a closed equity purchase transaction when the equity purchase investor exploits an unconscionable advantage during negotiations to acquire the property.

U

unconscionable advantage **45**
When an equity purchase investor or a mortgage holder exploits an element of oppression, helplessness or surprise to exact unreasonably favorable terms from a property owner or tenant.

unsecured debt **215**
A mortgage balance remaining unpaid following reconveyance of property subject to a trust deed, exhaustion of the security by foreclosure of a prior lien or errors in the principal amount of a mortgage debt in a beneficiary statement or payoff demand.

U.S. Department of Veterans Affairs (VA) mortgage guarantee ... **166**
A program that assists qualified veterans or their surviving spouses to buy a home with zero down payment. [See **ft** Form 153]

V

VA assumption fee **170**
A fee of 0.5% of a VA loan, assumed by the buyer of a VA-guaranteed single family residence (SFR) upon closing.

W

waiver agreement.. **162**
An agreement in which a mortgage holder consents to the owner's present or future transfer of an interest in the mortgaged property as a waiver of the mortgage holder's due-on rights. Also known as an assumption agreement. [See **ft** Form 431 and 432]

waste **177**
The intentional destruction or neglect of property which diminishes its value. [See **ft** Form 550 §6.8 and 552 §7.4]