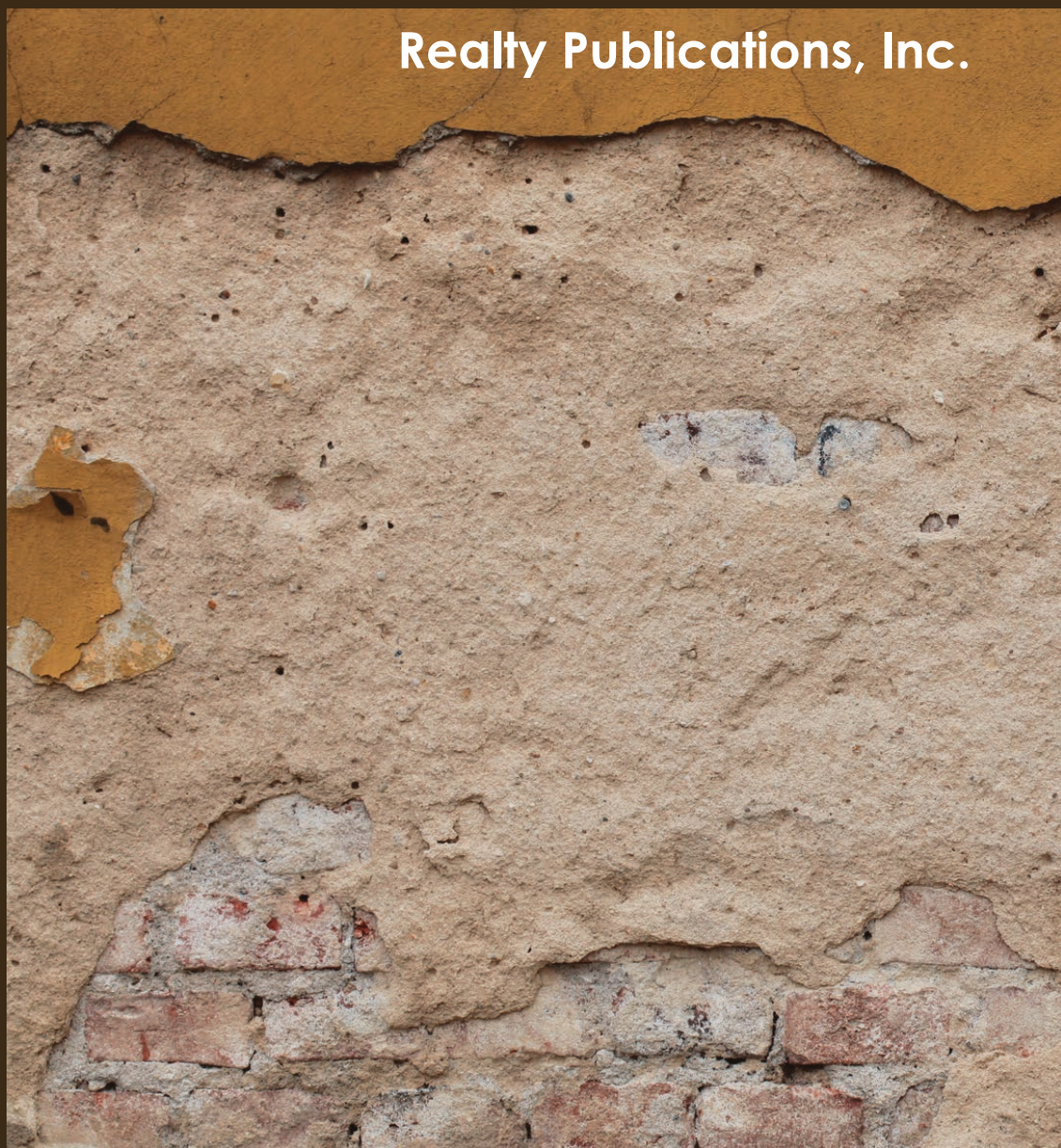
Due Diligence and Disclosures

Realty Publications, Inc.



CITE THIS READING MATERIAL AS:

Realty Publications, Inc.

Due Diligence and Disclosures

Fifth Edition

Cutoff Dates:

Legal editing of this book was
completed October 2016.

Printed in California

Editorial Staff

Legal Editor/Publisher:
Fred Crane

Project Editor:
Sarah Kolvas

Senior Editors:
Giang Hoang-Burdette
Connor P. Wallmark

Contributing Editors:
Fernando Nuñez
Carrie B. Reyes

Graphic Designer:
Mary LaRochelle

Editorial Assistant:
Kyle Scott W.

Comments or suggestions to:
Realty Publications, Inc., P.O. Box 5707, Riverside, CA 92517
contact@realtypublications.com

Table of Contents

Agency Issues

Listings: Employment by the Public

Property Conditions & Disclosures

Income Property

Taxes

Table of Forms

For a full-size, fillable copy of any form cited in this book, plus our entire library of 400+ legal forms, go to: ***realtypublications.com/forms****.*

Full Forms

Partial Forms

Chapter 1

An agent's perception of riches

Learning Objectives

After reading this chapter, you will be able to:

- estimate the potential income and expenses an agent will likely experience when employed by a broker; and
- evaluate competing brokerage firms for suitability with an agent's professional goals and expectations.

Key Terms

net operating income (NOI) **sales goal**
(employment)

The employing broker avoids agent deceptions

Consider an individual who receives an original salesperson license from the **California Bureau of Real Estate (CalBRE)**. The newly licensed agent contacts a real estate broker in response to an advertisement soliciting agents to join the broker's office. The agent interviews the broker, and others, in an effort to find a suitable office environment to work in.

Eventually, the agent selects the office they feel is most able to provide the training and guidance they need to earn a living in real estate sales.

During an *agent interview*, the broker addresses the question of earnings. The agent is told the employment relationship with the broker will be under an *independent contractor (IC) agreement* with workers' compensation coverage provided by the broker. [See **RPI** Form 506]

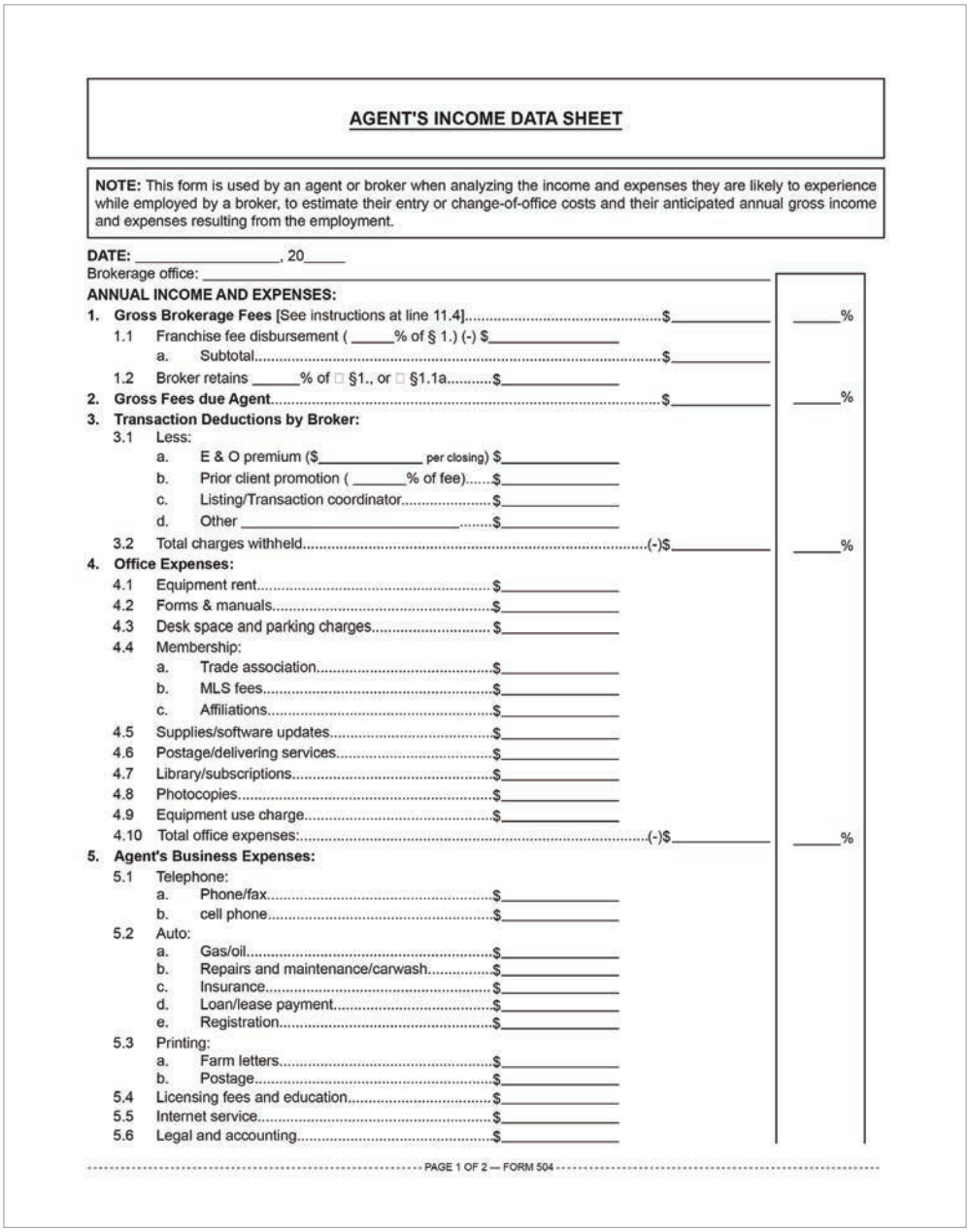
No income tax withholding or employer contributions exist, such as for:

- social security;
- Medicare; or
- unemployment insurance.

Form 504

Agent's Income Data Sheet

Page 1 of 2



AGENT'S INCOME DATA SHEET

NOTE: This form is used by an agent or broker when analyzing the income and expenses they are likely to experience while employed by a broker, to estimate their entry or change-of-office costs and their anticipated annual gross income and expenses resulting from the employment.

DATE: _____, 20_____
Brokerage office: _____

ANNUAL INCOME AND EXPENSES:

1.	**Gross Brokerage Fees** [See instructions at line 11.4]		$_____	_____%
1.1	Franchise fee disbursement (_____% of § 1.) (-)		$_____	
a.	Subtotal		$_____	
1.2	Broker retains _____% of ☐ §1., or ☐ §1.1a		$_____	
2.	**Gross Fees due Agent**		$_____	_____%
3.	**Transaction Deductions by Broker:**			
3.1	Less:			
a.	E & O premium ($_____ per closing)		$_____	
b.	Prior client promotion (_____% of fee)		$_____	
c.	Listing/Transaction coordinator		$_____	
d.	Other _____		$_____	
3.2	Total charges withheld	(-)	$_____	_____%
4.	**Office Expenses:**			
4.1	Equipment rent		$_____	
4.2	Forms & manuals		$_____	
4.3	Desk space and parking charges		$_____	
4.4	Membership:			
a.	Trade association		$_____	
b.	MLS fees		$_____	
c.	Affiliations		$_____	
4.5	Supplies/software updates		$_____	
4.6	Postage/delivering services		$_____	
4.7	Library/subscriptions		$_____	
4.8	Photocopies		$_____	
4.9	Equipment use charge		$_____	
4.10	Total office expenses:	(-)	$_____	_____%
5.	**Agent's Business Expenses:**			
5.1	Telephone:			
a.	Phone/fax		$_____	
b.	cell phone		$_____	
5.2	Auto:			
a.	Gas/oil		$_____	
b.	Repairs and maintenance/carwash		$_____	
c.	Insurance		$_____	
d.	Loan/lease payment		$_____	
e.	Registration		$_____	
5.3	Printing:			
a.	Farm letters		$_____	
b.	Postage		$_____	
5.4	Licensing fees and education		$_____	
5.5	Internet service		$_____	
5.6	Legal and accounting		$_____	

PAGE 1 OF 2 — FORM 504

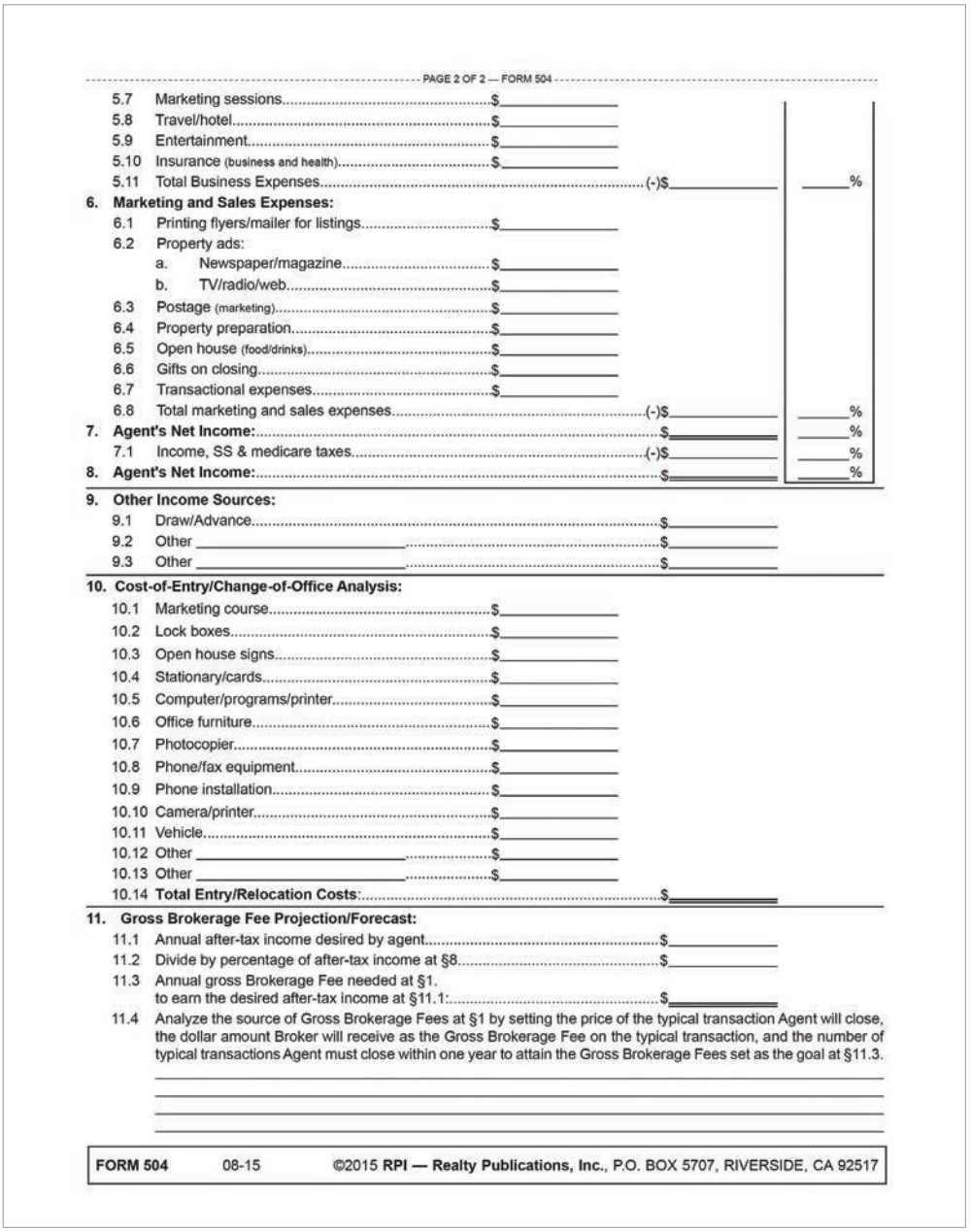
Further, the broker explains the agent needs cash reserves or income from other sources to meet their living and business expenses for six to nine months. Several months will pass before income will be forthcoming from closings in which the agent will have participated. The brokerage office does not make monthly advances against future fees.

To assist the agent in an analysis of potential earnings, an **income and expense data worksheet** is prepared by the agent. The agent enters the approximations made by the broker for the various expenses a typical agent may experience during their first year with the brokerage office. [See Form 504 accompanying this chapter]

Form 504

Agent's Income Data Sheet

Page 2 of 2



PAGE 2 OF 2 — FORM 504

5.7	Marketing sessions	$		
5.8	Travel/hotel	$		
5.9	Entertainment	$		
5.10	Insurance (business and health)	$		
5.11	Total Business Expenses		(-)$	%
6.	**Marketing and Sales Expenses:**			
6.1	Printing flyers/mailer for listings	$		
6.2	Property ads:			
	a. Newspaper/magazine	$		
	b. TV/radio/web	$		
6.3	Postage (marketing)	$		
6.4	Property preparation	$		
6.5	Open house (food/drinks)	$		
6.6	Gifts on closing	$		
6.7	Transactional expenses	$		
6.8	Total marketing and sales expenses		(-)$	%
7.	**Agent's Net Income:**		$	%
7.1	Income, SS & medicare taxes		(-)$	%
8.	**Agent's Net Income:**		$	%
9.	**Other Income Sources:**			
9.1	Draw/Advance		$	
9.2	Other		$	
9.3	Other		$	
10.	**Cost-of-Entry/Change-of-Office Analysis:**			
10.1	Marketing course	$		
10.2	Lock boxes	$		
10.3	Open house signs	$		
10.4	Stationary/cards	$		
10.5	Computer/programs/printer	$		
10.6	Office furniture	$		
10.7	Photocopier	$		
10.8	Phone/fax equipment	$		
10.9	Phone installation	$		
10.10	Camera/printer	$		
10.11	Vehicle	$		
10.12	Other	$		
10.13	Other	$		
10.14	**Total Entry/Relocation Costs:**		$	
11.	**Gross Brokerage Fee Projection/Forecast:**			
11.1	Annual after-tax income desired by agent		$	
11.2	Divide by percentage of after-tax income at §8		$	
11.3	Annual gross Brokerage Fee needed at §1. to earn the desired after-tax income at §11.1:		$	
11.4	Analyze the source of Gross Brokerage Fees at §1 by setting the price of the typical transaction Agent will close, the dollar amount Broker will receive as the Gross Brokerage Fee on the typical transaction, and the number of typical transactions Agent must close within one year to attain the Gross Brokerage Fees set as the goal at §11.3.			

FORM 504 08-15 ©2015 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

The agent uses the worksheet to further analyze income, expenses, cash reserves and the sales goal they determine are necessary to provide an acceptable after-tax income for personal living expenses.

Data underlying an income analysis

As a prerequisite to an agent's use of an *income and expense data worksheet*, the agent needs to collect income data during an interview with a prospective broker, including:

- the *price range* of property the agent is most likely to list and sell;
- the *number of sales* the agent is likely close in that price range during the first year;

- the *gross broker fees* generated by the number of sales during the first year; and
- the *share of the gross broker fees* the agent will receive under the fee-sharing schedule offered by the broker.

The likely *gross fees* the broker is to receive and the agent's share of those fees are entered on the worksheet as a result of the interview. [See Form 504 §§1 and 2]

sales goal
The amount of after-tax income agents and brokers intend to earn as a result of their real estate licensing activities.

Ultimately, the **sales goal** set by the agent is reflected in the amount of after-tax income the agent seeks for themselves. [See Form 504 §11]

Until the worksheet is filled out accurately, projecting fees to be received by the agent, estimating expenses to be incurred and attempting to set sales volume goals or probable after-tax earnings is an uneducated guess.

The agent's personal role

The volume of real estate sales closed by new agents during their first year in the business is a "numbers game." Only a low percentage of all sales efforts come to fruition in the form of fees received from closings. Thus, the type of person attracted to real estate sales needs to have an innate curiosity and enthusiasm for estimating and forecasting income and expenses if they are to succeed.

A prospective agent who is discouraged or daunted by the exercise of completing a worksheet is unlikely to be a prime candidate for employment in the real estate business.

The broker steps forward, with information

Brokers, by experience, tend to be more organized than agents. Brokers who employ agents are also better able to anticipate the income and expenses an agent will incur than recently licensed agents. It is the broker who is best able to draw a conclusion about an agent's future with the broker's office, not an agent new to the world of real estate sales or who has been languishing in another office due to inadequate or nonexistent planning and organization.

A broker's primary objective when hiring agents is to increase the gross broker fees received by the office without a disproportionate increase in operating expenses. For the broker to make hiring a productive endeavor, the broker needs to organize an agent selection and evaluation plan to avoid the *turnover of agents* who remain with the office for only a short period of time.

Long-term employment of agents contributes to a favorable industry-wide reputation for the broker, and provides a return to the broker for the time and energy invested with each agent during the employment process and the agent's start-up period. Energy, money, time and enthusiasm all wane fast when the turnover of talented agents in an office is due to the failure of unrealistic expectations held by the agents.

A broker's full disclosure — upfront and prior to employment — covering the agent's likely income and expenses, and why the fee sharing and expenses allocations are reasonable, leads to a realistic expectation of income by the agent.

Monthly and quarterly sales goals may then be set at levels designed to meet projected earnings if the agent is employed by the broker.

Estimating the initial cash investment

To control the agent's interview and get long-term results, the broker needs to initiate the income and expense discussion, not wait until the prospective agent takes charge by raising the question of earnings. Earning a living is the crux of entering the profession.

To be ready for an interview with a prospective agent, the broker needs to prepare a worksheet by estimating the expenses the agent is most likely to incur. Also, the broker needs to estimate the initial *cash investment* the prospective agent is required to make to cover one-time, nonrecurring expenditures and the carrying costs for a period of time necessary to get a proper start in real estate sales. [See Form 504 §10]

Once the operating expenses, nonrecurring costs and carrying costs to be incurred by the typical agent have been established — based on the broker's history with their present agents — what remains is the difficult task of anticipating an agent's **gross fees** from sales that will most likely close during the first year of employment.

Forecasting gross fees to set expectations, and goals

A couple of approaches for estimating future fees are apparent. For one, the broker may project a range of gross broker fee amounts, varying from the earnings generated by a high producer to those of a low producer during their first year with the office. The various gross broker fee projections — ranging from low, medium to high — may be entered on separate copies of the income and expense worksheet. The agent's expenses estimated for the first year are included in the worksheets.

Thus, the prospective *agent's after-tax* income can be calculated based on various levels of sales.

Another approach for the interview is to discuss the range of gross broker fees an agent can generate, without the broker first entering a projection of fees on the income and expense worksheet handed to the agent. Thus, the agent is left to enter and calculate the income they either believe they can produce or want to produce to attain the after-tax income they seek.

Reviewed by the broker and the prospective agent under either approach, or a combination of approaches, the worksheet becomes both a **budget and a sales goal** for the agent. With an open-minded review of the pros and cons of income sharing and expense allocation, the broker encourages the agent to set attainable production goals.

At the same time, the broker confirms whether the prospective agent has the financial capacity to carry their personal and business expenses during the start-up period with the office before the fees from closings start to roll in.

Steps a broker takes to inform

An employing broker informs a prospective agent about the out-of-pocket operating expenses the agent is most likely to incur while employed by the broker. Also, the agent needs to have a vehicle, computer and materials required for transactions involving real estate sales, leasing or financing. Agents need to pay *multiple listing service (MLS)* fees to become part of the market. An explanation of the **net operating income (NOI)** from sales the agent is to expect they will receive cannot be overlooked by the broker.

net operating income (NOI) (employment) The net revenue generated by an agent's employment, calculated by subtracting business operating costs from the expected income from fees generated from sales, leasing or financing transactions.

Without these disclosures, an analysis of the agent's long-term potential with the office has not taken place.

These types of disclosures will help avoid either a termination of employment or dissatisfaction over lost expectations.

Thus, a realistic and relatively accurate disclosure of income, expenses and the initial investment an agent is to make on entering the employ of the broker:

- reduces the office turnover of agents;
- reduces the broker's investment of time and energy hiring and training agents; and
- produces a sales staff whose income expectations are met based on their ability to attain the sales goals each have set for themselves.

Selecting a broker by comparative shopping

After a few years of employment in the business of real estate sales, efficient agents generally want to earn more for the time they spend:

- listing properties and buyers;
- locating buyers and properties; and
- engaging in all the activities surrounding a real estate sales transaction.

Before walking into the broker's or manager's office with a demand for the office to cover more expenses and give the agent a larger share of the broker fees, the agent is to first conduct *comparative shopping* to determine how other brokers share expenses and fees with their agents.

The first step for the agent interested in renegotiating their current employment arrangement with a broker or moving to another broker's office is to prepare a worksheet on their current operating conditions. The worksheet details:

- what fees the agent has generated;
- the share of the fees the agent received;
- the operating expenses paid by the agent and the net income; and
- the after-tax income experienced during the past 12-month period.

If the exercise goes no further, the worksheet may act as a *budget* or a basis for forecasting the next 12 months. Further, the variables controlling the amount of income and expenses may be analyzed, adjusted and projected to set sales goals the agent wants to attain during the next 12 months.

The second step is to distinguish the agent's current arrangement with their broker from the earning opportunities available with other acceptable brokerage offices. The comparative analysis is accomplished by preparing a worksheet for each prospective office. Information for the worksheet may be gathered from interviews with those brokers or their managers, or agents in those offices who have a handle on their income and expense arrangements with their broker.

On completion of the worksheet for each office, a comparison shows the distinctions and parallels between the different offices.

An informed comparison

Armed with comparisons reflected by the data on the worksheets, the agent seeking to renegotiate fee splits and the allocation of expenses with their current broker are able to structure their request for specific changes based on the market place of employing brokers.

Alternatively, the agent seeking to change offices uses the worksheet to make the same comparisons and size up prospective brokerage offices. Ultimately, the agent hopes to negotiate an income and expense sharing arrangement which satisfies the agent and provides a better opportunity for **greater earnings** — expectations realized based on comparison shopping and the agent's past sales history.

However, *timing* is important. The period during which the agent begins negotiations with their current broker or schedules interviews with other brokers can affect their results.

For instance, at the height of a booming market, a broker is more willing to increase a productive agent's share of the fees since the broker's current overhead is already covered without the fees from additional sales.

The agent's advantage of a better fee split and cost allocation carries over into the inevitable slowdown in sales which follows every boom.

Conversely, a new agent entering an office during a recessionary period just prior to an upswing in sales benefits from a broker's attention to the care and training of new agents. Also important is the invaluable assistance of experienced agents in the office who have a little extra time on their hands. The extra time afforded by a slower market allows agents to assist others, a bonding process important for a successful future in real estate sales in the following years.

Chapter 1 Summary

A new sales agent seeking employment with a broker may use an income and expense data worksheet to analyze income, expenses, cash reserves and the sales goal they need to meet to provide an acceptable after-tax income.

Established brokers are better able to anticipate the income and expenses an agent will incur. Thus, a broker's full disclosure of the agent's likely income and expenses leads to realistic expectations of income by the agent.

An employing broker needs to inform a prospective agent about the operating expenses the agent is likely to incur while employed by the broker. The agent needs to have a vehicle, computer and instruments and materials required for transactions involving real estate sales, leasing or financing. The agent also needs to pay multiple listing service (MLS) fees to become part of the market.

If an agent later seeks to negotiate higher fee splits or relocate to a new brokerage office, they are best served completing an operating data worksheet to assess their current operating conditions and compare them with prospective brokerages. Comparative shopping allows the agent to request employment changes or relocate based on the current market place.

Chapter 1 Key Terms

Chapter 2

The MLS environment

Learning Objectives

After reading this chapter, you will be able to:

- challenge misconceptions about multiple listing service (MLS) subscriptions and price-fixing practices imposed by industry brokers; and
- understand the duties of a buyer's agent to locate suitable property, seek the most advantageous price and terms available and diligently advise the buyer in the transaction.

Key Terms

Agency Law Disclosure
dual agency
dual agent
double-end
multiple listing service (MLS)
price fixing
subagent
supra-competitive

An industry-wide membership misconception

In every day practice, a sales agent who works with a buyer is commonly referred to as the **buyer's agent** or, less frequently, the **selling agent**. However, by law, it is the broker employed by the buyer who is the *buyer's agent,* while the sales agent is the "agent of the (buyer's) agent."[1] [See **RPI** Form 305 §3]

Historically, and incorrectly, the broker and their agent who represented a buyer in a sales transaction were — but no longer are — referred to as **subagents** within the residential **multiple listing service (MLS)** brokerage community until the late 1980s. The misnomer was a product of the pre-1980s *MLS environment.* As the genesis, it was said all brokers (and their agents) who were members of a trade union's MLS were automatically "seller's agents." Thus, MLS subscribers working directly with a buyer were merely subagents employed by the seller to sell a property listed in the MLS through the seller's primary broker.

subagent
An individual who has been delegated agency duties by the primary agent of the client, not the client themselves.

1 Calif. Civil Code §2079.13(n)

multiple listing service (MLS) An association of real estate agents pooling and publishing the availability of their listing properties.

The MLS subscriber who produced the buyer was artificially viewed as *appointed* by the seller's agent to act on behalf of the seller by virtue of:

- the MLS subscription; and
- the authority granted by a *subagency provision* in the listing agreement of the day.

dual agency The agency relationship that results when a broker represents both the buyer and the seller in a real estate transaction. [See **RPI** Form 117]

Unlike today's separate representation, the buyer of a property published in the MLS was segregated without representation and unable to employ a MLS member. In practice, no subscriber to a trade union-owned MLS could represent a buyer — an "industry trade standard" that typically led to **dual agency**.

Even the purchase agreements published by the union and used by union-owned MLS subscribers provided for all brokers and agents involved to be the employees of the seller. None were employed in writing by buyers.

The subagency dilemma of cooperating brokers

Today, the buyer's broker and the broker's agents still sometimes refer to themselves improperly as the *cooperating office* or cooperating agents in a sales transaction. They are not, and the respective positions of seller's and buyer's agents in a transaction are adversarial, though they properly agree to split fees typically paid by the seller.

Use of the term *cooperating* arose from the old MLS subagency concept. In those days, the seller's broker shared the fee paid by the seller with the buyer's broker as the seller's subagent by contract. *Fee sharing* exists today, but it is authorized by a fee-splitting clause in listing agreements and not by the conflicted and long-abandoned subagency provision. [See **RPI** Form 102 §4.3]

The purchase agreement forms used prior to the late 1980s were devoid of fee arrangement provisions in the buyer's offer. Yet, a fee provision is needed in the offer signed by the buyer. Offers so structured give the buyer's agent the ability to independently set their fee. If the offer is accepted or another fee arrangement is reached, the buyer's broker can enforce collection of the fee from the seller themselves. Otherwise, the buyer's broker is dependent on the seller's broker enforcing payment from their seller client, then sharing any fee collected with the buyer's broker.

Agency Law Disclosure Restatement of agency codes and cases which establish the conduct of real estate licensees. It is delivered to all parties in targeted sales and leasing transactions. [See **RPI** Form 305]

All MLS subagency arrangements came to a stop by the mid-1980s when the real estate agency law was enacted to codify case law and agency principles, which are disclosed through the **Agency Law Disclosure**. Only then did buyer's listings begin to be generally used.[2] [See **RPI** Form 305]

Presently, under a buyer's listing, MLS brokers and their agents effectively act on behalf of buyers without being subagents in a fee arrangement with the seller's broker, who is the *adversary* of the buyer and the buyer's broker in the transaction. As a result, buyer's agents are able to independently set

2 CC §2079 et seq

the amount of the fee they want to receive (paid by sellers) with the seller's agents no longer dictating, managing or controlling the amount of the fee buyers are willing to allow their agents to receive.

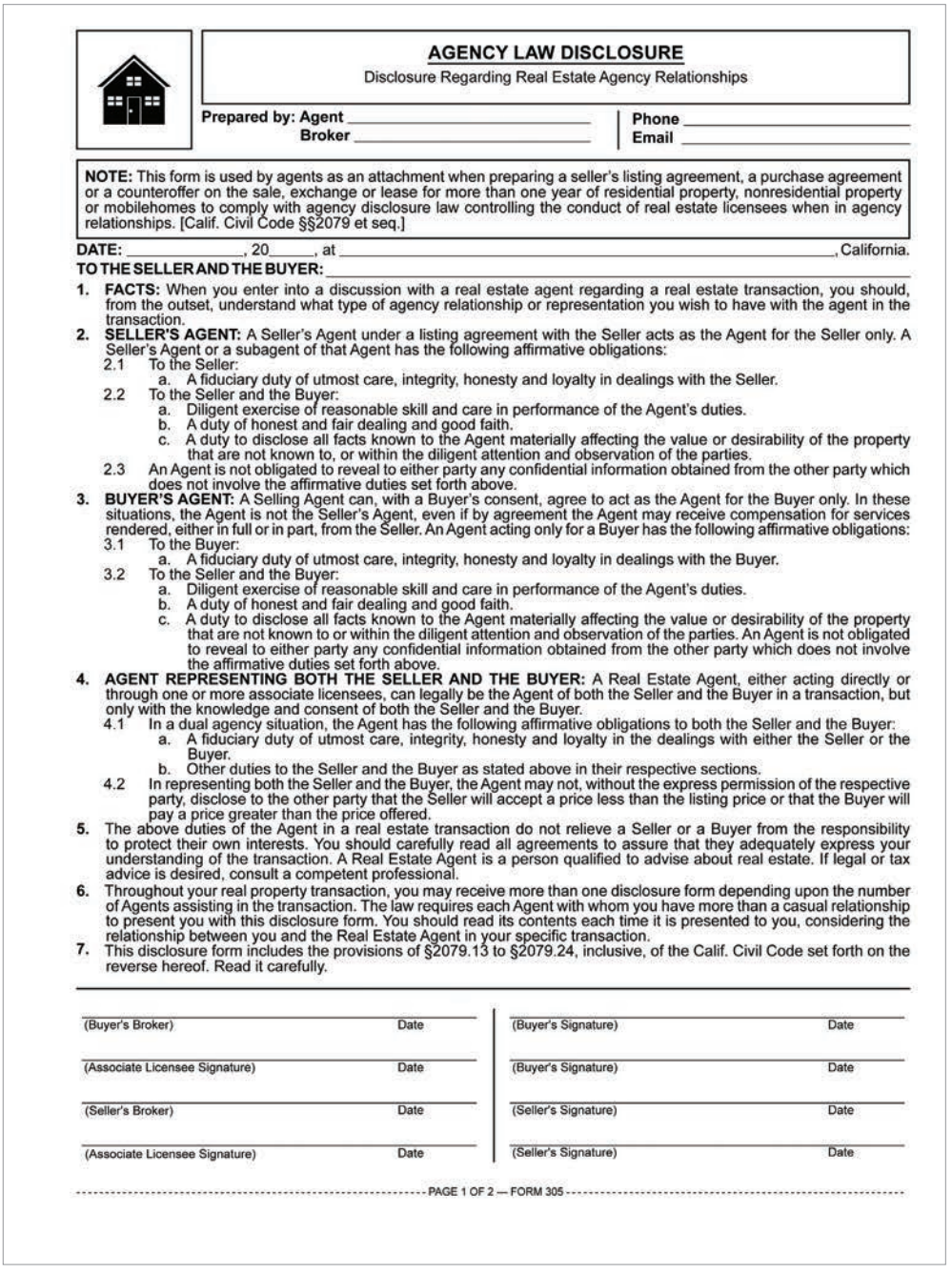
The buyer's offer now includes a provision for setting the fee the buyer's agent is to receive, not the MLS listing information as in the past. [See **RPI** Form 150 §15]

Editor's note — Though the buyer's agent has the ability to negotiate their earned fee through the purchase agreement, some buyer's agents believe their fee amount is dictated by the fee split offered by the seller's agent in the MLS listing. However, broker fees are always negotiable. [See Chapter 6]

Form 305

Agency Law Disclosure

Page 1 of 2



AGENCY LAW DISCLOSURE

Disclosure Regarding Real Estate Agency Relationships

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

NOTE: This form is used by agents as an attachment when preparing a seller's listing agreement, a purchase agreement or a counteroffer on the sale, exchange or lease for more than one year of residential property, nonresidential property or mobilehomes to comply with agency disclosure law controlling the conduct of real estate licensees when in agency relationships. [Calif. Civil Code §§2079 et seq.]

DATE: _____, 20_____, at _____, California.
TO THE SELLER AND THE BUYER: _____

1. **FACTS:** When you enter into a discussion with a real estate agent regarding a real estate transaction, you should, from the outset, understand what type of agency relationship or representation you wish to have with the agent in the transaction.
2. **SELLER'S AGENT:** A Seller's Agent under a listing agreement with the Seller acts as the Agent for the Seller only. A Seller's Agent or a subagent of that Agent has the following affirmative obligations:
   - 2.1 To the Seller:
     - a. A fiduciary duty of utmost care, integrity, honesty and loyalty in dealings with the Seller.
   - 2.2 To the Seller and the Buyer:
     - a. Diligent exercise of reasonable skill and care in performance of the Agent's duties.
     - b. A duty of honest and fair dealing and good faith.
     - c. A duty to disclose all facts known to the Agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of the parties.
   - 2.3 An Agent is not obligated to reveal to either party any confidential information obtained from the other party which does not involve the affirmative duties set forth above.
3. **BUYER'S AGENT:** A Selling Agent can, with a Buyer's consent, agree to act as the Agent for the Buyer only. In these situations, the Agent is not the Seller's Agent, even if by agreement the Agent may receive compensation for services rendered, either in full or in part, from the Seller. An Agent acting only for a Buyer has the following affirmative obligations:
   - 3.1 To the Buyer:
     - a. A fiduciary duty of utmost care, integrity, honesty and loyalty in dealings with the Buyer.
   - 3.2 To the Seller and the Buyer:
     - a. Diligent exercise of reasonable skill and care in performance of the Agent's duties.
     - b. A duty of honest and fair dealing and good faith.
     - c. A duty to disclose all facts known to the Agent materially affecting the value or desirability of the property that are not known to or within the diligent attention and observation of the parties. An Agent is not obligated to reveal to either party any confidential information obtained from the other party which does not involve the affirmative duties set forth above.
4. **AGENT REPRESENTING BOTH THE SELLER AND THE BUYER:** A Real Estate Agent, either acting directly or through one or more associate licensees, can legally be the Agent of both the Seller and the Buyer in a transaction, but only with the knowledge and consent of both the Seller and the Buyer.
   - 4.1 In a dual agency situation, the Agent has the following affirmative obligations to both the Seller and the Buyer:
     - a. A fiduciary duty of utmost care, integrity, honesty and loyalty in the dealings with either the Seller or the Buyer.
     - b. Other duties to the Seller and the Buyer as stated above in their respective sections.
   - 4.2 In representing both the Seller and the Buyer, the Agent may not, without the express permission of the respective party, disclose to the other party that the Seller will accept a price less than the listing price or that the Buyer will pay a price greater than the price offered.
5. The above duties of the Agent in a real estate transaction do not relieve a Seller or a Buyer from the responsibility to protect their own interests. You should carefully read all agreements to assure that they adequately express your understanding of the transaction. A Real Estate Agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional.
6. Throughout your real property transaction, you may receive more than one disclosure form depending upon the number of Agents assisting in the transaction. The law requires each Agent with whom you have more than a casual relationship to present you with this disclosure form. You should read its contents each time it is presented to you, considering the relationship between you and the Real Estate Agent in your specific transaction.
7. This disclosure form includes the provisions of §2079.13 to §2079.24, inclusive, of the Calif. Civil Code set forth on the reverse hereof. Read it carefully.

(Buyer's Broker)	Date	(Buyer's Signature)	Date
(Associate Licensee Signature)	Date	(Buyer's Signature)	Date
(Seller's Broker)	Date	(Seller's Signature)	Date
(Associate Licensee Signature)	Date	(Seller's Signature)	Date

PAGE 1 OF 2 — FORM 305

Selling agent or buying agent

The term "selling agent" also has its roots in the old, distorted subagent/cooperating agent MLS environment. MLS members working with buyers were tasked by their membership with "helping to sell" the properties to buyers on behalf of the seller.

Today, the term "selling agent" has been codified in real estate agency law, as has the term "buyer's agent." However, use of the term "selling agent" does not mean the selling agent is automatically the buyer's broker.

dual agent
A broker who represents both parties in a real estate transaction. [See **RPI** Form 117]

For instance, the buyer's agent is **always defined** as a selling agent in the agency law. However, the selling agent is *not always the equivalent* of the buyer's agent. The term "selling agent" is chaotically defined by law to include a seller's broker or their agent who is in direct contact with a buyer, whether or not the seller's agent is obligated as a **dual agent** to also act as the representative of the buyer.

Representing the best interest of the buyer

Representing the buyer requires the agent to locate suitable property and, with care and diligence, advise the buyer on the nature of the property. Further, the buyer's agent seeks the most advantageous price and terms available to the buyer when negotiating the acquisition of the property. It is of no concern who pays the fee — it is always included in the price paid for the property. However, the amount of fee received is the concern of the client and always disclosed to the client by their agent.

double-end
When the seller's agent receives the entire fee in the real estate transaction, there being no buyer's agent for fee splitting.

Thus, when no other broker is involved in a sales transaction, the *seller's broker* is also legally referred to as the selling agent, a situation referred to in practice as "**double-ending**" the sale. The seller's broker who *double-ends* a transaction need not be the buyer's agent at all, even though they are classified as the selling agent (but not the buyer's agent and, thus, not a dual agent).

Conversely, the seller's agent may undertake the representation of the buyer to locate and advise on the acquisition of suitable property. Here, the broker becomes the buyer's agent as well as a dual agent.

In a real estate sales transaction, the agent identified and referred to as the *buyer's broker* or *buyer's agent* is known to all persons as the agent exclusively representing the buyer. This terminology is words of plain meaning honored by:

- judges;
- legislators;
- sellers;
- buyers;
- lenders;
- escrow officers; and
- fellow licensees.

The title "buyer's agent" is now, but has not always been, conceded by the real estate profession to be an appropriate reference to the buyer's representative. The clarity and ease of its use is both undeniably generic and persuasive. The title indicates the *special agency duties* owed exclusively to the buyer in a sales transaction — an attitude dissipated by continued use of the contradictory and multifaceted term *selling agent*.

Price fixing and association membership

In 1955, a group of California residential MLS brokers agreed the fee charged a seller on all home sales was to be 6% of the price paid by a buyer. Further, it was to be shared 50/50 between the seller's broker and the buyer's broker (the so-called *cooperating broker*).

Though the price fixing scheme of "same-percentage, same-split" was ruled a violation of federal antitrust laws, it remained fully enforced by defiant residential brokers using the MLS system. They continued to require all member brokers to publish listing information on the MLS, including the total fee agreed to by the seller (to always be 6%), to be divided evenly between the listing office (LS) and the selling office (SO) — the seller's broker and buyer's broker in today's terminology.

When a seller's agent did not comply, all the other (fee-fixing) MLS brokers and their agents were instructed by the trade union to either refuse to deal with the nonconforming office or to unilaterally refuse to share fees (50:50) on the sale of their listings with the nonconforming, offending seller's broker.

Enforcement by residential brokers of the 6%/50:50 rule was made possible through board *binding arbitration*. Critically, the local trade union owned or controlled the MLS. More insidious, compulsory membership in one (the trade association with its binding arbitration agreement) was then a prerequisite for a subscription to the MLS. The rule: membership and subscription, or no access to the MLS.

Thus, when a broker using the MLS violated its price-fixing policies regarding fees, the trade association became the instrument used by conforming brokers to enforce their unlawful **price fixing activity** by a money award in arbitration. After a short period of fellow broker-inflicted financial injury, the fee-cutting (and successfully competitive) listing office — derogatorily denounced as a *discounter* — would eventually capitulate to the 6%/50:50 routine or go out of business.[3]

price fixing
An arrangement among providers of the same service to sell their services only at a predetermined price.

Restrictions on MLS access

Consider a real estate trade association that operates its own MLS. A part-time broker applies for MLS access without being a member of the trade association. The association denies the broker's application, stating MLS access is limited to full-time real estate professionals who are members of the trade association.

The broker seeks to compel the association to allow access, arguing the trade association's policies are anti-competitive.

3 **People** v. **National Association of Realtors** (1981) 120 CA3d 459

Is the trade association compelled to grant the broker access to an MLS subscription without maintaining a current membership in the association?

Yes! The association may not prevent brokers and their agents from accessing the MLS. Reason: access to the MLS is necessary for professional employment rendering services to members of the public as a real estate licensee.

No trade association membership required

In California, MLS subscribers do not need to be members of a trade association to post listings and access the MLS database, even if the MLS is owned by the association. Thus, MLS subscribers avoid the suppressive instrumentality of trade association membership.[4]

Yet, many real estate licensees still erroneously believe they need to join the *National Association of Realtors (NAR)*, the *California Association of Realtors (CAR)* or the local Association of Realtors (AOR) branch of CAR to practice real estate in California. Worse, these trade union leviathans are too often equated to the CalBRE due to their past inappropriate top-level political liaisons.

For a real estate sales agent, the obligation to become a trade union member depends on their broker's type of membership with the AOR. The agent is to parallel the broker's member or non-membership in the AOR since the sales agent acts on behalf of their broker – an *agent of the agent*.

For access to the MLS, AORs give brokers the option of being:

- a realtor member, which includes CAR and NAR membership along with MLS subscription; or
- an MLS participant/subscriber only.

No restrictions apply to MLS access for real estate brokers. Real estate brokers and their agents may continue to access an MLS without paying the excessive and unnecessary dues or entanglement in a trade union's membership bureaucracy, codes and arbitration rules.

MLS fees fixed and competition banned

Consider a group of local area real estate trade associations. Each operates its own MLS providing MLS support services to subscribers. It also sets the price for support services independently based on cost. Some trade associations are efficient and very successful at providing MLS services, incurring less than $10 in total costs per subscriber monthly. Other associations are inefficient and incur costs of $50 per subscriber monthly.

The associations then form a separate corporation to create and operate a county-wide MLS in which each is a shareholder. Each association contracts with the corporation to provide MLS support services for its members it subscribes to the new regional MLS.

To assure the continued financial viability of smaller, peripheral associations with disproportionately higher operating costs and inefficient services for

4 **Marin County Board of Realtors, Inc.** v. **Palsson** (1976) 16 C3d 920

MLS subscribers, the associations collaborate to set the minimum fee all associations will charge at $25 per subscriber monthly. The less efficient associations are paid a fixed monthly *cash subsidy* on top of the support services fee.

Without the subsidy, services the small associations provide would cause them to incur a loss. With the fee fixed for MLS services offered by the separate associations for their MLS subscribers, the efficient associations agree not to charge less and compete to deprive the less efficient associations of subscribers (and, indirectly, membership in their associations).

Here, as permitted, competitive organizations may *join together* to eliminate their separate MLS database operations in favor of a single county-wide MLS. The resulting MLS is more *effective* — greater regional coverage — and more *efficient* — reducing the need of brokers to subscribe to two or more MLS database services within the greater area.

No price fixing to curb competition

The question then arises as to whether the trade associations can *collude* to:

- set the fee charged for the services each MLS provides; and
- ban discounting or rebates by the efficient and more competitively operated associations.

The simple answer is no. Price fixing is illegal!

The fee that reimburses the associations for the cost of their MLS support services cannot be legally set by agreement between the competing associations. This is especially true when the larger, more efficient associations then receives millions of dollars from their members in increased MLS support service fees for exceeding the actual cost they incurred to provide those services.

This arrangement provides the large associations with huge financial rewards at the improper expense of the subscribers that produce for the MLS.[5]

supra-competitive
A market condition where prices are unfairly set by collusion, preventing others from entering the market and hurting consumers.

It is the likelihood that some of the peripheral associations would go out of business under an efficient county-wide MLS which led to the price being fixed at a **supra-competitive** and illegal level in the first place. This further led to the banning of competitive pricing for MLS services provided to subscribing brokers by the big associations agreeing not to discount or offer rebates for their broker-subscribers (which would have reflected the actual pro-rata costs incurred by the bigger associations).

However, competition or *economic darwinism* needs to be allowed to occur by the process of *creative destruction*. Under open market conditions, the more efficient associations bring about the demise of the less productive associations to the financial benefit of all the MLS subscribers within the enlarged servicing area.

5 **Freeman** v. **San Diego Association of Realtors** (9th Cir. 2003) 322 F3d 1133

Chapter 2 Summary

Enactment of the real estate agency law in the mid-1980s ended many of the complex and legally dubious customs of brokers working in the MLS environment. It clarified the relationships between brokers and agents, and buyers and sellers. For the first time, MLS brokers and their agents were able to act exclusively on behalf of a buyer without the seller's broker — who is the adversary of the buyer's broker — controlling the fee-sharing arrangement. Buyer's agents were no longer cooperating brokers working as subagents of the seller.

The term "selling agent" — a product of the old MLS environment — refers to agents representing buyers and was codified in real estate agency law along with the term "buyer's agent." However, though the buyer's broker is always defined as a "selling agent," the term does not apply exclusively to the buyer's broker.

"Selling agent" also legally includes a seller's broker or agent who is in direct contact with a buyer, whether or not the seller's agent obligates themselves as a dual agent to act as the representative of the buyer. A buyer's agent who exclusively represents the buyer owes a specific duty to the buyer to locate suitable property, seek the most advantageous price and terms available and diligently advise the buyer in the transaction.

In California, MLS subscribers do not need to become members of a trade association to subscribe to an MLS database, even if the MLS is owned by the association. Thus, the MLS subscriber avoids the suppressive instrumentality of trade association membership.

Competitive associations may join together to eliminate their separate MLS database operations in favor of a single county-wide MLS, which improves the effectiveness and efficiency of the consolidated service. However, associations may not collude to set the fee each component MLS charges for services it provides, or ban discounting or rebates by more efficient and competitive trade associations within the organization.

Chapter 2 Key Terms

Chapter 3

Subagency and dual agency

Learning Objectives

After reading this chapter, you will be able to:

- differentiate between agency and fee sharing;
- identify situations in which a dual agency or subagency is established and managed; and
- understand how conflicts of interest are managed.

Key Terms

conflict of interest
dual agent
listing agreement
multiple listing service (MLS)
subagent

Agency and fee sharing concepts

The **agency relationship** of the buyer's broker is determined by the conduct of the brokers and their agents, not by the seller's payment of a broker fee to the broker. Nor is it determined by splitting the fee received by the seller's broker.

Thus, neither a **subagency** duty owed the seller, nor a *dual agency* relationship with the buyer and seller, is imposed on the buyer's broker simply because the seller pays the buyer's broker a fee. This fee-agency rule applies whether the seller pays the fee directly to the buyer's broker, or indirectly when the seller's broker initially receives the entire fee.[1]

subagent
An individual who has been delegated agency duties by the primary agent of the client, not the client themselves.

Brokers and agents working for buyers to locate suitable property are not considered agents of the seller simply because they show their buyers properties listed with other brokers. Buyer's brokers do not typically conduct themselves as *subagents* of the seller or as *dual agents* representing both seller and buyer.

1 Calif. Civil Code §2079.19

Subagent vs. fee-sharing buyer's broker

A seller's **listing agreement** authorizes the seller's broker to cooperate with other brokers. Thus, the seller's broker may share property information with other brokers and share any broker fee due from the seller. [See **RPI** Form 102 §4.3]

Listing agreements do not authorize the seller's broker to delegate to other brokers the authority to also act on behalf of the seller to **locate buyers** and obtain offers to purchase as the seller's agent.

listing agreement
An employment agreement used by brokers and agents when a client retains a broker to render real estate transactional services as the agent of the client. [See **RPI** Form 102 and 103]

When another broker acts on behalf of a seller at the request of the seller's broker, a *subagency* with the seller has been established by the brokers. Further, the broker acting as the subagent is not employed by the seller's brokers as an *associate broker*.

However, a provision in a listing agreement may authorize the seller's broker to create a subagency between their seller and another broker. With authority, the seller's broker, acting on behalf of the seller, may employ another brokerage office as a *subagent* to also act on behalf of the seller to market the property.

Subagency: MLS membership myth

The membership of a buyer's broker in a **multiple listing service (MLS)** is not conduct that creates a dual agency or subagency relationship with any seller whose property is listed for sale with another broker who is a member of the MLS.

Agency, whatever the type, is created either by *contract* or by the *conduct of a broker* when interacting with a buyer or seller. Agency is not established by entering into trade memberships or by receipt of a fee paid by the seller.[2]

multiple listing service (MLS)
An association of real estate agents pooling and publishing the availability of their listing properties.

Subagency duties differ greatly from those misleading subagency concepts often generated at the MLS level. The claimed "MLS subagency" arose out of erroneous notions held about the nature of *cooperation* between brokers in fee-sharing arrangements.

The focus within the MLS for determining agency relationships in the past was improperly placed on the relationship between the MLS brokers. The analysis overlooked the relationship each broker had with their client in a sales transaction.

For a broker to become a subagent appointed by the seller's broker, the broker is in contact with the buyer but conducts themselves solely as the seller's representative throughout all negotiations with the buyer.

Dual agency as an authorized practice

A **dual agent** is a broker who simultaneously represents the best interest of *opposing parties* in a transaction, e.g., both the buyer and the seller.[3]

2 CC §2307
3 CC §2079.13(d)]

Dual agency has always been proper brokerage practice. It is a situation that arises naturally in the course of representing buyers and sellers. However, the existence of a dual agency must be promptly disclosed to each client.[4]

dual agent
A broker who represents both parties in a real estate transaction. [See **RPI** Form 117]

A broker who fails to promptly disclose their dual agency at the moment it arises is subject to:

- the loss of their broker fee;
- liability for their principals' money losses; and
- disciplinary action by the California Bureau of Real Estate (CalBRE).[5]

For example, a broker locates property sought by a buyer the broker has been working with. On determining the property is one the buyer is interested in purchasing, the broker solicits and receives a written listing agreement from the owner selling the property. The broker does not disclose their present agency relationship with the buyer to the seller. The buyer makes an offer to purchase the property which is accepted by the seller. Under the fee provision in the buyer's offer, the seller agrees to pay the broker a fee.

Before closing, the seller discovers the broker's working relationship with the buyer to locate property, and the seller cancels the escrow instructions. The broker demands payment of their fee for locating the buyer.

Can the broker recover their fee?

No! The broker failed to disclose their dual agency to the seller when it arose, i.e., at the time the broker entered into the listing with the seller.[6]

Dual agency and conflict of interest

A **conflict of interest** exists for a broker when:

- the broker has a positive or negative *bias* toward the opposing party in a transaction or a person indirectly involved in the client's transaction; and
- that *bias* might compromise the broker's ability to freely recommend action or provide guidance to the party they agreed to represent.

conflict of interest
When a broker or agent has a positive or negative bias toward a party in a transaction which is incompatible with the duties owed to their client. [See **RPI** Form 527]

Viewed another way, a *conflict of interest* arises when:

- a broker or their agent, acting on behalf of a client, has a competing professional or personal bias; and
- the bias hinders their ability to unreservedly fulfill the fiduciary duties they have undertaken to advise and act on behalf of the client.

The *conflict of interest* which exists when acting as a dual agent is handled by timely disclosure to all parties. Disclosure is made prior to providing a buyer with information on a property listed with the broker, or taking a listing from a seller when the broker already represents a buyer who will make an offer. [See **RPI** Form 527]

4 CC §2079.17
5 Calif. Business and Professions Code §10176(d)
6 **L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300

Disclosure of a conflict, such as a dual agency situation, allows the principals to take the disclosed bias into consideration in further discussion with the broker and in negotiations with the opposing party.

The disclosure and consent to the dual agency does not neutralize the bias disclosed. However, it does neutralize the element of deceit which, if left undisclosed, would be a breach of the broker's fiduciary duty.

Both clients are entitled to advice

When a *dual agency* is established in a one-to-four unit residential sales transaction, and both parties are represented by the same broker, the broker may not pass on *confidential pricing information* to the opposing parties. For example, when the broker is a dual agent, the broker and their agents may not tell the seller the price the buyer is willing to pay, or tell the buyer the price the seller is willing to accept.

Confidential pricing information must remain the undisclosed knowledge of the dual agent, unless authorized to release the information in a writing signed by the principal in question.[7]

The decision by the broker not to release pricing information must be made and maintained from the moment the dual agency arises, the same moment the dual agency is disclosed.

The dual agency conflict typically arises when the buyer is an existing client who has received property information from the broker and is now exposed to or expresses an interest in property listed by the broker. This conflict of dual agency occurs before the purchase agreement is prepared, including its agency confirmation provision.

Dual agency and diminished benefits

A broker owes their client the duty to pursue the *best business advantage* legally and ethically obtainable. However, by nature, the dual agent is prevented from actively achieving this advantage for either client. The dual agent cannot take sides with one or the other during negotiations. A natural inability exists to negotiate the highest and best price for the seller, and at the same time, negotiate the lowest and best price for the buyer.

Generally, clients of a dual agent do not receive the full range of benefits available from an *exclusive agent*. This holds true even if different agents employed by the same broker each work with different parties to the same transaction.

The *legal agent* for a buyer or seller in a transaction is the broker who employs the agents involved handling negotiations. It is not the broker's agents who are in contact with the clients. In-house transactions which involve the broker as a dual agent make it particularly difficult for the broker to **oversee and supervise** dual agency negotiations.

---

7 CC §2079.21

Typically, one agent employed by the broker enters into an exclusive sales listing with a property owner. At the same time, another agent in the broker's employment works separately with a buyer to locate qualifying properties, providing information on properties listed with other brokers.

The broker becomes a dual agent the moment this buyer is exposed to a property that is the subject of an in-house listing.

Dual agency is not automatic

However, an improper tendency in transactions involving only one broker and two of their agents is to automatically designate the broker as a dual agent. However, the buyer may be a party to whom only general duties regarding property disclosures are owed by the broker and their agents. Thus, no specific agency duties are owed the buyer and a dual agency does not arise.

For example, consider a buyer who simply responds to the broker's "For Sale" sign, open house or marketing ads. Without being shown unlisted properties or properties listed with other brokers, the buyer makes an offer on an "in-house" listing through an agent employed by the broker but not the agent who obtained the property listing.

Here, the buyer's inquiry and review of properties is limited to properties listed with the broker. Thus, the resulting sales transaction is on a property listed with the broker to a buyer who has only been shown properties listed with the broker, conduct that does not create an agency relationship with the buyer.[8]

However, there remains, as always, the seller's broker's *general nonfiduciary duty* owed to all other parties in the transaction who are not the broker's clients, including the non-client buyer.

8 **Price** v. **Eisan** (1961) 194 CA2d 363

Chapter 3 Summary

A provision in a listing agreement may authorize the seller's broker to create a subagency between their seller and another broker. Under the subagency provision, the seller's broker may act on behalf of the seller to employ another brokerage office to also act on behalf of the seller to market the property.

A dual agent is a broker who is simultaneously representing the best interests of each of the opposing parties in a transaction. Dual agency must be disclosed to the parties involved at the time the conflict arises. Failure to disclose a dual agency relationship can result in the loss of

the broker fee, liability for money losses incurred by the clients, and disciplinary action by the California Bureau of Real Estate (CalBRE) on a complaint.

A conflict of interest exists when a broker or their agent has a competing professional or personal bias that may hinder their ability to fulfill the fiduciary duties to give advice and act on behalf of the client.

Confidential pricing information must remain the undisclosed knowledge of the dual agent, unless they are authorized to release the information to the other party.

The conflicts that exist in a broker's dual representation rule out aggressive negotiations to obtain the best business advantage for either party. Thus, the principals of a dual agent do not receive the full range of benefits they would have obtained from an exclusive agent.

Chapter 3 Key Terms

Chapter 4

Conflict of interest

Learning Objectives

After reading this chapter, you will be able to:

- recognize the types of arrangements, situations, and relationships that can give rise to conflicts of interest in real estate transactions;
- disclose the kinds of relationships and interests presenting a potential conflict of interest; and
- mitigate potential conflicts resulting from familial and investment relationships.

Key Terms

affiliated business arrangement (ABA)
conflict of interest
dual agency
net listing

Professional relationships compromised

A **conflict of interest** arises when a broker or their agent, acting on behalf of a client, has a competing professional or personal bias which hinders their ability to fulfill the fiduciary duties they have undertaken on behalf of their client.

conflict of interest When a broker or agent has a positive or negative bias toward a party in a transaction which is incompatible with the duties owed to their client. [See **RPI** Form 527]

In a professional relationship, a broker's financial objective of compensation for *services rendered* is not a *conflict of interest*.

However, fees and benefits derived from conflicting sources must be **disclosed** to the client. This includes compensation in the form of:

- professional courtesies;
- familial favors; and
- preferential treatment by others toward the broker or their agents. [See **RPI** Form 119]

affiliated business arrangement (ABA) A business arrangement in which a broker may lawfully profit from referring a client to a service provider the broker owns; requires the broker to make a disclosure of their ownership interest to the client. [See **RPI** Form 205 and 519]

Similarly, the referral of a client to a financially controlled business, owned or co-owned by the broker must be disclosed by use of an **affiliated business arrangement (ABA)** disclosure. [See **RPI** Form 519 and Form 205]

A conflict of interest addresses the broker's personal relationships potentially at odds with the agency duty of care and protection owed the client.

Thus, a conflict of interest creates a fundamental **agency dilemma** for brokers; it is not a compensation or business referral issue.

Unless disclosed and the client consents, the conflict is a breach of the broker's fiduciary duty of good faith, fair dealing, and trust owed to the client when the broker continue to act on the client's behalf.

Situations involving a conflict

A conflict of interest, whether patent or potential, is disclosed by the broker at the time it occurs or as soon as possible after the conflict arises. Typically, the conflict arises prior to providing a buyer with property information or taking a listing from a seller.

The disclosure creates transparency in the transaction. It reveals to the client the bias held by the broker which, when disclosed, allows the client to take the bias into consideration in negotiations. The disclosure and consent does not neutralize the inherent bias itself. However, it does neutralize the *element of deceit* which would breach the broker's fiduciary duty if left undisclosed.

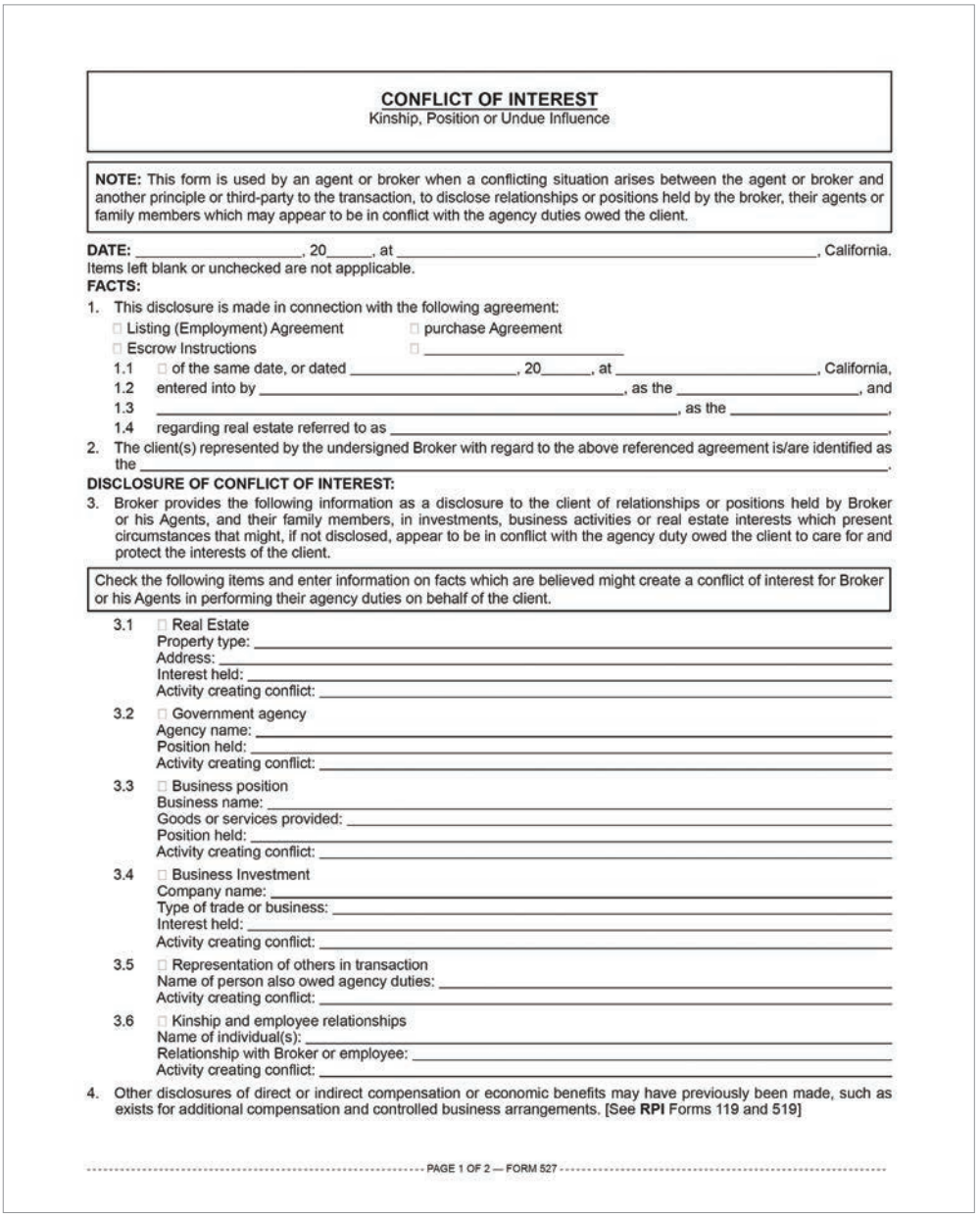
Potential overlaps of allegiance or prejudice which cause a conflict that a broker or their agent must disclose include:

- the broker or their agent holds a direct or indirect *ownership interest* in the real estate, including a partial ownership interest in a limited liability company (LLC) or other entity which owns or is buying, leasing, or lending on the property;
- an individual related to the broker or one of their agents by *blood or marriage* holds a direct or indirect ownership interest in the property or is the buyer;
- an individual with whom the broker or a family member has a *special pre-existing* relationship, such as prior employment, significant past or present business dealings, or deep-rooted social ties, holds a direct or indirect ownership, leasehold, or security interest in the property or is the buyer;
- the broker's or their agent's concurrent representation of the opposing party, a *dual agency situation* [See Chapter 3]; or
- an *unwillingness* of the broker or their agent to work with the opposing party, or others, or their brokers or agents in a transaction.

Form 527

Conflict of Interest

Page 1 of 2



CONFLICT OF INTEREST
Kinship, Position or Undue Influence

NOTE: This form is used by an agent or broker when a conflicting situation arises between the agent or broker and another principle or third-party to the transaction, to disclose relationships or positions held by the broker, their agents or family members which may appear to be in conflict with the agency duties owed the client.

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not appplicable.
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: _____

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 **RPI** Forms 119 and 519]

PAGE 1 OF 2 — FORM 527

Simply, a **conflict of interest** arises and is disclosed to the client when the broker:

- has a *pre-existing relationship* with another person due to kinship, employment, partnership, common membership, religious affiliation, civic ties, or any other socio-economic context; and
- that relationship might hinder their *ability to fully represent* the needs of their client.

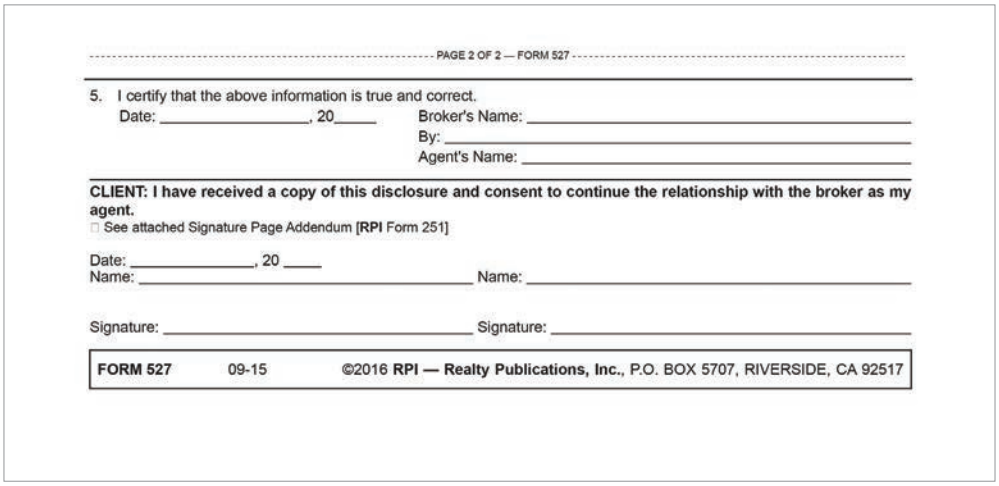
Unfortunately, comprehensive rules do not yet exist which establish those instances where a conflict of interest arises and needs to be disclosed.

To disclose or not to disclose?

Form 527

Conflict of Interest

Page 2 of 2



PAGE 2 OF 2 — FORM 527

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 **[RPI** Form 251]

Date: _____, 20 ____
Name: _____ Name: _____

Signature: _____ Signature: _____

FORM 527 09-15 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Thus, brokers are left to draw their own conclusions when situations regarding a property or a transaction with or involving third-parties arise. In practice, brokers, and especially agents, all too often err on the side of nondisclosure, putting their broker fee, if not their license itself, at risk. [1]

Generally, if a broker even questions whether it is appropriate to disclose a potential conflict of interest to a client, they should disclose it. The existence of *any concern* is reason enough for a prudent broker to be prompt in seeking their client's consent to the potential conflict. By timely disclosing a conflict of interest and obtaining consent, the broker immediately creates an honest working relationship with their client.

Fundamentally, a broker who becomes aware they have a conflict of interest, but is reluctant to disclose it and seek the client's consent, should consider rejecting or terminating the employment with that individual.

Relative's participation in a transaction

A seller's broker must disclose their acquisition of any direct or indirect interest in the seller's property. The broker must also disclose whether a family member, a business owned by the broker, or any other person holding a special relationship with the broker will acquire an interest in the seller's property. [See Form 527 §3.6 accompanying this chapter]

For example, a broker's brother-in-law makes an offer to buy property the broker listed. The purchase agreement states the broker is to receive a fee and that they represent the seller exclusively.

The broker does not disclose to the seller that the buyer is their brother-in-law.

The broker opens two escrows to handle the transaction. The first escrow facilitates the sale and transfers the property from the seller to the broker's brother-in-law.

1 Calif. Business and Professions Code §10177(o)

The second escrow is for the sole purpose of transferring title to the property from the brother-in-law to a limited liability company (LLC) in which the broker holds an ownership interest. Both escrows close and the broker receives their fee.

The seller discovers the buyer was their broker's brother-in-law and the true buyer was an entity partially owned by the broker. The seller demands a return of the broker fee claiming the broker had a conflict of interest which breached the fiduciary duty they owed to the seller since it was not disclosed and the seller did not consent.

In this instance, the broker is not entitled to retain the broker fee they received from the seller. Further, the seller is entitled to recover any property value at the time of the sale in excess of the price they received. Alternatively, the seller may set the sale aside due to the failure of the broker's agency with the seller and the conflict of interest with the buyer.

A broker cannot act for more than one party in a transaction, including themselves, without disclosing their **dual agency** and obtaining the **client's consent** at the time the conflict arises.[2] [See Chapter 3; see Form 527]

dual agency
The agency relationship that results when a broker represents both the buyer and the seller in a real estate transaction. [See **RPI** Form 117]

Also, a seller's broker has an affirmative duty to disclose to the seller their agency or other conflicting relationship they might have with the buyer. The duty to disclose exists even if the seller fails to inquire into whether the broker has a relationship with the buyer.

Further, failure to disclose a broker's personal interest as a buyer in a transaction when they are also *acting as a broker* on behalf of the seller constitutes grounds for discipline by the Real Estate Commissioner.[3]

Conflict under a net listing

Consider a seller who, acting on a broker's advice as to the estimated value of their real estate, retains the broker to find a buyer for the property. [See **RPI** Form 318]

The broker and seller enter into a **net listing agreement**.

net listing
A type of listing in which the agent's fee is set as all sums received exceeding a net price established by the owner.

Under the *net listing*, the seller agrees to take a fixed sum of money as the net proceeds for their equity should the property sell. The net listing further provides for the broker to receive all further sums paid on the price as their broker fee.

The broker arranges a sale of the property to their daughter and son-in-law. The seller is not informed of the broker's relationship with the buyers. On the close of the transaction, the broker receives their fully disclosed broker fee as the net proceeds remaining from the sale in excess of the net listing price.

On discovery of the broker's relationship with the buyer, the seller demands a return of the broker fee. The seller claims the broker's kinship with the buyer created an undisclosed conflict of interest which violated the fiduciary duty

2 Bus & P C §10176(d)

3 **Whitehead** v. **Gordon** (1970) 2 CA3d 659

the broker owed to the seller. The broker claims the seller cannot recover the broker fee no matter who the buyer was since the seller only bargained to receive a fixed amount on the sale of their property under the net listing agreement.

Whenever a broker is employed under any type of listing, the broker has an obligation to **voluntarily disclose** to their seller any special relationship they may have with the buyer and obtain the seller's consent before proceeding. Thus, the seller can recover the broker fee they paid to the broker.[4]

A relative owns the property sold

A buyer's broker must disclose to the buyer the nature and extent of any direct or indirect interest the broker or the broker's agents hold in any property presented to the buyer.

For example, a buyer's broker shows the buyer several properties, one of which is owned by the broker and others, vested in the name of an LLC. The broker does not inform the buyer of their indirect ownership interest in the property.

The buyer later decides to purchase the property owned by the LLC. An offer is prepared on a purchase agreement with an agency confirmation provision stating the broker is the agent for both the buyer and seller. The offer is submitted to the LLC. [See **RPI** Form 159]

The broker, aware the buyer will pay a higher price for the property than the initial price offered by the buyer, presents the buyer with a counteroffer from the LLC at a higher selling price. The buyer accepts the counteroffer.

Here, the broker has a duty to promptly disclose their ownership interest in the property to the buyer the moment the conflict arises. The conflict of interest in the broker's ownership is a **material fact** requiring disclosure since the buyer's decisions concerning acquisition of the property might be affected.

As a result of the nondisclosure, the buyer can recover the fee received by the broker and the increase in price under the counteroffer.

Had the buyer known the broker held an ownership interest in the property when it was first presented, the buyer might have negotiated differently when setting the price and terms for payment. Alternatively, the buyer may have retained a different broker who was not compromised by a conflict of interest.

Taking a fee when acting as a principal

A broker acting solely as a **principal** in the sale of their own property is not restricted in their conduct by compliance with agency obligations. The broker selling or buying property for their own account acts solely as the seller or

4 **Sierra Pacific Industries** v. **Carter** (1980) 104 CA3d 579

buyer. The licensee has no conflict due to the existence of their license since they are not holding themselves out as a broker or agent acting on behalf of another person in the transaction.[5]

However, when a *broker-seller* receives a broker fee on the sale of their own property, or on the purchase of their own property, the broker subjects themselves to real estate agency requirements.

For example, a broker sells their residence. The residence is in violation of safety requirements for occupancy due to known defects in the foundation. The broker does not tell the buyer about the foundation defects.

Out of the proceeds the broker receives on closing the sale of the property, the broker-seller pays themselves a broker fee, claiming to *exclusively represent themselves* (which is not an agency and does not require a license).

The buyer later discovers they must demolish the residence and rebuild it with an adequate foundation. The buyer obtains a money judgment against the broker for breach of their general agency duty owed to all parties in a real estate transaction to disclose known property defects.

The broker is unable to pay the money judgment. The buyer seeks payment from the **Real Estate Recovery Account**.

Recovery is received from the *Real Estate Recovery Account* since the broker held themselves out as *acting as a real estate* broker in the transaction by receiving a fee. The broker's license is then suspended. Before the broker can reactivate their license, they must reimburse the Recovery Account.[6]

Conflicts in a real estate syndication

A potential conflict of interest also exists when a broker *manages multiple LLCs* which own like-type properties in the same market area.

Consider a broker entrusted with managing two investment groups which own similar apartment projects located within the same market. The two projects thus compete for the same prospective tenants. The broker is paid a management fee by each investment group based on a percentage of the rents received.

When contacted by a prospective tenant, the broker is initially faced with the dilemma of which apartment building to refer the tenant to and thus which investment group will benefit from the tenant's occupancy.

A similar conflict of interest results from parallel transactions by multiple LLCs managed by the same broker are actively competing to sell or buy property within the same marketplace.

A potential conflict of interest of this nature must be disclosed to the investors before they agree to participate as members in an LLC the broker manages. This disclosure is contained in **RPI** Form 371, *Investment Circular* provision 6d, which states:

5 **Robinson** v. **Murphy** (1979) 96 CA3d 763

6 **Prichard** v. **Reitz** (1986) 178 CA3d 465

> *The Manager has numerous other business responsibilities and ownership interest which will demand some or most of their time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent their time is required on other business and ownership management decisions, they will not be involved in monitoring or marketing of the LLC's property. [See **RPI** Form 371]*

With this disclosure, the **broker's allegiance** to multiple projects and investment groups is transparent and can be taken into consideration by all investors at the time they receive the Investment Circular from the Broker – before investing and consenting to the risk.

Chapter 4 Summary

A broker's positive or negative bias toward the opposing party, or an indirectly involved third party in a transaction, must be disclosed and consented to by the client. This bias is known as a conflict of interest.

A conflict of interest is disclosed at the time the conflict arises. Timely disclosure allows the client to take the bias held by the broker into consideration during negotiations.

A licensee acting solely as a principal on their own behalf when buying or selling property need not disclose the existence of their real estate license.

A potential conflict of interest also exists when a broker manages multiple LLCs which own like-type properties in the same market area. A similar conflict exists when parallel transactions by multiple LLCs managed by the same broker are actively competing to sell or buy property within the same marketplace.

Chapter 4 Key Terms

Chapter 5

Greater transparency in marketing

Learning Objectives

After reading this chapter, you will be able to:

- induce an owner to increase the marketability of their listing by authorizing the ordering of third-party reports on the property's condition;
- attract potential buyers to a listing by employing greater transparency about the property's condition in the marketing process; and
- increase your annual sales volume by using efficient, up-front marketing plans, which make finding buyers and closing sales easier while taking less time.

Key Terms

advance costs
advance cost sheet
marketing package
trust funds

Costs for preparing to market a property for sale

Consider an owner of a single family residence (SFR) who wants to list the property for sale with the brokerage office of an agent known to the owner.

The agent prepares an exclusive right-to-sell listing agreement form for review with the owner.

The agent also prepares an addendum (among others), called an **advance cost sheet.** On it, the agent estimates the cost of third-party *investigative reports* frequently demanded by prospective buyers and their agents who seek out additional information on the property — a request that marks the commencement of negotiations by a prospective buyer.

The owner's agent will present the *advance cost sheet* addendum to the owner as a "seller's budget" when entering into the listing agreement.

advance cost sheet
An itemization of the costs incurred to properly market a property for sale which are to be paid by the owner. [See **RPI** Form 107]

Advance cost sheet for buyer evaluation

The *advance cost sheet* prepared by the agent estimates the cost of third-party investigative reports prepared by other professionals or government agencies. The reports help put a face on the property so it can be better *evaluated by prospective buyers* and more quickly sold. The recommended third-party reports include:

- an occupancy (transfer) certificate (by local ordinance);
- a Natural Hazard Disclosure Statement (NHD);
- a structural pest control report (and possible clearance);
- a home inspection report;
- a well water report; and
- a septic tank report. [See Form 107 accompanying this chapter]

Once the cost sheet is signed by the owner, the agent is able to prepare and deliver various authorization requests to third-party service providers to prepare and deliver the informational reports. [See Form 133 accompanying this chapter; see **RPI** Forms 124-136]

marketing package
A property information package handed to prospective buyers containing disclosures compiled on the listed property by the seller's agent.

The reports will become part of the **marketing package** the owner's agent puts together and presents to prospective buyers of the listed property. The agent is aware that fully disclosing the condition of the property "upfront" when first dealing with a prospective buyer is the best way to market property and avoid further negotiations after entering into a purchase agreement.

Staging to set the buyer's expectations

A *buyer's enforceable expectations* about the conditions of the property being acquired are legally established based on their impression of the property — by observations or disclosures received — at the time they enter into a purchase agreement. Conditions revealed to the buyer for the first time after the price has been set in a purchase agreement are not binding on the buyer since they were not known for consideration when setting the price to be paid for the property.[1]

Thus, the owner has to make a choice, on the advice of their agent, about when they want to incur the *expense of third-party reports*, either:

- **now**, when the owner lists the property for sale, so any purchase agreement entered into with a prospective buyer will be the result of the prior delivery by the owner's agent of the reports and act as a limitation of claims of deception about the property's existing condition; or
- **later**, after entering into a purchase agreement with a buyer who has already developed expectations about the property's condition which are likely to differ from the reports and, unless the owner repairs the defects or adjusts the price, are likely to result in the buyer canceling the purchase agreement, demanding the defects be eliminated by the owner before closing, or closing escrow and demanding a refund of the overpayment in price or the payment of costs incurred for repairs.[2]

1 **Jue** v. **Smiser** (1994) 23 CA4th 312
2 Jue, *supra*

Form 107

Listing Package Cost Sheet

Page 1 of 2

MARKETING PACKAGE COST SHEET
Due Diligence Checklist

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

NOTE: This form is used by a seller's agent as an addendum when entering into the employment of an owner who lists a property for sale, to disclose the itemized costs the owner can expect to incur during the marketing and sale of the property as anticipated by the employment agreement.

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This is an addendum to an employment agreement referred to as a Seller's Listing Agreement [See **RPI** Form102]
1.2 ☐ of same date, or dated _____, 20_____, at _____, California,
1.3 entered into by _____, as the Broker, and _____, as the Seller,
1.4 regarding real estate referred to as _____,
1.5 for a period beginning on _____, 20_____, and expiring on _____, 20_____.

2. BROKER'S DISCLOSURE AND PERFORMANCE:

2.1 The items listed below with estimated costs constitute a disclosure of the reports and activities Seller can reasonably expect will be required to either bring about or close a transaction under the employment agreement, and if acquired early, will assist Broker to provide prospective buyers with property information Broker anticipates he will need to effectively perform under the employment agreement.

a.	Natural hazard disclosure report [See **RPI** Form 314]	$_____
b.	Local ordinance compliance certificate	$_____
c.	Structural pest control report and ☐ clearance	$_____
d.	Smoke detector and water heater anchor installation	$_____
e.	Home inspection report	$_____
f.	Homeowners' Association (HOA) documents charge	$_____
g.	Lead-based paint report [See **RPI** Form 313]	$_____
h.	Mello-Roos assessment notice	$_____
i.	Listing (transaction) coordinator's fee	$_____
j.	Well-water quality and quantity report	$_____
k.	Septic/sewer report	$_____
l.	Soil report	$_____
m.	Survey of property (civil engineer)	$_____
n.	Appraisal report	$_____
o.	Architectural (floor) plans	$_____
p.	Title report: ☐ property profile, ☐ preliminary report, ☐ abstract	$_____
q.	MLS and market session input fees	$_____
r.	Sign deposit or purchase, installation and removal	$_____
s.	Advertising in newspapers, magazines, radio or television	$_____
t.	Information flyers and postage (handout or mailing)	$_____
u.	Open house — food and spirits	$_____
v.	Photos or video of the property	$_____
w.	Credit report on prospective buyer	$_____
x.	Travel expenses	$_____
y.	Other _____	$_____
z.	Other _____	$_____

2.2 **TOTAL ESTIMATED COSTS** $_____

2.3 ☐ Broker is hereby authorized and instructed to incur on behalf of Seller the cost estimated above.

PAGE 1 OF 2 — FORM 107

A competitive sales advantage

The owner's agent meets with the owner to review the listing agreement and its addenda. The advance cost sheet is presented as an itemized list of reports and activities, some of which are an integral part of the agent's *marketing plan* to attract buyers.

With the delivery of the reports, a prospective buyer will be entering into a purchase agreement and acquiring the property based on their full knowledge of its condition. Availability of the disclosures provide a *competitive sales advantage* over other qualified properties available to buyers which are not marketed with reports to corroborate their condition.

Further, buyers' agents are first attracted to properties offered with all investigative third-party reports available to them in a complete *marketing*

Form 107

Listing Package Cost Sheet

Page 2 of 2

3. PAYMENT OF COSTS:

3.1 ☐ Seller agrees to pay, on presentation of a billing, those costs estimated above and incurred by Broker.

3.2 ☐ Broker agrees to incur the expenses of the estimated costs set out and authorized in §2.3 during the first 21 days of the employment and to timely pay the charges. Seller agrees to reimburse Broker for the costs Broker incurs, IF:

a. Seller closes a transaction which is the subject of the employment agreement;

b. Seller terminates the employment agreement by cancellation or by conduct before it expires; or

c. Seller retains another Broker on the expiration of the employment agreement to pursue a transaction which is the subject of the employment agreement with Broker.

3.3 ☐ Costs paid by Seller under this addendum shall be credited toward any contingency fee earned by Broker upon closing a transaction which is the subject of the employment agreement.

3.4 Seller herewith hands Broker a deposit of $_____ as an advance for the payment of costs incurred by Broker on behalf of Seller as estimated above.

4. TRUST ACCOUNT: (To be filled out only if a deposit is entered at §3.4 above.)

4.1 Broker will place the advance cost deposit received under §3.4 above into his trust account maintained with _____ at their _____ branch.

4.2 Broker is authorized and instructed to disburse from the trust account those amounts required to pay and satisfy the obligations incurred as agreed.

4.3 Within 10 days after each calendar ☐ month, or ☐ quarter, and upon termination of this agreement, Broker will deliver to Seller a statement of account for all funds withdrawn from the advance cost deposit handed Broker under §3.4 above.

4.4 Each statement of account delivered by Broker shall include no less than the following information:

a. The amount of the advance cost deposit received.

b. The amount of funds disbursed from the advance cost deposit.

c. An itemization and description of the obligation paid on each disbursement.

d. The current remaining balance of the advance cost deposit.

e. An attached copy of any advertisements paid from the advance cost deposit since the last recorded accounting.

f. _____

4.5 On termination of this agreement, Broker will return to Seller all remaining trust funds.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: _____, 20 _____	Date: _____, 20_____
Broker's name: _____	Seller's name: _____
CalBRE#: _____	Seller's name: _____
	Seller's Signature: _____
By: _____	Seller's Signature: _____
Phone: _____ Cell: _____	Phone: _____ Cell: _____
Email: _____	Email: _____

package, sometimes called a *backup package*. With a backup package, property disclosures provided to buyers containing third-party reports reduce:

- the owner's exposure to liability under their duty to fully disclose their knowledge of the property's condition;[3] and
- the owner's agent's exposure to liability under their duty to personally inspect, observe and report their findings to buyers about a property's condition.[4]

Importantly, closing escrow on the purchase agreement is not subject to the buyer's further-approval of the property conditions when all reports are delivered to the prospective buyer prior to entering into a purchase agreement.

3 Calif. Civil Code §1102.4

4 CC §2079

The primary marketing advantage for the owner whose agent provides prospective buyers with third-party reports is that the sale of the property is *transparent* at its inception — on entering into a purchase agreement. The price agreed to in the purchase agreement is based on property conditions "as disclosed" by the reports.

The owner avoids the undisclosed (and prohibited) "as is" sale. "As is" sales situations inevitably lead to price renegotiations, repairs, cancellation of the purchase agreement or litigation for failing to disclose facts about material defects known when the buyer's purchase agreement offer was accepted.[5]

The owner's motivation to sell

An owner's reaction to their agent's request for the owner to participate in an advantageous marketing plan by incurring the costs of property reports up front offers the agent insight into the owner's motivation for selling the property. The agent's goal — besides getting a property listing and a fee — is to encourage and receive maximum cooperation from the owner in their sales effort.

An owner may "dress up" the property and enhance its "curb appeal" by cosmetic painting, landscaping and clean up. However, it is the buyer's knowledge of the *property's fundamentals* which generate firm and uncontested offers to purchase. Thus, the owner is asked not only to list the property for sale, but also to willingly and openly disclose the property's fundamentals to prospective buyers at the *earliest opportunity* — when the marketing begins.

However, the owner's motivation to sell often has more to do with a lack of available cash for mortgage payments than a desire to incur the cost of the reports needed to properly market the property. In the case of a financially distressed owner who is unwilling or unable to obtain expert third-party reports, the listing comes with a significant increase in their agent's risk of losing a sale due to a buyer's disapproval of contingencies involving delayed, in-escrow disclosures.

Thus, the agent has to sell the property twice: once to find out what the property conditions are that caused the buyer to drop out, and again when the conditions are disclosed to a new buyer upfront.

Timely disclosure

An owner (and lazy agent) may not want to disclose the condition of the property until after a purchase agreement offer from a buyer has been accepted. This sequence of events may be sought by the owner with the intent to make only those concessions necessary to keep the transaction together, or resell the property to a competing back-up buyer who has been fully informed about the property's condition — but such conduct by an owner is deceitful.

5 CC §§1102.1, 2079

Sidebar

FARMing: cultivating new leads and harvesting past clients

***FARMing** is a business event undertaken to convert a set of neighborhoods into a vibrant collective of owners, branded to turn to the dedicated agent. This creation of yourself as the "go to agent" can be fully accomplished within two years through dedicated, consistent FARMing.*

Step 1: Find a mentor

Tag along (or team up) with an experienced agent who is a long-time FARMer. Observe the agent's strategies and scripts. Ask questions. Likely, they will be happy to show you the ropes. Since your chosen FARM will not overlap with their area, you will not present direct competition.

Step 2: Choose your FARM

Choose the neighborhood or community you will FARM. The first choice is one you know well already. Acquire a map of the area — city planning is most helpful for this — and decide on boundaries and routes.

Create a FARMing goal based on:

- *how many doors you can realistically knock on per day; and*
- *how many deals you need to make in a year to meet your financial goals. [See **RPI** Form 504]*

Consider the fee you receive per transaction as it varies based on the area you FARM. If you live in a neighborhood with little annual turnover or low-tier home prices, consider commuting to a more profitable center.

Start by knocking on 50 doors a day — an amount likely to require two hours at most and provide 20 contacts. If you need to close more transactions each year, increase the investment of your time door knocking.

Once familiar with your chosen FARM, catalog the status of individual properties on a spreadsheet (distressed appearance, negative or positive equity, length of ownership, price paid, current value, tenant occupied, etc.). This knowledge enables you to adjust your marketing strategy for each category of home.

Step 3: Prepare a script

An effective script includes:

- *a proper greeting;*
- *a brief introduction of yourself and your business;*
- *opening questions to the potential client;*
- *answers to their common questions; and*
- *a closing.*

Devote time to practicing your script every day to help you internalize the script and make it your own. Most importantly, listen to the homeowner. Don't get caught up in the script to the point of reciting or lecturing.

Step 4: Craft your FARM materials

Create a flyer or handout appropriate to your area so homeowners have something by which to remember you. The best flyer brags about your recent sales, but you may also include:

- *sales made within your office;*
- *local market activity; or*
- *various tips for homeowners.*

Sidebar

FARMing: cultivating new leads and harvesting past clients

cont'd

A creative personal style helps you stand out from the competition. Alternatively, magnetized notepads or schedules that can be affixed to a refrigerator ensure your name stays fresh in their minds.

Each time you make a contact, harvest their email address. Always ask for the names and emails of three people they know who are interested in buying or selling, and not just within the farm. Set up an e-mail database and send out a ***drip letter*** *once a month. This e-mail newsletter may contain your recent sales, local market activity or an adapted FARM letter.*

Expect to spend $3,000-$6,000 a year on mailings and handouts — one deal from the effort will make up for the investment.

Step 5: FARM past clients

Keep in touch with previous clients and people who have befriended you. They are your best source of business. Make a database of past clients and friends with their particular holidays, such as birthdays and anniversaries. Send cards on these special days, and consider sending a bulk email to past clients each time you close a listing. This lets them know you remain successful and willing to help in their next move or acquisition.

The key to FARMing success is…

Consistency: *It takes 3-5 years before FARMing begins to pay off with a steady stream of transactions. Consider each door knock an investment in a future client for your career. Meanwhile, continue using your talent prospecting.*

Persistence: *Explore all possible leads. Ask if the homeowner knows of any neighbors or friends who are considering buying or selling, and get their names. If a good lead does not answer the door during the week, go back on the weekend.*

Commitment: *A 50% effort yields a 50% return. Make a schedule for your FARMing activities and stick to it. Dedication is good, and pays well. Do not expect a relaxed schedule and easy money.*

When an owner generally knows fundamental facts about the property which negatively affect its value, then withholds property disclosures until after the buyer commits to purchasing the property, this constitutes a type of *intentional fraud*.

To avoid owner misconduct and gauge the owner's motivation, the best time for the owner's agent to present the owner with the advance cost sheet is when the listing is entered into. An owner who is motivated to sell and not merely "testing their price" in the marketplace is likely to respond positively to the agent's advice.

A negative response from the owner to making property disclosures at the earliest opportunity is an indicator of the level of future cooperation in marketing, contracting to sell and closing an escrow which the agent may expect to later encounter from the owner. For the owner's agent, they end up with a complete lack of control over marketing and take on risk from the moment the listing is entered into, all due to acquiescing to a deliberate delay in disclosures.

Broker fee considerations

The amount of the broker fee sought by an owner's agent on a property is implicitly related to:

- the *price* sought by the owner of the property;
- the *time and effort* the agent spent servicing the listing; and
- the *probability* of actually locating a buyer and closing a sale.

If a property looks likely to sell after analyzing these factors, a broker is well-advised to agree to a listing, which results in a broker fee under reasonable circumstances.

Consider a broker who requires agents to attach an advance cost sheet to all listings. By including the addendum, the owner does (or does not) authorize the owner's agent to order out reports needed to more effectively market the property and screen prospective buyers. The broker requires the advance cost sheet addendum to help increase the productivity of their agents. Property reports reduce the time spent negotiating and closing a purchase agreement since entry into the purchase agreement has been *preceded by disclosures*.

As part of the agent's broker fee negotiations, the agent is instructed by their broker to ask and encourage the owner to authorize the immediate purchase of the necessary reports. If the owner concedes the reports are necessary, but wants to wait until a buyer is located, the owner's agent may be able to negotiate terms for payment and acquire the immediate authority to order reports.

Offsetting broker fees

As an economic inducement, the broker, through their agent, may offer to *offset the fee* earned on a sale by the amount of the cost of the reports. The broker is not to agree to pay the cost of any corrective work undertaken on the owner's property, unless to settle a dispute over disclosures which expose the broker to liability. [See Form 107 §3.3]

Alternatively, a reduction in the broker fee by one-quarter to one percent, or more, may be offered to induce the owner to assist in the marketing process by paying for the reports now. The reduced fee reflects the greater likelihood of a successful closing of a sale, devoid of complications before or after closing.

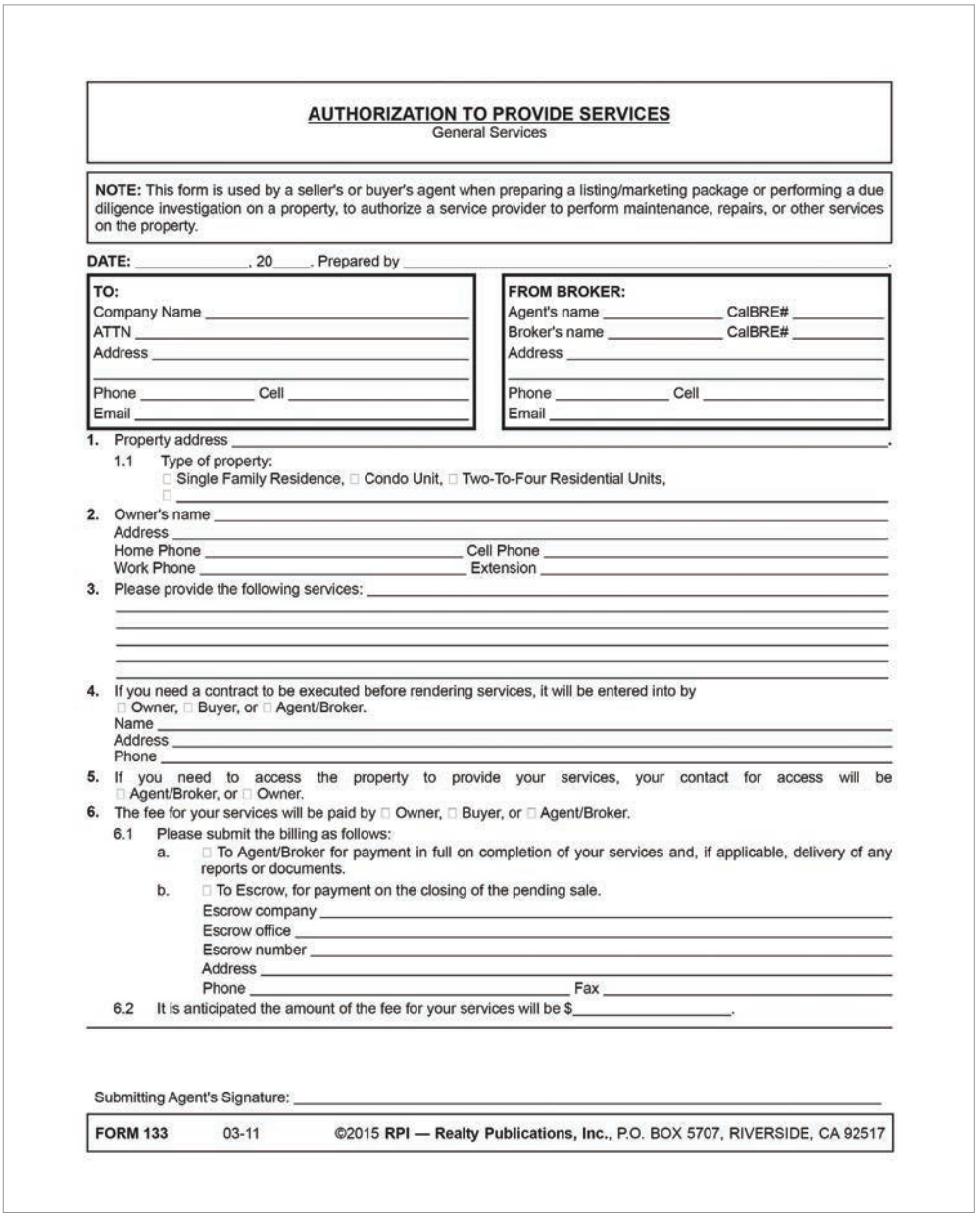
Thus, the fee ultimately agreed to reflects:

- the reduced time and effort necessary to service the listing;
- the reduced risk of loss of the time, talent and money invested in the listing by the broker and the agent; and
- a more effective marketing plan, which, on average, produces more transactions annually for the broker.

Making a sales transaction more transparent for buyers rewards the brokers and agents for their professionalism in their current and future transactions.

Form 133

Authorization to Provide Services



AUTHORIZATION TO PROVIDE SERVICES
General Services

NOTE: This form is used by a seller's or buyer's agent when preparing a listing/marketing package or performing a due diligence investigation on a property, to authorize a service provider to perform maintenance, repairs, or other services on the property.

DATE: _____, 20____. Prepared by _____.

TO:
Company Name _____
ATTN _____
Address _____
_____
Phone _____ Cell _____
Email _____

FROM BROKER:
Agent's name _____ CalBRE# _____
Broker's name _____ CalBRE# _____
Address _____
_____
Phone _____ Cell _____
Email _____

1. Property address _____.
   1.1 Type of property:
   ☐ Single Family Residence, ☐ Condo Unit, ☐ Two-To-Four Residential Units,
   ☐ _____
2. Owner's name _____
   Address _____
   Home Phone _____ Cell Phone _____
   Work Phone _____ Extension _____
3. Please provide the following services: _____
   _____
   _____
   _____
   _____
   _____
4. If you need a contract to be executed before rendering services, it will be entered into by
   ☐ Owner, ☐ Buyer, or ☐ Agent/Broker.
   Name _____
   Address _____
   Phone _____
5. If you need to access the property to provide your services, your contact for access will be ☐ Agent/Broker, or ☐ Owner.
6. The fee for your services will be paid by ☐ Owner, ☐ Buyer, or ☐ Agent/Broker.
   6.1 Please submit the billing as follows:
   a. ☐ To Agent/Broker for payment in full on completion of your services and, if applicable, delivery of any reports or documents.
   b. ☐ To Escrow, for payment on the closing of the pending sale.
   Escrow company _____
   Escrow office _____
   Escrow number _____
   Address _____
   Phone _____ Fax _____
   6.2 It is anticipated the amount of the fee for your services will be $_____.

Submitting Agent's Signature: _____

FORM 133 03-11 ©2015 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Requesting authority from the owner

When preparing the advance cost sheet and authorization for the agent to incur the cost for property reports, cost estimates are entered for items which will be ultimately required to close a sale.

An owner who refuses to incur the cost of third-party reports on the sale of their property needs to be advised that a prudent buyer is likely to incur the costs on the advice of the buyer's agent. In turn, the buyer is inevitably going to use the reports against the owner as a "punch list" for demanding repairs and replacements to be completed before the buyer will close escrow.

Thus, for an owner, it is best to request the reports sooner rather than later. The same advice holds true for implementing the agent's marketing plan for sale of the property.

It is worth noting that none of the listed items on the advance cost sheet are part of the broker's overhead for maintaining a brokerage office. All the costs listed, if incurred, are related solely to establishing the *condition of the property* listed, marketed and sold. They are not incurred as compensation paid for the services of the broker and the owner's agent. Thus, the costs are properly the obligation of the owner and are not to be borne by the broker or the owner's agent.

Further, as the reports assist the owner's agent in marketing the owner's property, the costs are to be incurred by the owner at the time of the listing. The reports are to be received *before* the owner's agent publishes the listing of the property to market it for sale. Functionally, reports provide the buyer and their agents with helpful information about the nature and condition of the property. This information helps to reduce any omissions (by silence) of facts and agent misstatements.[6]

The influence of business cycles on timing

Business cycles in real estate sales also influence a broker's desire to request authorization to obtain property reports for a listing package. During periods of rising prices, disclosures occur less frequently. In boom/bubble times, owners are impatient and driven to sell, while buyers are more anxious and permissive — not justification for failure to disclose. Both owners and buyers drop their guard in a deliberate effort to meet their objectives. Agents, however, may not be caught off guard.

Yet, brokers and their agents are too often accommodating of a lax disclosure environment. Typically, these failures lay dormant until the next recession when the inevitable drop in property values often brings failures to mediation or worse.

Conversely, during periods of decreased sales volume when buyers are more selective and buyer's agents more protective of their clients, owners have to step forward to fund the cost of reports in order to "sell" the property. The owner's agent with property reports in hand has a better backup package with more comprehensive property disclosures than competing, under-disclosed properties — an advantage that makes the selling process easier.

When to pay

trust funds
Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.

An owner can choose when and how to pay for the cost of the reports when filling out the advance cost sheet. The owner may opt to pay the charges directly to the third-party vendors once billed, in which case the agent coordinates the arrangements for payment with the vendors. The owner's check is, thus, payable to the vendor, not the broker. If a check is handed to the owner's agent for delivery to the vendor, the check constitutes **trust funds.** As trust funds, an entry is made in the *trust fund* ledger maintained by the agent's broker. [See Form 107 §4.1]

Alternatively, the owner may deposit the estimated cost of the reports with the broker by making the check payable directly to the broker, called **advance costs**. The broker then pays the charges from the deposit when billed by the reporting service. [See Form 107 §3.4]

6 Jue, *supra*

Advance costs as trust funds

Funds advanced by a client payable directly to a broker belong to the client. The broker needs to place all advance deposits received in the broker's name in a trust account, whether they are advances for future costs or fees.[7]

advance costs
Deposits handed to a broker to cover out-of-pocket costs incurred on behalf of the depositor while performing brokerage services.

The advance cost sheet authorizes the broker to disburse the client's funds from the trust account only as costs are incurred. When the listing terminates, the broker is to return all remaining trust funds to the client. The broker is prohibited from using trust funds to offset any fees the client may owe them.

The broker is also required to give the client a statement of accounting at least every calendar quarter for all funds held in the trust. However, increasing the frequency by mailing a copy of the client's trust account ledger each month creates a better business relationship.

A final accounting needs to be made when the listing agreement expires. Again, if any funds remain in trust, they are to be returned to the client with this accounting.[8]

Statement of account

The *statement of account* for the trust funds needs to include the following information:

- the amount of the **deposit** toward *advance costs*;
- the amount of each **disbursement** of funds from the trust account;
- an itemized **description** of the cost obligation paid on each disbursement;
- the current remaining **balance** of the advance cost deposit; and
- an attached copy of any **advertisements** paid for from the advance cost deposit.

Lastly, the broker needs to keep all accounting records for at least three years and make them available to the California Bureau of Real Estate (CalBRE) on request.[9]

A broker who fails to place advance deposits payable to the broker in the trust account, or who later fails to deliver proper trust account statements to the client, is *presumed* to be guilty of **embezzlement**.[10]

7 Calif. Business and Professions Code §10146
8 Bus & P C §10146
9 Bus & P C §10148
10 **Burch** v. **Argus Properties, Inc.** (1979) 92 CA3d 128; Bus & P C §10146

Chapter 5 Summary

An advance cost sheet is used by an owner's agent to estimate the cost of third-party investigative reports frequently demanded by prospective buyers and their agents who seek out additional information on the property — a request that marks the commencement of negotiations by a prospective buyer. The reports help put a face on the property so it can be better evaluated by prospective buyers and more quickly sold.

Property disclosures made through third-party reports also reduce:

- the owner's exposure to liability under their duty to fully disclose their knowledge of the property's condition; and
- the owner's agent's exposure to liability under their duty to personally inspect, observe and report their findings to buyers about a property's condition.

An owner's reaction to their agent's request for the owner to participate in an advantageous marketing plan by incurring the costs of property reports up front offers the agent insight into the owner's motivation for selling the property. A negative response to making property disclosures at the earliest opportunity is an indicator of the level of future cooperation in marketing, contracting to sell and closing an escrow the agent may expect to encounter from the owner.

Business cycles in real estate sales also influence a broker's desire to request authorization to obtain property reports. During periods of rising prices, disclosures occur less frequently as owners are impatient and driven to sell, while buyers are more anxious and permissive. Both owners and buyers drop their guard in a deliberate effort to meet their objectives. Agents, however, may not be caught off guard.

Conversely, during periods of decreased sales volume with buyers more selective and buyer's agents more protective of their clients, the owner is more likely to step forward to fund the cost of reports to "sell" the property.

An owner can choose when and how to pay for the cost of the reports: either directly to the vendors, or to their agent for delivery to the vendors. A check given to the owner's agent constitutes trust funds, requiring an entry in the trust fund ledger maintained by the owner's agent's broker. Alternatively, the owner may deposit the estimated cost of the reports with the broker directly by making the check payable to the broker, called advance costs.

As an economic inducement, the broker, through their agent, may offer to offset the fee earned on a sale by the amount of the cost of the reports. The broker is not to agree to pay the cost of any corrective work undertaken on the owner's property, unless to settle a dispute over disclosures which expose the broker to liability.

Chapter 5 Key Terms

Chapter 6

Sharing fees on a sale

Learning Objectives

After reading this chapter, you will be able to:

- differentiate between a "buyer's agent" and the misnomer "cooperating agent";
- arrange for fee-sharing between a buyer's broker and a seller's broker in a real estate transaction, agreed to by the buyer in a purchase agreement offer; and
- abide by rules and regulations to prevent the improper payment of referral fees between providers, duplicate charges and kickbacks.

Key Terms

affiliated business arrangement (ABA)

cooperating broker

kickback

Real Estate Settlement Procedures Act (RESPA)

referral fee

subagent

Buyer's agent or cooperating agent?

In real estate practice, the characterization of a buyer's agent as a "cooperating agent" is improper. The word "cooperating" lacks clarity and fails to convey the agent's or broker's role when they are the representative of a buyer.

The *plain meaning* of "cooperating" denotes collaboration between two brokers to pair their respective clients for the transfer of a property. However, the word's implication excludes industry inferences about **fee sharing** and the legal establishment of an agency relationship. Thus, the word "cooperating" suggests to members of the public only that brokers are *sharing information* in a joint effort to assist the buyer in a decision to purchase property.

Judicially and based on legislation, "cooperating agent" is used as the title for a **subagent of the seller**, not a buyer's agent acting exclusively and in the

best interests of the buyer. Thus, use of "cooperating (selling) broker" is a legal reference to a subagent acting on behalf of the seller and, if they are a dual agent, the buyer as well.

cooperating broker
A broker or their agent acting as a subagent of the seller's broker with specific affirmative duties of care owed the seller, but not the buyer.

As a subagent, a **cooperating broker** is defined as having specific affirmative duties of care *owed the seller*, not the buyer. However, any cooperating broker — that is, the subagent — is to deal fairly and in a non-deceitful manner with the buyer, as is also the seller's primary broker and their agents.[1]

subagent
An individual who has been delegated agency duties by the primary agent of the client, not the client themselves.

Further, a **subagent** is identified by code as the agent in the sales transaction who cooperates with the seller's agent *to sell* the property or *to locate* a buyer on behalf of the seller. The real estate agency scheme also strangely labels the subagent as a *selling agent* if, while acting on behalf of the seller, they deal directly with the prospective buyer — thus, the buyer has no agent in the transaction to look after their interests and give advice. The scheme distinguishes the seller's subagent as separate from any buyer's agent who is specifically engaged by the buyer to represent them to locate property.[2]

Thus, the "cooperation" contemplated by the legislature is not the fee-sharing jargon employed in the fee-sharing addendum attached to purchase agreements used by some residential brokers. Simply put: brokers and their agents who act exclusively as agents for the buyer and share fees are not cooperating brokers. They are the buyer's broker, an adversarial position to the seller's broker.

Unbundled, off-form fee provisions

For a buyer's broker to have **equal ability** as the seller's broker to negotiate, contract for and enforce collection of a fee:

- the buyer's broker needs to first enter into an employment agreement with the buyer, called a **buyer's listing**, to assure the buyer's broker that the buyer has legal incentive to back up fee demands the buyer's agent makes on the seller;
- a fee provision exists or is included in the body of the buyer's *purchase agreement offer*, stating the seller is to pay a broker fee in an amount set by the buyer's broker and the buyer;
- the fee earned and payable by the seller to the buyer's broker will be *paid directly to the buyer's broker* by the seller through escrow, not via the seller's broker;
- the seller agrees to pay the fee earned by the brokers if the seller wrongfully *fails to close* the sale so the buyer's broker may pursue collection of their share of the fee independent of the seller's broker; and
- the buyer agrees to pay the fee earned by the brokers if the buyer unjustifiably *fails to close*, allowing both the seller's broker and the buyer's broker to enforce collection of their respective share of the fee from the buyer.

1 Calif. Civil Code §2079.16
2 CC §§2079.13(n), 2079.13(o)

The seller's payment of the fee earned by the buyer's broker in no way establishes or indicates an agency with the seller without words and representations that the buyer's broker is also the seller's broker. Thus, no rationale exists to take the payment of the brokers' fees due on the acceptance of a purchase agreement offer "off form," placing it in a separate agreement calling for the seller to pay only the seller's broker.[3]

Off-form fee disclosure

Occasionally, the fee offered the buyer's broker by the seller's broker through the multiple listing service (MLS) is less than the amount the buyer's broker believes they are entitled to on the transaction. Here, the buyer's broker may negotiate with the seller's broker and agree in writing to a different fee schedule than the one offered in the MLS.

Thus, on acceptance of the buyer's purchase agreement offer — improperly devoid of a broker fee provision — the buyer's broker is assured that the "off-form" fee agreement is to provide for the seller's broker to pay the agreed share to the buyer's broker. [See **RPI** Form 105]

If the buyer's broker agrees to the off-form fee agreement in which they receive their fee from the seller's broker, the buyer's agent will inform the buyer of the amount in fees paid to the buyer's broker. Failure to disclose fees to the client is a direct violation of agency rules. The client needs to be informed of all compensation received from all sources by their agent as a result of their representation. [See Form 119 accompanying Chapter 8]

Had the buyer's agent been only a **cooperating agent** negotiating the sale of the property to the buyer on behalf of the seller (as a statutory subagent), then the off-form fee arrangement and the nondisclosure to the buyer of the subagent's compensation is of no concern to the buyer. Here, the buyer has no agent, or has employed their own agent separate from the subagent. The seller, as the client of the cooperating (selling) broker, is fully aware of their subagent's compensation since they are agreeing to it.

Buyer's agent protects their fee

All distortions and shortcomings in fee arrangements are avoided and the buyer's broker's fee is protected for collection when the buyer's agent simply includes the fee arrangements as a provision in the purchase agreement offer signed by the buyer.

Occasionally, the seller's broker gets into a dispute with the seller and the unilateral fee provision in escrow is cancelled, leaving the seller's broker with no fees on close. Consequently, the buyer's agent does not get paid by the seller's broker.

Rarely, but often enough, the seller's broker is put into bankruptcy before the fees are disbursed to the buyer's broker, interfering with payment of any amount of the fee.

3 CC §§2079.16, 2079.19

A profit, not a referral fee

affiliated business arrangement (ABA) A business arrangement in which a broker may lawfully profit from referring a client to a service provider the broker owns; requires the broker to make a disclosure of their ownership interest to the client. [See **RPI** Form 205 and 519]

Real Estate Settlement Procedures Act (RESPA) A federal law governing the behavior of service providers on a federally related mortgage which prohibits them from giving or receiving unlawful kickbacks.

referral fee A fee paid by one service provider to another for referring a client to them. Prohibited by the Real Estate Settlement Procedures Act (RESPA) when consumer financing funds the purchase of one-to-four unit residential property.

In times of slowed real estate activity, prudent residential brokers listing a property or representing a buyer are able to generate additional income by diversifying their brokerage business. To this end, they may become *full-service brokers* by referring buyers and sellers to lenders and service providers they own or co-own. These business relationships, called **affiliated business arrangements (ABA)** or *controlled business arrangements*, enable the broker to indirectly benefit by sharing in any profits from the referrals they make to these controlled businesses. [See **RPI** Form 205 and 519]

However, the single family residential (SFR) broker's ability to *profit from referrals* is regulated by the federal **Real Estate Settlement Procedures Act (RESPA)** Section 8.

RESPA was enacted to prohibit brokers and lenders from unnecessarily augmenting a buyer's costs when negotiating a transaction involving the origination of a federally related mortgage on a one-to-four unit residential property. These augmented costs too frequently take the form of illegal **referral fees**.

Referral fees are unlawfully paid by one service provider to another provider, namely transaction agents, to refer principals to them for their service in a real estate purchase agreement transaction or escrow. These service providers, essential to closing a sale, include:

- title and finance companies;
- credit reporting agencies;
- home inspection and pest control companies;
- hazard insurers;
- escrow companies; and
- other brokers.

The broker receiving a broker fee for negotiating the sale or purchase of a one-to-four unit residential property involving a mortgage origination is not allowed to receive *a referral fee in addition* to their broker fee on the sale — this activity is unlawful.

However, the broker is still able to profit from referring a buyer or seller if the broker is an owner or co-owner of the recommended service provider. Thus, the broker creates an *ABA*.

Profiting by referral to an affiliate

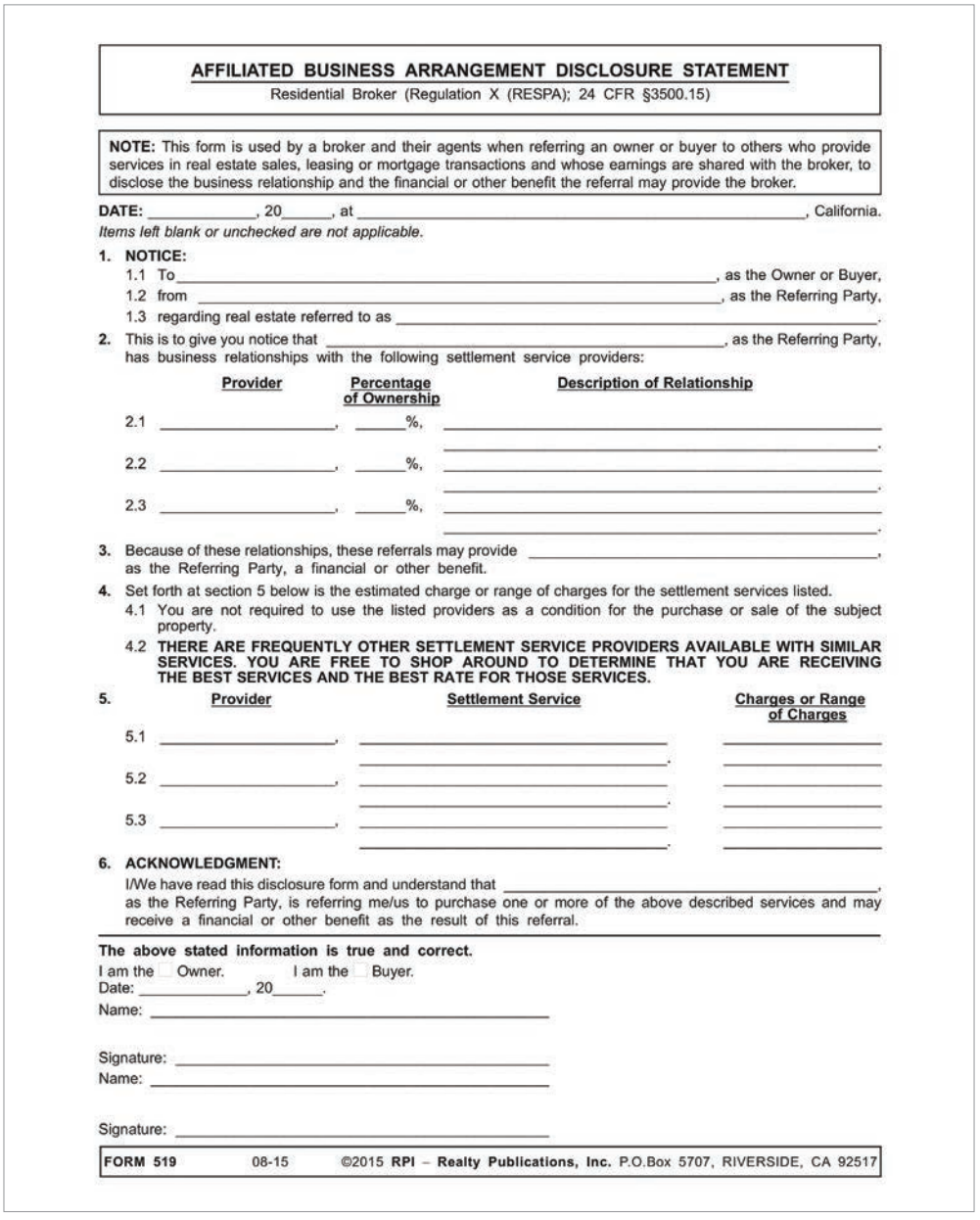
For the broker to meet conditions to profit from an *ABA,* the broker needs to:

- have an *ownership interest* greater than one percent in the business being recommended to the buyer or seller; and
- provide the person referred to the controlled business a *written disclosure* of the broker's affiliation. [See Form 519 accompanying this chapter]

The referral to an owned or co-owned service provider for profit is an *ABA* and is not subject to RESPA referral fee regulations. As an owner of the

Form 519

Affiliated Business Arrangement Disclosure Statement



AFFILIATED BUSINESS ARRANGEMENT DISCLOSURE STATEMENT
Residential Broker (Regulation X (RESPA); 24 CFR §3500.15)

NOTE: This form is used by a broker and their agents when referring an owner or buyer to others who provide services in real estate sales, leasing or mortgage transactions and whose earnings are shared with the broker, to disclose the business relationship and the financial or other benefit the referral may provide the broker.

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

1. NOTICE:
1.1 To _____, as the Owner or Buyer,
1.2 from _____, as the Referring Party,
1.3 regarding real estate referred to as _____.

2. This is to give you notice that _____, as the Referring Party, has business relationships with the following settlement service providers:

	Provider	Percentage of Ownership	Description of Relationship
2.1	_____,	_____%,	_____
2.2	_____,	_____%,	_____
2.3	_____,	_____%,	_____

3. Because of these relationships, these referrals may provide _____, as the Referring Party, a financial or other benefit.

4. Set forth at section 5 below is the estimated charge or range of charges for the settlement services listed.
4.1 You are not required to use the listed providers as a condition for the purchase or sale of the subject property.
4.2 **THERE ARE FREQUENTLY OTHER SETTLEMENT SERVICE PROVIDERS AVAILABLE WITH SIMILAR SERVICES. YOU ARE FREE TO SHOP AROUND TO DETERMINE THAT YOU ARE RECEIVING THE BEST SERVICES AND THE BEST RATE FOR THOSE SERVICES.**

5.

	Provider	Settlement Service	Charges or Range of Charges
5.1	_____,	_____	_____
5.2	_____,	_____	_____
5.3	_____,	_____	_____

6. ACKNOWLEDGMENT:
I/We have read this disclosure form and understand that _____, as the Referring Party, is referring me/us to purchase one or more of the above described services and may receive a financial or other benefit as the result of this referral.

The above stated information is true and correct.
I am the ☐ Owner. I am the ☐ Buyer.
Date: _____, 20_____.
Name: _____

Signature: _____
Name: _____

Signature: _____

FORM 519 08-15 ©2015 **RPI – Realty Publications, Inc.** P.O.Box 5707, RIVERSIDE, CA 92517

service provider, the benefit the broker receives from the referral is not the payment of a referral fee. Rather, the broker receives an indirect benefit from the referral through annual profits generated for the co-owners by the operations of the service provider to whom the principal in the real estate transaction was referred.

Thus, when the broker of a listed property refers the owner to a pest control business in which they hold an ownership interest, an ABA is created. If fully disclosed, the broker is able to benefit by sharing in any end-of-year profit the business realizes on the referral.

Conversely, the broker who does not possess an ownership interest in the referred business is not involved in an ABA. Thus, the broker will receive neither a referral fee nor any financial benefit from the referral.

However, referral fees are allowed between two brokers if the broker receiving the referral fee is not providing another service in the home sales transaction such as financing, insurance, escrow, etc. [See **RPI** Form 114]

Permitted referral fee

Compensation for a referral permitted by or between brokers under RESPA includes:

- payments to the buyer's broker by the seller's broker, and referral arrangements between real estate agents and brokers;
- payment to any person of a bona fide salary or compensation or other payments of goods or facilities actually furnished or for services actually performed, such as finders employed by a broker; and
- an employing broker's payment to their own employees for any referral activities.[4]

Further, brokers and agents need to adhere to specific California Bureau of Real Estate (CalBRE) rules and codes when paying or accepting referral fees from other brokers or agents. Initially, agents are prohibited from accepting a fee or other benefit from any person who is not their employing broker. Also, agents are forbidden from paying a fee to any other broker or agent without first directing the payment through the agent's employing broker.[5]

Referral fee disclosure

Most importantly, as a fiduciary matter, brokers and their agents need to advise their clients of the dollar amount of any compensation received from service providers related to the real estate transaction in which their client is involved. If the compensation (monetary or otherwise) is not disclosed, agents and their employing broker are subject to their client recovering all fees received, as well as license suspension or revocation by the CalBRE.

Further, a broker who refer a seller or buyer to a service provider they own or co-own also has to disclose any *ownership interest* in the provider on or before their referral.[6] [See Form 519]

The disclosure includes the nature of the business relationship between the broker and the business providing services, as well as an estimate of the cost or range of costs to be charged.[7]

Other disclosures for direct or indirect compensation exist and are available for use in conjunction with the ABA. The form used for Compensation Disclosure in a Real Estate Transaction discloses the amount, its form and the source of compensation and benefits the broker anticipates receiving for any service or from any party or provider as a result of their client's entry into a purchase agreement or other real estate transaction. [See Form 119 accompanying Chapter 8]

---

4 Calif. Business & Professions Code §10177.4; 12 USC §2607

5 Bus & P C §10137

6 12 Code of Federal Regulations §1024.14(b)(1)

7 12 CFR §1024.14(b)(1)

However, fees prohibited by RESPA are not legalized by disclosure or consent of the client.[8]

An individual who accepts a referral fee or fails to disclose the existence of an affiliated relationship as prescribed by RESPA is subject to criminal penalties of $10,000, one year in jail or both for each offense. The principal referred to the service provider is also able to receive up to three times the amount of the improper referral fee received by the broker, plus attorney fees, in a civil suit.[9]

No additional service, no additional fee

A transaction agent (broker) may receive a second fee from a mortgage lender if the broker renders substantial mortgage origination services otherwise performed by the lender. Again, this activity for payment is strictly regulated by RESPA.

RESPA established a *no-service, no-fee* restriction on real estate brokers and agents who are already acting for compensation on behalf of a buyer or seller in an SFR real estate transaction financed by a RESPA mortgage. A mortgage lender in the transaction is prohibited from paying brokers and their agents a fee of any type when the broker is already receiving a fee for their brokerage services rendered in the transaction for a buyer or seller, unless the broker performs **significant services** on behalf of the lender. Thus, a second fee cannot be paid to a transaction agent by anyone if it is received for acting only as a **referral agent**.

Significant second service

The broker and their agent are entitled to a second fee in a sales transaction if they handle the mortgage escrow or process a mortgage application and documentation — services *significantly more involved* than the act of a mere referral.

A lender and broker are in compliance with the no-service, no-fee rule if the earnings the broker is to receive for the *second service* were due the broker as:

- payment for *goods*; or
- payment for *services rendered*, other than the referral.[10]

Before a broker and their agent are able to accept a fee for a *second significant service* in addition to a broker fee, the broker or agent has to perform *numerous mortgage origination activities*.

Further, if sufficient mortgage origination activities are performed by the broker or their agent, the second fee for the mortgage-related services has to be justified as a dollar amount that is competitive with fees paid for the same services by other lenders.

8 Bus & P C §10176(g)

9 12 United States Code §§2607(a), 2607(c)(4)(a), 2607(d)

10 12 USC §2607(c)

Duplicate charges for services

kickback
A fee improperly paid to a transaction agent (TA) who renders no service beyond the act of referring when the TA is already providing another service in the transaction for a fee.

Real estate sales transactions are increasingly subject to *duplicate charges* imposed on both buyers and sellers by brokers, lenders, escrow agencies and title companies during periods of rising property values. Duplicate charges for integral services, called **kickbacks** or *hidden costs*, are redundant and frequently experienced by the buying and selling public.

Kickbacks to brokers and agents representing sellers and buyers in a home sales transaction are openly undertaken in an illegal effort by a third-party service provider to garner a larger share of the available business. This is a *corrupting business policy* and a violation of RESPA. Legitimate operators find it difficult, if not impossible, to compete with fraud without themselves stooping to the same corrupt kickback practices.

Referral fees are not the only form of kickback which violates RESPA. Indirect kickbacks commonly provided by third-party services in exchange for referrals include:

- entry into a "referral contest" drawing for referring a lead;
- paying for sporting events or theater tickets;
- throwing a party for anyone who referred business;
- paying the admission to a real estate seminar;
- paying for real estate listing advertising; and
- paying for subscriptions to 800 numbers and call-capture numbers.

However, promotional and educational activities are allowed if:

- they are not conditioned on the referral of business; and
- they do not involve the payment of expenses (rent, IT services, supplies, etc.) incurred by a broker or agent in a position to refer business.[11]

The improper "closed office"

Another classic example of kickbacks is found in so called "closed offices," where brokers ban third-party service providers from competing legitimately for business with their one chosen service provider – their "preferred" lender or title company. The preference is typically the result of some direct or indirect payment arrangement the broker has with the title company or lender, as noted above.

Whether in the form of referral fees or other indirect financial benefits used to steer or capture business, kickbacks interfere with the availability of lower rates and fewer charges. Rather than directing buyers to legitimate service providers, buyers are referred to those businesses providing kickbacks to the broker or agent.

11 12 Code of Federal Regulations §1024.14(g)(vi)

Chapter 6 Summary

"Cooperation" is often improperly used to describe fee-sharing arrangements between brokers or agents. However, a "cooperating broker" is merely the title for a subagent of the seller, having specific affirmative duties of care owed the seller only, not the buyer.

For a buyer's broker to have equal ability as a seller's broker to negotiate, contract for and enforce collection of a fee:

- the buyer's broker needs to enter into an employment agreement with the buyer;
- a fee provision is included in the body of the buyer's purchase agreement offer;
- the fee earned has to be payable directly to the buyer's broker by the seller through escrow, not via the seller's broker;
- the seller agrees to pay the fee earned by the brokers if the seller wrongfully fails to close the sale; and
- the buyer agrees to pay the fee earned by the brokers if the buyer unjustifiably fails to close.

The buyer's broker's fee is protected when the buyer's agent simply includes the fee arrangements as a provision in the purchase agreement offer signed by the buyer.

The Real Estate Settlement Procedures Act (RESPA) was enacted to prohibit brokers and lenders from augmenting a buyer's costs when negotiating a transaction involving the origination of a federally related mortgage on a one-to-four unit residential property. These augmented costs too frequently take the form of illegal referral fees.

Referral fees are unlawfully paid by one service provider to another provider, namely transaction agents, to refer principals to them for their service in a real estate purchase agreement transaction or escrow. The broker receiving a broker fee for negotiating the sale or purchase of a one-to-four unit residential property involving a mortgage origination is not allowed to receive a referral fee in addition to the broker fee on the sale — this activity is unlawful.

A broker may refer a buyer or seller to a service provider the broker owns or co-owns for profit, called an affiliated business arrangement. However, the broker is required to disclose their ownership interest in the provider on or before their referral.

A broker and their agent may accept a fee for a second significant service in addition to a broker fee if the broker or agent performs numerous mortgage origination activities. However, duplicate charges, called kickbacks, are improper and make the real estate market less efficient by systematically eliminating more competent and less costly competition. Kickbacks from mortgage banks, title companies and other third-party service providers are a violation of RESPA.

Chapter 6 Key Terms

Chapter 7

"For Sale" sign regulations

Learning Objectives

After reading this chapter, you will be able to:

- properly display a "For Sale" sign on a property on behalf of the seller to advertise the property for sale;
- understand when permission is needed to advertise a property with a "For Sale" sign in a common interest development (CID); and
- abide by the regulations concerning the placement of a "For Sale" sign on a private or public right-of-way or on a mobilehome.

Key Terms

covenants, conditions and restrictions (CC&Rs)

restraint on alienation

Property owners may display "For Sale" signs

Consider the owner of a residential unit in a common interest development (CID) who wants to sell their property. The owner and their agent place a "For Sale" sign on the interior side of the window of their unit where it can be seen by others.

A neighbor in the project complains about the sign to the homeowners' association (HOA) which manages the project. In response, the HOA makes a demand on the owner to remove the sign, claiming the sign is a violation of the **conditions, covenants and restrictions (CC&Rs)** controlling conduct in the project.

May the owner and their agent place a "For Sale" sign in the window of their unit when the display is in violation of restrictions in the HOA's CC&Rs?

covenants, conditions and restrictions (CC&Rs) Written rules, limitations and restrictions on use agreed to by all property owners in a subdivision or common interest development.

Yes! Owners of real estate and their brokers have the right to display "For Sale" signs of reasonable dimension and design on their property. Also, they may display for sale signs on property owned by others if they have their *consent*, despite title restrictions in the CC&Rs.[1]

"For Sale" signs displayed by the owner or their agents on the property being sold, or on another private property with that owner's consent may contain:

- advertising stating the property is for sale, lease or exchange;
- directions to the property;
- the owner's or agent's name; and
- the owner's or agent's address and telephone number.

However, the sign or location of a "For Sale" sign may not adversely affect public safety or impede the safe flow of vehicular traffic.[2]

Also unenforceable are any attempts by local governmental ordinance to **bar or unreasonably restrict** the placement of a real estate "For Sale" sign on the property for sale, or private property owned by others who have consented to the placement of a directional "For Sale" sign on their property.[3]

Reasonably located on-site signs

"For Sale" signs may be reasonably located in plain view for the public to observe.[4]

In a CID, the boundaries of a unit owned as the separate interest of a member of the CID are the walls, windows, floors and ceilings. If the CC&Rs of the CID do not state otherwise, the interior surface of the perimeter walls, floors, ceilings, windows, doors, outlets and airspace located within a unit are considered the owner's separate interest. All other portions of the walls, floors, ceilings and real estate are part of the common area maintained and managed by the HOA.[5]

Thus, the owner is entitled to display a "For Sale" sign on the *interior side* of the window of their condominium unit. The interior side of the window belongs to the owner. Thus, placing the sign in the window is reasonable.[6]

However, if the owner seeks to display the sign on the ground area surrounding their unit, the owner needs to obtain the permission of the HOA. Here, the ground area is part of the common area *owned by others*, specifically, the undivided ownership interest held by all the owners of units in the CID.[7]

A copy of a HOA's governing documents and CC&Rs controlling the dimensions and design of "For Sale" signs are available from the HOA. [See **RPI** Form 309]

---

1 Calif. Civil Code §712
2 CC §713
3 CC §713
4 CC §§712, 713
5 CC §4185(b)
6 CC §4710
7 CC §712

Reasonable restrictions

Now consider a city which prohibits the display of all "For Sale" signs. It is enacted with the purpose to stop perceived white-flight from a racially integrated city.

A seller and their agent claim the ban is an unconstitutional interference with the sale and transfer of real estate, called a **restraint on alienation**, and violates the owner's freedom of speech.

restraint on alienation
A limit placed on a property owner's ability to sell, lease for a period exceeding three years or further encumber a property, as permitted by federal mortgage policy.

The city claims the sign prohibition is constitutional since it does not prohibit other ways in which to advertise property for sale, only those advertisements located on the property.

Is the city ordinance a reasonable restriction on the display of "For Sale" signs?

No! Prohibiting the display of "For Sale" signs is a violation of the First Amendment freedom of speech right. Other methods of advertising real estate for sale are less effective and the ordinance prohibits the free flow of truthful commercial information.[8]

Further, cities and counties may not prohibit the placement of "For Sale" signs on private property, whether it is the property sold or property owned by others who consent to a directional sign being placed on their property. However, government agencies may determine the location, shape and dimensions of "For Sale" signs to ensure the signs do not affect public safety, including traffic safety.[9]

Cities and counties restrict the display of "For Sale" signs on private property through ordinances, nuisance laws or building requirements. Restrictions may vary between residential and industrial zones, and among cities. Copies of "For Sale" sign ordinances controlling their use on private property are available through the city and county planning departments.

Signs on right-of-ways and alongside public highways

The display or placement of a "For Sale" sign on a private or public right-of-way, such as roadways, may be limited or regulated by local government agencies.[10]

Further, a directional sign advertising real estate for sale, lease or exchange that is located on property other than the property advertised for sale and visible from a highway which is subject to the federal Highway Beautification Act requires a *special permit* be obtained from the Director of Transportation of the State of California before the sign may be erected.[11]

Locating signs off-site

Consider an agent who, on behalf of a seller of real estate, advertises the seller's property by placing a directional "For Sale" sign on a neighbor's property without first obtaining the neighbor's permission.

8 **Linmark Associates, Inc.** v. **Township of Willingboro** (1977) 431 US 85
9 CC §713
10 CC §713
11 Calif. Business and Professions Code §§5200 et seq.

The neighbor discovers the "For Sale" sign on their property and removes it. However, the seller's agent continues to replace the sign on weekends without permission from the neighbor.

Does the neighbor have recourse against the agent?

Yes! Placing a sign on private property without the *property owner's permission* is a **misdemeanor public nuisance**. Preventing a *public nuisance* is the responsibility of local government authorities on a complaint from the owner who does not consent to the placement of directional signs.[12]

Further, when a property owner or a real estate agent places a "For Sale" or a directional sign on public property without permission, such as on a sidewalk right-of-way or at the curbside, the placement is also a misdemeanor public nuisance.[13]

Cities and counties often refuse or severely limit the granting of permission for placement of "For Sale" signs on public property, such as street corners, choosing to strictly enforce the penalties allowed by the California Penal Code.[14]

When government agencies allow "For Sale" signs, they are usually by a *special permit* and with the payment of *use fees*. Further, they are typically only allowed for the sale of parcels in a subdivider's development.

Mobilehome regulations

A mobilehome owner may place a "For Sale" sign:

- in the window of their mobilehome; or
- outside the mobilehome facing the street.

Signs posted outside of the mobilehome can be of an H-frame or A-frame design and need to face the street. However, they cannot extend into the street.[15]

Signs in mobilehome parks may:

- be up to 24 inches wide and 36 inches high; and
- contain the name, address and telephone number of the mobilehome owner or the owner's agent.[16]

The right to display mobilehome "For Sale" signs extends to:

- brokers;
- joint tenants;
- heirs; or
- representatives of a mobilehome owner's estate who acquire ownership of a mobilehome on the owner's death.

12 Calif. Penal Code §§556.1, 556.3
13 Pen C §556
14 Pen C §556
15 CC §798.70
16 CC §798.70

Also, mobilehome owners and their agents may display an "Open House" sign in the same locations as "For Sale" signs, if the mobilehome park does not prohibit "Open House" signs.

Tubes or holders for leaflets with information on the mobilehome being advertised may be attached to either the "For Sale" sign or to the mobilehome.[17]

17 CC §798.70

Chapter 7 Summary

Owners of real estate and their brokers have the right to display "For Sale" signs of reasonable dimension and design on their property or on property owned by others if they have their consent.

"For Sale" signs may contain:

- advertising stating the property is for sale, lease or exchange;
- directions to the property;
- the owner's or agent's name; and
- the owner's or agent's address and telephone number.

However, the sign or location of a "For Sale" sign may not adversely affect public safety or impede the safe flow of vehicular traffic.

Any attempts by local governmental ordinance to bar or unreasonably restrict the placement of a real estate "For Sale" sign on the property for sale, or private property owned by others who have consented to the placement of a directional "For Sale" sign on their property, are unenforceable.

An owner of a separate interest in a common interest development (CID) is entitled to display a "For Sale" sign on the interior side of the window of their condominium unit. However, if the owner seeks to display the sign on the ground area surrounding their unit, the owner needs to obtain the permission of the homeowners' association (HOA).

Government agencies may determine the location, shape and dimensions of "For Sale" signs to ensure the signs do not affect public safety, including traffic safety. Cities and counties restrict the display of "For Sale" signs on private property through ordinances, nuisance laws or building requirements.

When a property owner or a real estate agent places a "For Sale" or a directional sign on public or private property without permission, the placement is a misdemeanor public nuisance.

A mobilehome owner may place a "For Sale" sign:

- in the window of their mobilehome; or
- outside the mobilehome facing the street.

Signs posted outside of the mobilehome can be of an H-frame or A-frame design and need to face the street. However, they cannot extend into the street.

Chapter 7 Key Terms

Chapter 8

Due diligence obligations

Learning Objectives

After reading this chapter, you will be able to:

- appreciate the due diligence an exclusively employed broker owes a seller or buyer; and
- implement a best effort obligation to a client under an open listing employment.

Key Terms

Annual Property Operating Data sheet (APOD)
best effort obligation
due diligence
marketing package
material fact
Natural Hazard Disclosure Statement (NHD)
property profile
seller's net sheet

The duty owed to clients

Every exclusive listing agreement entered into by an agent on behalf of their broker documents an employment which establishes a client relationship. The employment imposes *special agency (fiduciary) duties* on the broker and the agent to use **due diligence**.

Due diligence is a continuous effort by the broker and their agents to meet the objective of the employment. This is true whether the goal is to:

- buy;
- sell;
- lease; or
- finance an interest in real estate. [See **RPI** Form 102 §1.2]

due diligence
The concerted and continuing efforts of an agent employed to meet the objectives of their client, the agent's promise given in exchange for the client's promise to pay a fee.

The promise of due diligence is the consideration a broker and their agents owe their client when rendering services in exchange for employment as the exclusive *representative* of the client. If the promise to use diligence in the employment is not stated in the exclusive listing agreement, it is a duty implied as existing in the relationship.

material fact
A fact that, if known, might cause a prudent buyer or seller of real estate to make a different decision regarding what price to offer or demand for a property or whether to remain in a contract or cancel it.

The broker with authority to be the exclusive representative of a client takes reasonable steps to promptly gather all **material facts** about the property in question which are *readily available* to the broker or the broker's agent.

After gathering factual information about the integrity of the property, the broker's agent proceeds to do every reasonable and ethical thing to pursue, with utmost care, the purpose of the employment.

best effort obligation
Obligations under an open listing requiring the agent to take reasonable steps to achieve the objective of the client but requiring no affirmative action until a match is located at which point due diligence is required.

In contrast to an exclusive listing, a broker and agents entering into an *open listing* are not committed to render any services at all. The broker and agents only have a **best effort obligation** to act on the employment.

However, when an agent holding an open listing enters into preliminary negotiations, such as an exchange of property data on inquiry by a third party, a due diligence obligation arises. The due diligence obligation triggered by inquiry requires the client's broker to provide the utmost care and protection of the client's best interests in managing that inquiry. Having *acted on the open listing*, the agent now inspects the property and gathers all readily available information on the property under consideration.

Once the agent actually begins to perform services under an open listing entered into by a buyer or seller, the agent has *acted on the employment.* Thus, the due diligence standards of duty owed to the client apply to the agent's future conduct.

The seller's broker becomes the buyer

Consider an agent employed under a listing agreement to locate a buyer for the listed property.

The agent prepares a purchase agreement naming themself as the buyer and submits it to the seller. The agent states the price offered is the fair market value of the property. Based on this representation, the seller agrees and enters into the purchase agreement.

Prior to the close of escrow, and still within the listing period, the agent locates a buyer who agrees to pay the agent for an *assignment* of the agent's right to buy the property under the purchase agreement entered into with the seller. The amount paid to the agent for the assignment is equal to 10% of the price stated in the purchase agreement.

When the agent asks the seller to consent to the assignment and substitution of a new buyer under the purchase agreement and escrow instructions, the agent tells the seller the buyer is buying the property for no more than the purchase price stated in the purchase agreement. The seller, based on the agent's representation of the amount paid for the property by the substituted buyer, agrees to the assignment of the agent's right to buy the property.

Form 119

Compensation Disclosure in a Real Estate Transaction

COMPENSATION DISCLOSURE IN A REAL ESTATE TRANSACTION
(California Business and Professions Code §10176(g), CalBRE Reg. §2904)

NOTE: This form is used by an agent when negotiating a sale, lease or mortgage of property and otherwise undisclosed compensation arising out of the transaction will be received by the agent, to disclose to their client the form, amount and source of the additional compensation.

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:
1. This disclosure is made in connection with the following agreement:
   ☐ Purchase Agreement [See **RPI** Form 150] ☐ Exchange Agreement [See **RPI** Form 171]
   ☐ Escrow Instructions [See **RPI** Form 401] ☐ _____
   1.1 ☐ of the same date, or dated_____, 20 ____, at _____, California,
   1.2 entered into by _____, as the Buyer,
   1.3 and _____, as the Seller,
   1.4 regarding real estate referred to as _____.
2. The client represented by the undersigned Broker with regards to the above referenced agreement is the ☐ Buyer, ☐ Seller, or ☐ both Buyer and Seller.

DISCLOSURE OF COMPENSATION:
3. Broker provides the following information as a disclosure to the client of all compensation and economic benefits to be received as a direct or indirect result of the client's entry into the above referenced agreement and not previously disclosed by Broker and their agents.

	Source of Compensation (Seller, Lender, etc.)	Form (Cash, Membership, etc.)	Amount (Dollar Values)
3.1			$_____
3.2			$_____
3.3			$_____
3.4			$_____

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for controlled business arrangements and conflicts of interest. [See **RPI** Forms 519 and 527]

BROKER:
5. I certify the above information is true and correct and represents all compensation not previously disclosed that Broker and their agents anticipate receiving in the above referenced transaction.
   Date: _____, 20____ Broker's Name: _____ CalBRE #: _____
   By: _____
   Name: _____ Title: _____

CLIENT: I have recieved a copy of this disclosure. ☐ See attached Signature Page Addendum [**RPI** Form 251]
Date: _____, 20 _____
Name: _____ Name: _____
Signature: _____ Signature: _____

If the source of the compensation is connected to the origination of a loan in the above referenced agreement, the other party to the agreement is to also acknowledge receipt of a copy of this disclosure.
PARTY other than client: I have received a copy of this disclosure.
Date: _____, 20 _____
Name: _____ Name: _____
Signature: _____ Signature: _____

FORM 119 09-15 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

After escrow closes, the seller discovers the buyer paid the agent a higher purchase price in the form of an **assignment fee** on top of the price agreed to in the purchase agreement between the agent and seller.

The seller makes a demand on the agent for the assignment fee, as an undisclosed secret profit, and a return of the broker fees paid. The seller claims the agent breached their fiduciary duty since the agent failed to disclose the profit the agent received as a result of their employment under the listing agreement, depriving the seller of the ability to sell the property for its highest possible value.

Duty to disclose profits

Continuing our previous example, the agent claims they had no duty to disclose the profit taken for the assignment on their sale of the right to purchase the property. The agent argues that their status as buyer under the purchase agreement was as a principal with an interest in the property the agent may sell.

Does the agent have a duty arising out of the listing agreement to disclose the profit taken on the assignment to the seller of the agent's right to buy the listed property?

Yes! The *agency relationship* created by the listing agreement was *not extinguished* by the purchase agreement when the agent acting on behalf of the seller also became the buyer. The agent owed the seller a duty upon entering into a listing agreement to get the seller the highest possible price for the property and to disclose any and all compensation or profit made as a result of being the seller's agent.

The agent owes the seller all of their benefits received on the transaction, including the assignment fee and the broker fee received. Further, the California Bureau of Real Estate (CalBRE) Commissioner may revoke the agent's license for taking compensation which was not disclosed.[1] [See **RPI** Form 401-2; see Form 119 accompanying this chapter]

Due diligence includes:

- the advice and counsel the agent gives the client about the property;
- the market pressures affecting the clients expectations; and
- impending negotiations and their consequences for the client's change of position.

Maintaining the client file

Typically, the agent who produces a listing (and thus their broker's right to a fee) becomes the agent in the broker's office who is responsible to the broker for the care and maintenance of the **client's file**.

On entering into a listing employment, a *physical client file* is set up to house information and document all the activity which arises within the broker's office due to the existence of the employment.

For example, the file on a property listing for sale is to contain:

- the original listing agreement;
- any addenda to the listing;
- all the property disclosure documents the seller and seller's agent provide to prospective buyers in the process of marketing the property; and
- an **activity sheet** for entry of information on all manner of file activity.

Any paperwork, notes, messages, billings, correspondence, email printouts, fax transmissions, disclosure sheets, worksheets, advertising copy, tear

1 **Roberts** v. **Lomanto** (2003) 112 CA4th 1553; Calif. Business and Professions Code §10176(g)

sheets, copies of offers/counteroffers and rejections and all other related documentation are to be kept in the file. Everything that occurs as a result of the client employment is to be retained in the file.

The file belongs to the *broker*, not the seller's agent, although it will likely remain with the listing agent until close of a sale on the listed property or the listing expires un-renewed. The agent hands the broker the entire file on close of escrow, usually a *condition precedent* to payment of the agent's share of the fee received by the broker.

Guidelines and checklists

Guidelines used to build a file's content are available in many forms, such as:

- checklists prepared by a broker or their listing coordinator;
- a transaction coordinator's (TC's) closing checklist;
- escrow worksheets [See **RPI** Form 403];
- work authorization forms;
- advance fee and advance cost checklists; or
- income property analysis forms.

Checklists belong in the file to be reviewed periodically by the agent, office manager, TC or employing broker for oversight, and work to be done in the future to better service the listing and earn a fee.

Following are some — but certainly not all — steps a broker and their agent may undertake to fulfill their employment responsibilities owed to the client. They include:

1. A **property profile** of the seller's title from a title company in order to identify all owners needed to list, sell and convey the property. [See Chapter 25]
2. A *Transfer Disclosure Statement (TDS),* also known as a condition of property disclosure sheet, filled out and signed by the seller. [See **RPI** Form 304; see Chapters 9]
3. A *home inspection report* (prepared by a home inspector) paid for by the seller and attached to the TDS before the seller's agent signs the TDS. [See Chapter 12]
4. A **Natural Hazard Disclosure Statement (NHD)** on the property from a local agency or a vendor of NHD reports, paid for by the seller, and reviewed and signed by the seller and the seller's agent. [See **RPI** Form 314; see Chapter 14]
5. An **Annual Property Operating Data sheet (APOD)** covering the expenses of ownership and any income produced by the property, filled out and signed by the seller, together with a rent roll and copies of lease forms which the owner uses, to be included in the **marketing (listing) package** only after reviewing the seller's data. [See **RPI** Forms 352 and 562]

property profile
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

Natural Hazard Disclosure Statement (NHD)
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 **RPI** Form 314]

Annual Property Operating Data sheet (APOD)
A worksheet used when gathering income and expenses on the operation of an income producing property, to analyze its suitability for investment. [See **RPI** Form 352]

marketing package
A property information package handed to prospective buyers containing disclosures compiled on the listed property by the seller's agent.

Guidelines and checklists, cont'd

6. Copies of all the Covenants, Conditions and Restrictions (CC&Rs), disclosures and assessment data from any *homeowners' association* involved with the property. [See **RPI** Form 150 §11.9]
7. A *termite report* and clearance paid for by the seller.
8. Any replacement or *repair of defects* noted in the home inspection report or on the TDS, as authorized and paid for by the seller.
9. An occupancy *transfer certificate* (including permits or the completion of retrofitting required by local ordinances), paid for by the seller.
10. A statement on the amount and payment schedule for any special district property improvement bonds which are liens on the property (shown on the title company's *property profile*).
11. A **visual inspection** of the property and a survey of the surrounding neighborhood by the seller's agent to become informed about readily available facts affecting the marketability of the property.
12. *Advising* the seller about the marketability of the listed property based on differing prices and terms for payment of the price, and for property other than one-to-four residential units, the financial and tax consequences of various sales arrangements which are available by using alternative purchase agreements, options to buy, exchange agreements and installment sales.
13. A *marketing package* on the property compiled by the seller's agent and handed to prospective buyers or buyer's agents before the seller accepts any offer to purchase the property. This consists of copies of all the property disclosures required to be handed to prospective buyers or the buyer's agent by the seller and seller's broker.
14. A *marketing plan* prepared by the seller's agent and reviewed with the seller for locating prospective buyers. This plan may include distributing flyers, disseminating property data in multiple listing services, newspapers and periodicals, broadcasts at trade meetings attended by buyer's agents, press releases to radio or television, internet sites, posting "For Sale" signs on the premises, hosting open house events, posting on bulletin boards, mailing to neighbors and using all other advertising media available to reach prospective buyers.
15. A **seller's net sheet** prepared by the seller's agent and reviewed with the seller each time pricing of the property is an issue. Issues may include obtaining a listing, changing the listed price, reviewing the terms of a purchase offer or when substantial changes occur in charges or deductions affecting the net proceeds from a sale since the *net sheet* discloses the *financial consequences* of the seller's acceptance of a purchase agreement offer. [See **RPI** Form 310]
16. Informing the client of the listing agent's sales activities by weekly due diligence communications advising what specifically has been done during the past several days and what the seller's agent expects

seller's net sheet
A document prepared by a seller's agent to disclose the financial consequences of a sale when setting the listing price and on acceptance of a buyer's price in a purchase offer. [See **RPI** Form 310]

to do in the following days, as well as what the seller may do in response to comments taken by the seller's agent from buyers and their agents, and to changes in the real estate market.

17. Keeping records in a client file of all communications, activities and documents generated due to the listing.

Duty to CalBRE to keep records

All records of an *agent's activities* on behalf of a client during the listing period are retained by the agent's broker for three years.[2]

The *three-year period* for retaining the buyer's or seller's activity file for CalBRE review begins to run on the closing date of a sale or from the date of the listing if a sale does not occur.

The records will be made available for inspection by the Commissioner of Real Estate or their representative, or for an audit the Commissioner may order.

Advising the seller

Consider an agent who, on behalf of their broker, solicits an owner of a run-down (deteriorated) single-family residence to list the property for sale.

After gathering and analyzing data on comparable sales, the agent advises the seller that the present condition of the property justifies a listing price of no more than $230,000.

However, the agent believes the property will sell for $300,000, an additional $70,000 in price, if the seller is willing to spend $15,000 to $20,000 to correct deferred maintenance and eliminate some obsolescence.

The agent is aware the current demand by buyers of a residence in this price range consists mostly of individuals who are looking for a ready-to-occupy home, with few speculators looking for "fixer-uppers" they can restore in that price range and resell at a profit.

The agent determines the seller has the funds needed to correct the defects and appearance of the property. Based on market demands and housing prices, the agent advises the seller to invest the time, effort and money to fix up the property. However, the seller is not now willing to invest funds to fix up the property.

Rejecting the agent's advice, the seller agrees to list the property for sale at $230,000. The property will be sold in its present condition, after full disclosure of the property's condition including a home inspection report.

Since the client has rejected the agent's advice, does the agent still need to explain the reasoning behind their advice?

Yes! Professionals are liable for their failure to explain the *rationale* behind their advice and the consequences which can result when advice is rejected. Here, the agent needs to advise the seller (and confirm in a memo) that the

2 Bus & P C §10148

resale value of the property after the property has been fixed up for sale will increase. So, when it is fixed up by a buyer and resold at a far greater price, the broker and their agent have evidence they advised the client about the consequences (costs) of this inaction.[3]

Advice and consequences

In a real estate transaction, brokers and their agents need to be certain who their **client** is. Likewise, agents need to determine who is not their client, but a **customer** with whom the broker is directly negotiating or who is represented by another broker. The seller's broker only owes a customer a **general duty** to deal fairly and honestly.

For example, the *general duty* owed a prospective buyer by a seller's agent regarding property disclosures does not include advice on what investigations, audits or additional reports on the disclosed defects are available. The general duty also does not require what reasons the agent may have to believe a prudent buyer obtains these reports.

Further, a seller's agent does not owe a duty to the prospective buyer to explain the consequences of the customer's *failure to further investigate* or analyze adverse facts disclosed by the agent. Investigations and inquiries are the *customer's duty of care* owed to themself to exercise concern for the protection of their own interests.

Also confusing for customers is the purpose behind the brokerage community's use of pre-printed suggestions, recommendations, and disclaimers of responsibilities, few if any being relevant to any one transaction. They are typically handed to each person in a sales transaction by the seller's agent with a demand the parties acknowledge receipt of the preprinted, boilerplate and mostly irrelevant advice, called **advisory disclaimers**.

When a seller's agent hands these advisory disclaimers to a third-party customer, such as a prospective buyer, the advisory provides a disclosure of the services available to the customer (by other than the seller's agent). The advisory disclaimers recommend that the buyer independently check out and determine the consequences of the property information disclosed by the seller's agent. Importantly, the buyer is advised to undertake efforts to protect their own interests in the transaction (whether or not they have retained a broker to do so).

Advising the buyer

A buyer is entitled to far more assistance from their agent than the naked suggestions or recommendations contained in *advisory disclosures* about the availability of services. The duty of the buyer's agent goes well beyond the seller's agent's limited disclosure obligations.

If these boilerplate advisory services were contracted for, the buyer will be provided with an independent analysis of the property and the transaction.

---

3 **Truman** v. **Thomas** (1980) 27 C3d 285

Here, the buyer's agent minimum counsel is to use the advisory statement of recommended investigations as a *checklist* of activities. The buyer's agent will select those services from the checklist the agent believes the buyer needs to undertake to protect the buyer's interests.

More strategically, third party services the buyer's agent has *reason* to believe the buyer needs to consider engaging are to be made the subject of *contingency provisions* in the purchase offer. Thus, buyer's agent allows the buyer (and themself) an opportunity and the time needed to investigate and analyze the agent's concerns prior to closing. Buyer's agents have a purpose in transactions continuing well beyond locating property to bring about a match.

Advisory statement of recommended activities

A buyer's agent has an affirmative duty of care to protect their buyer by pointing out why a recommended activity or inquiry needs to be undertaken in a transaction when the activity might uncover a situation which, if it exists, needs to be dealt with prior to closing. If it were otherwise, the conditions suspected by the buyer's agent to exist will interfere with the buyer's expected use, occupancy and successful ownership of the property after closing.

A residential broker and their agents nearly always know more about one-to-four unit residential property conditions and the transactional aspects (legal, financial and tax) which will affect the client than the client does. With this knowledge of facts and inclinations about the property, information about the principals involved, available services, documentation and the provisions they contain, agents have insight into the need for a particular investigative report. The reports will address problems the agent suspects might exist and might have an adverse impact on the client's sale or use of the property.

The buyer's agent using an advisory statement of recommended activities as a checklist will:

- determine which of the itemized activities their buyer is to undertake before closing;
- counsel with the buyer to weigh the probability of discovering undisclosed defects or conditions which will have consequences adverse to the buyer's objectives; and
- assist the buyer to analyze the risk of loss if defects of the type suspected be discovered after closing.

Chapter 8 Summary

Employment in a client relationship imposes special agency (fiduciary) duties on the broker and the agent to use due diligence in meeting the client's objectives. The promise to use due diligence on behalf of the client is the consideration a broker and their agents owe their client when rendering services in exchange for employment as the exclusive representative of the client.

In contrast to an exclusive listing, a broker entering into an open listing is not committed to render any services at all. The broker and agents only have a best efforts obligation to act on the employment.

On entering into a listing employment, a physical file is set up to house information and document all the activity which arises within the broker's office due to the existence of the employment. All records of an agent's activities on behalf of a client during the listing period are retained by the agent's broker for three years.

In a real estate transaction, brokers and their agents first ascertain who among the principals involved is their client. If not a client, the person is a customer with whom the broker might be directly negotiating or who is represented by another broker. If the person is a customer and not a client, the duty owed this individual is a general duty to deal fairly and honestly.

Chapter 8 Key Terms

Chapter 9

The seller's agent and the prospective buyer

Learning Objectives

After reading this chapter, you will be able to:

- distinguish an agent's specific agency duty owed to their client from the limited general duty they owe to others in a transaction;
- conduct a due diligence investigation to observe property conditions adversely affecting value for disclosure to prospective buyers;
- protect your seller by ensuring all readily known material facts on the listed property are disclosed to prospective buyers before the seller enters into a purchase agreement; and
- understand the need to qualify your representations in a transaction when they are opinions and not based on the results of an investigation into the facts.

Key Terms

fiduciary duty
general duty
marketing package
material fact
multiple listing service (MLS)
preliminary title report (prelim)
title conditions
Transfer Disclosure Statement (TDS)

General duty to voluntarily disclose

A seller's broker and their agents have a special **fiduciary agency duty**, owed solely to a seller who has employed the broker, to diligently market the listed property for sale. The objective of this employment is to locate a prospective buyer who is ready, willing and able to acquire the property on the listed terms.

On locating a prospective buyer, either directly or through a buyer's agent, the seller's agent owes the prospective buyer, and thus also the buyer's

fiduciary duty
That duty owed by an agent to act in the highest good faith toward the principal and not to obtain any advantage over their principal by the slightest misrepresentation, concealment, duress or undue influence.

general duty
The duty a licensee owes to non-client individuals to act honestly and in good faith with up-front disclosures of known conditions which adversely affect a property's value. [See **RPI** Form 305]

agent, a limited, non-client **general duty** to voluntarily provide critical factual information on the listed property, collectively called **disclosures of material facts**.

What is limited about the duty is not the extent or detail to which the seller's agent may go to provide information, but the **minimal quantity of fundamental information** and data about the listed property which the seller's agent will hand to the prospective buyer or the buyer's agent before the seller enters into a purchase agreement.

The information disclosed by the seller's agent need only be sufficient enough in its content to place the buyer on *notice of facts* which may have an adverse effect on the property's value or interfere with the buyer's intended use.

In California's public policy pursuit of transparency in property information between sellers and buyers, the disclosure obligations of the seller's agent to voluntarily inform prospective buyers about the fundamentals of the listed property act to eliminate asymmetry and power relationships in sales transactions. Thus, the seller's agent is severely limited in their ability to engage in any conduct or means at hand to exploit the prospective buyer's lack of knowledge about the condition of the property by use of these disclosures.

The seller's agent may not:

- deliver less than the minimum level of information to put the buyer on notice of the property's fundamentals affecting value;
- give unfounded opinions or deceptive responses in response to inquiries; or
- stifle inquires about the property in a vigorous pursuit of the best financial advantage possible for the seller (or the seller's broker).

Gathering facts on adverse features

Transfer Disclosure Statement (TDS)
A mandatory disclosure prepared by a seller 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 **RPI** Form 304]

The methods for gathering *adverse facts* about a property's fundamental characteristics, as well as facts which enhance value, require the seller's agent to actively take steps to make **specific disclosures** when marketing a one-to-four unit residential property for sale, actions which include:

- conducting a **visual inspection** of the property to observe conditions which might adversely affect the market value of the property, and then enter any observations of adverse conditions on the seller-prepared **Transfer Disclosure Statement (TDS)**, also known as a *Condition of Property Disclosure*, if not already noted on the TDS by the seller or if inconsistent with the seller's disclosures, whether or not a home inspector's report has or will be received by the seller [See **RPI** Form 304];[1]
- assuring **seller compliance** with the **seller's duty** to deliver statements to prospective buyers as soon as possible, namely, the upfront disclosure in marketing documents of routine facts about natural hazards (NHD), the condition of the property (TDS),

1 Calif. Civil Code §2079

environment hazards (TDS), Mello-Roos liens, lead-based paint, neighborhood industrial zoning, occupancy and retrofit ordinances, military ordnance locations, numerous condo (CID) documents, etc., by providing the seller with statutory forms at the listing stage to be filled out, signed by the seller, and returned to the agent for inclusion in the marketing package to be handed to prospective buyers on their inquiry into additional property information;

- **reviewing and confirming**, without further investigation or verification by the seller's agent, that all the information and data in the disclosure documents received from the seller are consistent with information and data known to the seller's agent, and if not, correct the information and data; and if the seller's agent has reason to believe information might not be accurate, either investigate and clarify the information or disclose uncertainty about the information to the seller and the prospective buyer in the documents;
- advising the seller on **risk avoidance procedures** by recommending the seller obtain third-party inspections of the property's condition and its components (roof, plumbing, septic, water, etc.), to **reduce the exposure** to claims by a buyer who might discover deficiencies in the property not known to the seller or the seller's agent or worse, they were known and not disclosed **prior to acceptance** of a purchase agreement, and on discovery make a demand on the seller (and the broker) to correct the defects or reimburse the buyer for the costs incurred to correct them; and
- **responding to inquiries** by the prospective buyer or buyer's agent into conditions relating to any aspect of the property with a full and fair answer of related facts known to the seller's agent which are or might be considered detrimental to the value of the property and does so without suppressing further investigation or inquiry by the buyer or the buyer's agent since the inquiry itself makes the subject matter a **material fact** about which the prospective buyer may want more information before completing negotiations or acquiring the property.

material fact
A fact that, if known, might cause a prudent buyer or seller of real estate to make a different decision regarding what price to offer or demand for a property or whether to remain in a contract or cancel it.

The pass-through of filtered information

A seller's agent's statutory duty owed to prospective buyers to disclose facts about the integrity of the physical condition of a listed one-to-four unit residential property is limited to prior knowledge about the property and the observations made while conducting the *mandatory visual inspection*.

To complete the disclosure process, the seller's agent serves as a conduit through which property information provided by the seller is filtered before the seller's agent passes it on to the prospective buyer.

Accordingly, all property information received from the seller is reviewed by the seller's agent for any inaccuracies or untruthful statements known or suspected to exist by the seller's agent. *Corrections or contrary statements* by the seller's agent necessary to set the information straight are included in the document or the document corrected before the information may be used to market the property and induce prospective buyers to make an offer to acquire the property.

The extent to which disclosures about the physical condition of the property will be made is best demonstrated by what the seller's agent is **not obligated to disclose**. All facts adversely affecting value and known to the seller's agent will be disclosed – brought to the attention of prospective buyers at the earliest opportunity.

On the other hand, buyer's agents need to understand that seller's agents have no duty to investigate any of the information or data disclosed as provided by the seller — the seller's agent need not make an effort to authenticate its accuracy or truthfulness before passing it on to the prospective buyer.

However, as a minimum effort to be made before handing prospective buyers information received from the seller, the seller's agent is to:

- review the information received from the seller;
- include comments about the agent's actual knowledge and observations made during the visual inspection of the property which expose the inaccuracies, inconsistencies, false nature or omissions in the seller's statements; and
- identify the source of the information as the seller.

The dumb agent rule for SFRs

A seller's agent on a one-to-four unit residential property owes **no affirmative duty** to a prospective buyer to gather or voluntarily provide the prospect with any **facts unknown** to the seller's agent about:

title conditions
Encumbrances such as liens, conditions, covenants and restrictions and easements which affect title to property.

preliminary title report (prelim)
A report constituting a revocable offer by a title insurer to issue a policy of title insurance, used by a buyer and escrow for an initial review of the vesting and encumbrances recorded and affecting title to a property.

- the property's **title conditions**, consisting of encumbrances which a **preliminary title report (prelim)** is to disclose, such as easements, Covenants, Conditions and Restrictions (CC&Rs), legal descriptions, trust deed provisions, etc., other than assuring compliance by the seller with disclosures about liens for improvement district bonds, such as Mello-Roos bonds [See Chapter 25];
- the **operating expenses** for the property (and any tenant income) the buyer will experience during ownership, such as utilities, sanitation, property taxes, yard and pool maintenance, insurance, etc., except the statutory disclosures the seller makes about any fire hazard clearance requirements which exist due to the property's location (NHD) [See **RPI** Form 314];
- the **zoning** or other **use restrictions** which may affect the buyer's future use of the property, except for the existence of industrial zoning which affects the property, and nearby military ordnance locations;
- the **income tax aspects** of the buyer's acquisition (or seller's disposition) of the property, such as limitations on interest deductions, avoidance of profit tax by exclusion or exemption on the sale of other property (on which the purchase of the listed property may be contingent);
- the **suitability of the property** based on the facts disclosed to actually meet the buyer's objectives in the acquisition, be they financial, legal, possessory, etc.; and

- information or data on any **mixed use** of the property, such as acreage included in the purchase for use as subdividable lands, groves or other farming operations, or for use for tenant income or as a vacation rental.

Further, the seller's agent owes no duty to prospective buyers to give advice, make recommendations, offer suggestions, comment on the extent of the adversity of the (adverse) facts disclosed, offer assistance (locate boundaries), investigate (due diligence), state an opinion or explain the effect on the buyer of any facts about the property's physical, natural or environmental conditions which have been provided by the seller's agent.

Respond fully and fairly

However, **when asked** by the prospective buyer or a buyer's agent about any aspect, feature or condition which relates to the property or the transaction in some way, the seller's agent is duty-bound to respond fully and fairly to the inquiry. The response includes *material facts* known to the seller's agent about the subject matter of the inquiry and is free of half-truths and misleading statements.

Conversely, it is the buyer or the buyer's agent who has a **duty to care for and protect** the buyer's best interests in the purchase of property. The buyer's agent, not the seller's agent, is to determine what due diligence efforts are necessary to learn the extent to which the facts disclosed by the seller's agent interfere with the buyer's expectations for the use and enjoyment of the property before allowing the buyer to make the decision to purchase or close escrow.

Opinions in lieu of factual investigations

Consider a seller's agent of a residence who is asked by a prospective buyer to point out the location of the boundaries for the lot on which the home is located. The agent does not provide the buyer with the metes and bounds descriptions contained in subdivision maps or tell the buyer to investigate the location of the boundaries themselves. Instead, the agent says the boundaries are represented by a fence which surrounds the property — an absolute statement indicating a fact, not a mere opinion.

The buyer further indicates they intend to have a pool built if they acquire the property.

The seller's agent does not respond to the buyer's statement about their intent to build a pool. The agent has no actual knowledge of easements or zoning ordinances which could adversely affect implementation of the buyer's intended future use of the property.

Further, the buyer asks the seller to confirm whether the fences are the outside parameters of the property. The seller indicates the fences demarcate the division line between the properties.

Without further investigation by anyone, a purchase agreement is entered into by both the prospective buyer and the seller.

In preparation of the purchase agreement offer, the agent does not include a **contingency provision** to provide the buyer with an opportunity to verify the location of the boundaries or to confirm the ability to obtain a permit to build a pool as a condition for closing escrow.

Prior to closing, the title company does not ask for nor is a surveyor brought in to establish the boundaries. Neither the local planning department nor a pool contractor is consulted about the ability to obtain a permit to build a pool.

The actual facts place the physical location of the rear fence several feet beyond the actual property line, giving the rear yard the appearance of having sufficient room to accommodate a pool, which it will not. Also, an easement for water lines and a sewer line runs across the entire rear of the property, as well as along one side of the home allowing these services to be supplied to a rear, uphill property.

Failure to condition an opinion

Continuing the previous example, the buyer acted in reliance on the agent's (and seller's) unqualified opinion about the location of the boundaries in their decision to close escrow. As a result, liability for the boundary discrepancy will be imposed on the agent for their failure to condition their statement – opinion – about the location of the boundaries.

Without qualifying their statement, the agent misrepresented the actual location of the boundaries. The agent, when giving the advice, needs to either identify the source of the information as coming from the seller or include a contingency provision for the buyer's further approval of the location of the fence and ability to build a pool.

Further, the agent, due to their lack of actual knowledge of the easements, has **no liability exposure** for their failure to disclose the easements (unknown to them) which further interfered with meeting the announced interest of the buyer to build a pool. The seller's agent did not owe the buyer a duty to advise them of the need to check title for any easements or restrictions which might interfere with the construction of a pool, unless the buyer made an inquiry of the agent.

The seller's agent conducted a visual inspection of the property and observed nothing which indicated the existence of an easement. Further, the agent knew nothing about any easements and, importantly, had no duty to investigate the condition of title or zoning since they are public records and go beyond observations resulting from a visual inspection.

Reliance on unconditional statements

Since the buyer made an inquiry (boundaries) and announced an intended use of the property (improvement), the information about the subject matter of the inquiries and the announced use became *material facts*. When a seller's agent responds to an inquiry by a prospective buyer and gives information

without conditioning the statement, the buyer may rely on the information and proceed to acquire the property without further confirmation of the accuracy or truthfulness of the information.

Here, due to the inquiry, the seller's agent was alerted to include a *contingency provision* in the purchase agreement to cover the agent's duty to respond. Thus, with contingency provisions, the buyer is the one required as a condition of closing to further investigate and approve by waiving the contingency as satisfied. Thus, if the results of the buyer's (or the buyer's agent) due diligence investigation into the feasibility of constructing a pool (and the location of the boundaries) were not satisfactory to the buyer, they may cancel the transaction.

Without an inquiry from the buyer, the seller's agent had no duty to volunteer an opinion about the location of the boundaries. Thus, without the inquiry, the seller's agent need not go beyond the minimum required disclosures about the physical condition of the property known to be defective.

In response to an inquiry

A seller's agent on a one-to-four unit residential property owes no duty to a prospective buyer to address the existence, much less the nature, of an easement located on the listed property since they are public records.

However, when the seller's agent *responds to an inquiry* by the prospective buyer by providing information on the easement, the seller's agent is to state fully and fairly, without deceptive or misleading wording, their knowledge of the easement.

Further, the seller's agent needs to:

- identify the source of information if they have not confirmed its accuracy or correctness; or
- condition the response in such a way as to prevent the prospective buyer from justifying their reliance on the information without further investigation.

Candid response to a buyer's question

Consider a prospective buyer who has no experience in real estate matters. The prospective buyer deals directly with the seller's agent of a property which seems suitable to the buyer. The prospective buyer observes a 30-foot easement on the lot in the subdivision map running the entire width of the frontage to the property. When the buyer asked about the easement, the seller's agent explained it is "for those water lines you find on the curb of the street, it is nothing to worry about."

The prospective buyer decides to buy the property and build a home on it. In escrow, the **preliminary title report (prelim)** also reflects the easement. On further inquiry by the buyer, the seller's agent again assures the buyer the easement is on the front side of the lot and is not a problem due to the large setbacks.

After close of escrow and commencement of construction of a residence, the local water company digs a ditch 16 feet deep and installs a major waterline. The interference of the easement causes the buyer to relocate the driveway to the side street entrance since placing the driveway over the easement requires the buyer to remove it at their own expense if the water company needs to access the easement in the future.

The buyer makes a demand on the seller's agent for lost value paid for the property. The buyer had relied on the seller's agent's representation that the easement presented no problem to use of the property, when in fact it did.

Here, the seller's agent, having responded to an inquiry from the prospective buyer on the nature of the easement, needs to be candid in explaining the significance of the buyer's limited ability to use the portion of the lot burdened by the encumbrance of the easement. Instead, the seller's agent gave evasive answers calculated to stifle and avoid the buyer's further investigation.

The buyer's inquiry is entitled to a response based on the seller's agent's working knowledge of the underlying facts or identification of the source of the information given. If the seller's agent lacks sufficient knowledge to comment, they are duty-bound to say so.

Ads based on seller information

A seller's agent may use information obtained from a seller concerning the size of a property in an **advertisement** offering property for sale, such as stating a parcel contains more than one acre or a home contains 5,000 square feet. The seller's agent does not need to investigate whether this information is accurate as long as it is not known to the agent to be false, nor does the agent need to identify the seller as the source of the data in advertisements.

As for the advertisement used to locate buyers, the figures given need to be consistent with the observations made by the seller's agent while conducting a visual inspection of the property. However, the seller's agent is not required to measure the property or check the public records when using information in an advertisement.

Conversely, in *response to an inquiry* from a prospective buyer expressing an interest or concern about the size of a parcel or improvement, the seller's agent either confirms the accuracy and report on the area or size, or attributes the information to their source.

Identify the source of income property operating data

For income-producing property, the operating income and expense data received from the seller can be passed on to the buyer or the buyer's broker and agent by the seller's agent without either confirming its accuracy or disclaiming any responsibility for its correctness, so long as the source is identified.

However, no matter how the data is presented to the prospective buyer, the seller's agent is the conduit for information received from the seller. The

seller's agent first reviews it and, if they have no knowledge the data might be suspect, inaccurate or a misrepresentation, hands it to the prospective buyer and indicates the seller is the source of the data.

By identifying the source of the information, the seller's agent demonstrates the information **does not constitute the opinion** of the seller's agent.

Sufficient notice to alert the buyer

Consider a seller's agent of a condominium unit who is aware other units in the project have suffered **water intrusion damage**. Also, they are aware the homeowners' association (HOA) has filed a lawsuit against the developer to recover the cost of repair for the water intrusion damage in the affected units.

The agent conducts a statutorily mandated visual inspection of the unit, but finds no visible signs of water damage in the unit. The seller claims none exist.

A prospective buyer is located who is not represented by a broker. The seller's Condition of Property disclosure (TDS), which includes the seller's agent's observations, is handed to the buyer.

The TDS discloses the seller and the seller's agent know of no water intrusion damage in the seller's unit.

Further, the seller's agent advises the prospective buyer about the existence of HOA litigation over water intrusion damage in other units within the project. The buyer does not further inquire or comment on the HOA litigation or water damages to the project.

The buyer then makes an offer to purchase the property as prepared by the seller's agent. The offer contains wording acknowledging the buyer's awareness of the HOA's water intrusion lawsuit and receipt of the TDS, as well as other mandated disclosures.

Later, the seller's agent receives newsletters and minutes from the HOA's meetings which further discuss the previously disclosed water intrusion problems. The seller's agent also reads the HOA's complaint against the developer. The documents contain no new information and are not brought to the attention of the buyer.

Escrow closes and the buyer moves into the unit. Later, the buyer discovers pre-existing water intrusion damage to the unit.

Essential facts to put the buyer on notice

Continuing the previous example, the buyer claims the seller's agent owed them a **general duty** to pass on all documents known to exist concerning the extent of the water intrusion damage in the development, such as the newsletters, minutes from the HOA meetings and a copy of the lawsuit filed by the HOA.

Sidebar

Seller's Agent's Disclosure of Solar Leases

Solar leases

Leasing solar panels may be a cost-effective alternative to a solar panel purchase for some property owners. Under a solar lease, property owners enter into a lease agreement with a solar company for the installation of solar panels and equipment for the owner's use.

Owners are able to lock in a reduced electrical rate and a full warranty for the duration of the lease. The lease term ranges from 20 to 30 years and calls for the owner to make monthly payments. All the owner needs is:

- *an area to dock the solar panels (typically a roof);*
- *adequate exposure to sunlight; and*
- *a good credit score (680+).*

However, before an owner puts themselves on the hook for a long-term solar lease, they need to consider whether:

- *installing solar panels will increase their property's value;*
- *installing solar panels will save them money on their monthly bills; and*
- *the savings from solar panels outweigh the potential difficulties or extra costs of selling their property with an existing solar lease.*

If their main objective is to save money on energy costs over time, a solar lease offers long-term benefits. However, if they are planning to sell their property within the next few years, the solar lease may pose some obstacles.

Actual savings from a solar lease depend on the size and output of the solar panel system. The first step for an owner is to get an estimate of the solar panel system suitable for their property, and a general idea of the fixed-rate for solar power. The next step is for the owner to compare their current electric bill with the fixed-rate electric bill offered by a solar lease.

Consider a homeowner who spends $200 a month on electricity. If the fixed-rate solar lease saves them $30 a month, that's $360 a year back in their pocket. However, if the homeowner plans to sell and relocate within two or three years, the $360 saved each year will not likely be worth the extra effort needed to transfer or terminate the solar lease.

Solar leasing programs in the past have relied heavily on government subsidies to pay for the cost of solar panel installation.

One concern is that government subsidies by design create a fertile breeding ground for new solar companies to pop up overnight. As a new field of enterprises some will offer cheap equipment and employ unlicensed installers.

Another concern is solar company longevity. While the subsidies flow, business continues to be good for solar leasing companies. However, once the government reduces subsidies, some companies may not be able to sustain themselves. More importantly, property owners may worry about what will happen to the solar panels (and their 20- and 30-year warranties) if their solar company goes under.

Derailing a sale

When a property owner with a solar lease sells their property, there are typically three options:

- *the buyer can choose to assume the solar lease;*

Sidebar

Seller's Agent's Disclosure of Solar Leases

cont'd

- *the seller can purchase the solar panels and include the cost in the asking price; or*
- *if the seller is moving within the same utility territory, they can pay to have their solar panel system transferred to their new property.*

Property owners frequently experience a cancelled sale due to an unwanted solar lease. For many potential buyers, a solar lease is a liability rather than an asset as leased solar equipment is personal property and not part of the real estate itself. Further, the leasing solar company needs to run a credit check and approve the buyer before transferring the lease agreement.

Thus, before listing a property, sellers are advised to find out from their solar company information about:

- *penalties for cancelling the solar lease prior to the end of the lease term;*
- *fees and requirements for transferring a solar lease;*
- *who pays for removal of solar panels;*
- *whether the solar company will work with the owner to arrange a transfer or removal of solar panels;*
- *whether the solar company returns the roof to its original condition after the solar panels are removed; and*
- *whether the solar company provides their policies on these questions in writing.*

The seller's agent needs to disclose the existence of the solar lease in the published MLS listing. This includes the details of assuming the lease, or alternatives to assuming the lease. As with all property disclosures, it's imperative that the prospective buyer and seller have the same information about the solar lease before — not after — the purchase agreement is inked.

The owner/seller can then plan for one of two events:

- *the buyer is willing and able to assume the solar lease; or*
- *the buyer is unwilling and/or unable to assume the solar lease.*

Most solar companies will transfer the solar lease, provided the buyer qualifies. Ideally, the buyer will agree to assume the solar lease upon purchasing the property from the seller. Even if they don't qualify right away, solar companies will negotiate. They have an incentive to make it work: solar companies absorb the upfront costs of a zero-down lease, so the longer the lease runs, the lower the solar company's turnover costs.

When the buyer doesn't want to assume a solar lease initiated by the seller, agents can help negotiate by suggesting different options. For instance, the seller and buyer can split the cost of paying the lease cancellation penalty. Or, the seller can find out about removing and relocating the solar panels to their new property.

Did the seller's agent sufficiently inform the buyer about the water intrusion problem to place the buyer on notice that a water intrusion problem existed?

Yes! The seller's agent disclosed the essential facts necessary to notify the buyer about the water intrusion damage. Once informed of the potential problem within the project, it was the buyer's duty (or the buyer's agent's duty) to exercise reasonable care to protect the buyer.

With notice of the problem, any further details concerning the extent or nature of the water intrusion were readily ascertainable by the buyer on request of

the seller's agent, the HOA or a third-party investigator. It was not the duty of the seller's agent to also advise the prospective buyer to investigate the consequences of the facts disclosed before deciding to buy.[2]

Solar shade notice puts the buyer on notice

Also consider a seller who previously received a Solar Shade Control Notice from a neighbor. The neighbor then installed a solar energy collector on their property.

While the seller is not mandated by law to voluntarily give a copy of the notice to any prospective buyer, the seller's agent advises the seller that the notice needs to be handed to the buyer or the buyer's agent when delivering the TDS.

A prudent buyer's agent will likely include a solar shade notice contingency in the purchase agreement. [See **RPI** Form 150 §11.12]

Trees or shrubs which shade more than 10% of a neighbor's solar energy collector can be deemed a nuisance by the neighbor. Having the seller voluntarily give a copy of the notice to the buyer protects the seller and the seller's agent from claims of misrepresentation by omission. The basic information gives the buyer sufficient notice to alert them to conditions which might affect the buyer's future use of the property.[3]

Editor's note — If the seller sent notices to neighbors prior to installing a solar energy collector, they need to voluntarily provide the buyer who purchases the property with a list of everyone they sent the notice to.

Timely disclosures are made prior to acceptance

multiple listing service (MLS)
An association of real estate agents pooling and publishing the availability of their listing properties.

Consider a buyer's agent who represents a prospective buyer of a one-to-four unit single family residence (SFR). The buyer's agent makes an inquiry of the seller's agent about the availability of a home for sale on a **multiple listing service (MLS).** The seller's agent responds by advising the buyer's agent the property is still for sale as listed.

The buyer's agent and the prospective buyer inspect the property and determine that it meets all of the buyer's needs. The buyer's agent requests a property marketing package from the seller's agent. The purpose is to quickly inform the buyer about the property and, if the buyer decides to buy the property, to set a price and draw up an offer.

The seller's agent does not provide the buyer's agent with a **marketing package** detailing the seller's agent's diligent inspection and investigation into the mar. The buyer's agent is told any disclosures will be made according to standard operating procedure, as provided in the trade union purchase agreement, after an offer is accepted and escrow is opened.

marketing package
A property information package handed to prospective buyers containing disclosures compiled on the listed property by the seller's agent.

Undeterred by the seller's agent's failure to hand over required disclosures, the buyer's agent prepares and submits an offer on behalf of the prospective buyer. The seller rejects the offer as unacceptable. The seller's agent prepares

2 **Pagano** v. **Krohn** (1997) 60 CA4th 1
3 Calif. Public Resources Code §25982.1

a counteroffer on behalf of the seller, bargaining for a better price. Again, no disclosures are presented about facts which might adversely affect the buyer's decisions to buy or price the property. The seller's agent does not disclose their knowledge of liens encumbering title which may interfere with the seller's ability to deliver title at the offered price.

In addition to their failure to perform the general duty owed to the buyer in providing a complete marketing package to the buyer's agent, the seller's agent likewise fails to protect the seller from liability resulting from the undisclosed liens on the property by including a **short sale contingency addendum** with the counteroffer.

The buyer accepts the counteroffer, which was structured as a cash-to-new-loan sales transaction, and escrow is opened. In reliance upon the buyer's right to acquire the seller's home and unaware of recorded facts about the property's condition that might interfere with their expectations for purchasing the property, the buyer closes escrow on the sale of their primary residence. The buyer incurs expenses related to their preparation for taking ownership and possession of the seller's home.

Information about the clouded condition of the property's title, known to the seller's agent prior to the seller and buyer entering into a purchase agreement, is discovered by the buyer in a prelim, obtained and handed to the buyer's agent by escrow.

The prelim details lien amounts on the property in excess of the negotiated price set in the purchase agreement. The seller is unable to perform their obligations to deliver title and close escrow since the seller's lenders will not accept the net sales proceeds for *reconveyance of the trust deeds*.

Due to the seller's insolvency, the buyer is unable to force the seller to perform and deliver title, which would require the seller to pay the shortage. Thus the buyer exercises their right to cancel due to the seller's material breach of the purchase agreement. On cancellation, the buyer suffers losses due to the seller's inability to convey title free and clear of all encumbrances.

An agent's failure to give disclosures prior to acceptance

Continuing with this example, the buyer then makes a demand on the seller's broker and their agent to recover the money losses incurred after selling the home. Based on the seller's agent's conduct when the purchase agreement was entered into, the buyer expected the seller to perform as nothing contrary to the expectation was disclosed.

The buyer claims the seller's agent is liable for the losses since the agent had a duty to disclose all property conditions that might have an adverse effect on the buyer, including the existence of liens encumbering the property for amounts in excess of the contract price – and do so **prior to acceptance** of an offer.

The seller's agent claims they are not required to disclose the seller's clouded title condition prior to the acceptance of an offer since to do so releases

confidential financial information, a breach of the *fiduciary duty* owed exclusively to the seller as well as a violation of the trade union's code of ethics.

Is the seller's agent liable for the buyer's losses if the agent fails to disclose, prior to acceptance of an offer, that the title is encumbered by liens in excess of the contract price, possibly causing the seller to be unable to deliver title as agreed?

Yes! The seller's agent has a general duty owed to prospective buyers to disclose information before an acceptance occurs regarding risks, known to the agent, that affect the seller's ability to perform as bargained. Without this information, the buyer is unable to make an informed decision whether or not to enter into a purchase agreement.[4]

A seller's agent fails to perform the general duty owed to the buyer to disclose knowledge of material facts when information that might possibly affect the buyer's decisions regarding an offer is withheld. It is the seller's agent who sets the buyer's expectations for the desirability of a property and the ability of the seller to deliver the property in the condition **as disclosed** prior to the moment an offer is accepted.

These expectations are set by both the information the seller's agent does and does not provide. The absence of information about adverse conditions, either known or readily available to the seller's agent, is as powerful in forming the buyer's expectations of a property as an explicit and timely disclosure. The buyer is to be put on notice of adverse property conditions **prior to acceptance of an offer.**

Minimum level of disclosure

A seller's agent locating a prospective buyer for their client's one-to-four unit residential property owes a duty to the prospective buyer to conduct a *reasonably diligent visual inspection* of the property for defects which adversely affect the value of the listed property.

On completing the inspection, the seller's agent is to note on the (seller's) TDS any defects observable or known to the seller's agent which are not already noted by the seller or are inconsistent with the seller's disclosures. The TDS is to be handed to prospective buyers as soon as practicable (ASAP).[5]

However, the visual inspection and investigation of one-to-four unit residential property by the seller's agent and the disclosure of their knowledge and observations excludes other readily available information not already known to the seller's agent, such as knowledge that may be obtained by:

- the inspection of areas reasonably and normally **inaccessible** to the broker;
- the investigation of **off-site areas** and areas surrounding the property; and

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

5 CC §§2079 et seq.

- the inquiry into or review of **public records** or permits concerning title or use of the property.[6]

However, the minimum disclosure rule for seller's agents does not apply to a buyer's broker or agents, much less limit the buyer's agent's duty to fully and fairly inform and advise on what investigations the buyer ought to undertake.

Further, the minimum one-to-four unit inspection and reporting requirements imposed on seller's agents excludes the common law duty still imposed on seller's agents of other types of property to further investigate and disclose to buyers or sellers any material facts the agent discovers regarding:

- title conditions;
- the financial consequences of owning the property, such as the property's operating costs; or
- the tax aspects of the transaction (seller only).

Purpose of inspection

The one-to-four unit disclosure limitation on seller's agents serves to set a minimum level of information and data to be disclosed to put the buyer and the buyer's agent on **notice of physical defects** in the property which are **observable or known** to the seller or the seller's broker and their agents. [See Figure 1, **RPI** Form 304]

For example, a prospective buyer for a property on a hillside is located by the seller's agent. The buyer is informed a neighboring owner has had problems with underground water on the property and that the neighbor installed a pump to manage the high water level. The seller's agent also tells the buyer the neighbor's property previously suffered landslide damages, including a back fence that was removed due to erosion.

The seller's agent provides the buyer with a geological report the seller had acquired regarding the property. The report indicates the property lies within a geological hazard area and is susceptible to landslides and groundwater buildup.

When asked by the buyer, the seller also discloses the pool is located in the front yard since a fault line runs through the backyard.

After a review of the disclosures, the buyer makes an offer to purchase the property.

The seller's agent prudently (without legal compulsion) includes a further-approval contingency provision in the purchase agreement to reduce the risk of litigation. The contingency provision calls for the buyer to further investigate the hazards by obtaining their own geological report and approving it as a condition of closing.

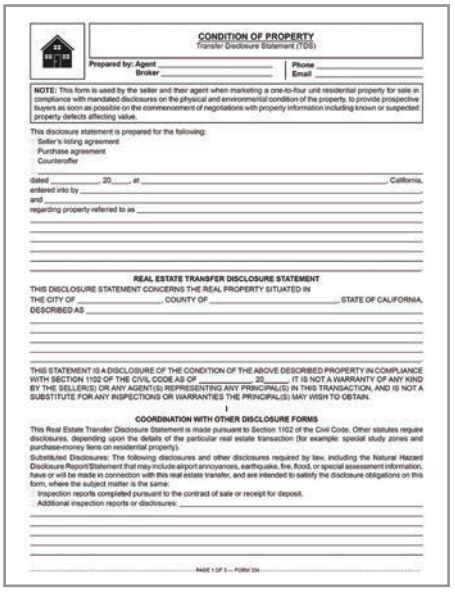
6 CC §2079.3

Figure 1

Form 304

Condition of Property — Transfer Disclosure Statement (TDS)

Page 1 of 2



CONDITION OF PROPERTY
Transfer Disclosure Statement (TDS)

Prepared by: Agent _____ Phone _____
Broker _____ Email _____

NOTE: This form is used by the seller and their agent when marketing a one-to-four unit residential property for sale in compliance with mandated disclosures on the physical and environmental condition of the property, to provide prospective buyers as soon as possible on the commencement of negotiations with property information including known or suspected property defects affecting value.

This disclosure statement is prepared for the following:
☐ Seller's listing agreement
☐ Purchase agreement
☐ Counteroffer

dated _____, 20____, at _____, California,
entered into by _____
and _____
regarding property referred to as _____

REAL ESTATE TRANSFER DISCLOSURE STATEMENT

THIS DISCLOSURE STATEMENT CONCERNS THE REAL PROPERTY SITUATED IN THE CITY OF _____, COUNTY OF _____, STATE OF CALIFORNIA, DESCRIBED AS _____

THIS STATEMENT IS A DISCLOSURE OF THE CONDITION OF THE ABOVE DESCRIBED PROPERTY IN COMPLIANCE WITH SECTION 1102 OF THE CIVIL CODE AS OF _____, 20____. IT IS NOT A WARRANTY OF ANY KIND BY THE SELLER(S) OR ANY AGENT(S) REPRESENTING ANY PRINCIPAL(S) IN THIS TRANSACTION, AND IS NOT A SUBSTITUTE FOR ANY INSPECTIONS OR WARRANTIES THE PRINCIPAL(S) MAY WISH TO OBTAIN.

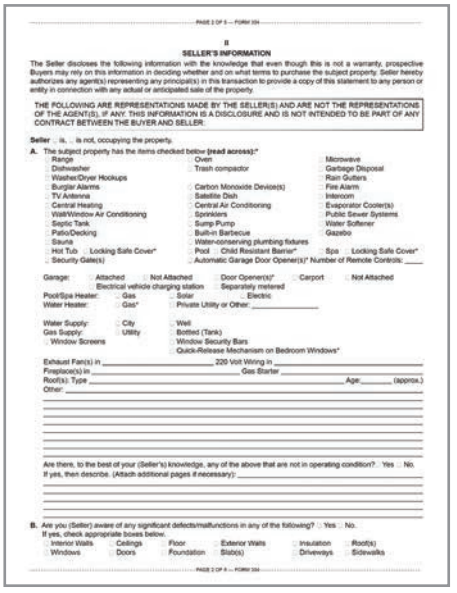
I
COORDINATION WITH OTHER DISCLOSURE FORMS

This Real Estate Transfer Disclosure Statement is made pursuant to Section 1102 of the Civil Code. Other statutes require disclosures, depending upon the details of the particular real estate transaction (for example: special study zones and purchase-money liens on residential property).

Substituted Disclosures: The following disclosures and other disclosures required by law, including the Natural Hazard Disclosure Report/Statement that may include airport annoyances, earthquake, fire, flood, or special assessment information, have or will be made in connection with this real estate transfer, and are intended to satisfy the disclosure obligations on this form, where the subject matter is the same:

☐ Inspection reports completed pursuant to the contract of sale or receipt for deposit.
☐ Additional inspection reports or disclosures: _____

PAGE 1 OF 5 — FORM 304



II
SELLER'S INFORMATION

The Seller discloses the following information with the knowledge that even though this is not a warranty, prospective Buyers may rely on this information in deciding whether and on what terms to purchase the subject property. Seller hereby authorizes any agent(s) representing any principal(s) in this transaction to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY THE SELLER(S) AND ARE NOT THE REPRESENTATIONS OF THE AGENT(S), IF ANY. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN THE BUYER AND SELLER.

Seller ☐ is, ☐ is not, occupying the property.

A. The subject property has the items checked below (read across):*

☐ Range	☐ Oven	☐ Microwave
☐ Dishwasher	☐ Trash compactor	☐ Garbage Disposal
☐ Washer/Dryer Hookups		☐ Rain Gutters
☐ Burglar Alarms	☐ Carbon Monoxide Device(s)	☐ Fire Alarm
☐ TV Antenna	☐ Satellite Dish	☐ Intercom
☐ Central Heating	☐ Central Air Conditioning	☐ Evaporator Cooler(s)
☐ Wall/Window Air Conditioning	☐ Sprinklers	☐ Public Sewer Systems
☐ Septic Tank	☐ Sump Pump	☐ Water Softener
☐ Patio/Decking	☐ Built-in Barbecue	☐ Gazebo
☐ Sauna	☐ Water-conserving plumbing fixtures	
☐ Hot Tub ☐ Locking Safe Cover*	☐ Pool ☐ Child Resistant Barrier*	☐ Spa ☐ Locking Safe Cover*
☐ Security Gate(s)	☐ Automatic Garage Door Opener(s)* Number of Remote Controls: ____	

Garage: ☐ Attached ☐ Not Attached ☐ Door Opener(s)* ☐ Carport ☐ Not Attached
☐ Electrical vehicle charging station ☐ Separately metered
Pool/Spa Heater: ☐ Gas ☐ Solar ☐ Electric
Water Heater: ☐ Gas* ☐ Private Utility or Other: _____

Water Supply: ☐ City ☐ Well
Gas Supply: ☐ Utility ☐ Bottled (Tank)
☐ Window Screens ☐ Window Security Bars
☐ Quick-Release Mechanism on Bedroom Windows*

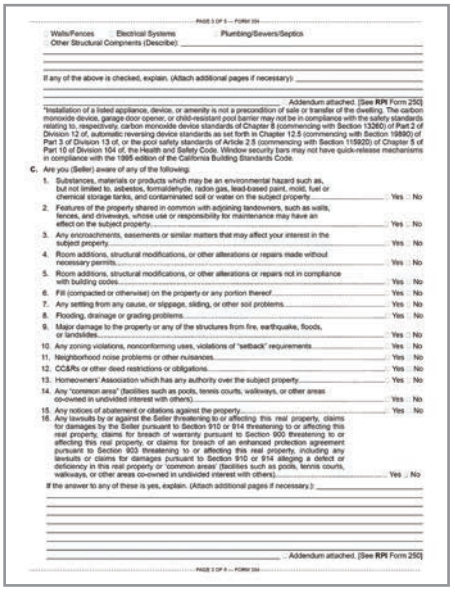
Exhaust Fan(s) in _____ 220 Volt Wiring in _____
Fireplace(s) in _____ Gas Starter _____
Roof(s): Type _____ Age: _____ (approx.)
Other: _____

Are there, to the best of your (Seller's) knowledge, any of the above that are not in operating condition? ☐ Yes ☐ No.
If yes, then describe. (Attach additional pages if necessary): _____

B. Are you (Seller) aware of any significant defects/malfunctions in any of the following? ☐ Yes ☐ No.
If yes, check appropriate boxes below.

☐ Interior Walls	☐ Ceilings	☐ Floor	☐ Exterior Walls	☐ Insulation	☐ Roof(s)
☐ Windows	☐ Doors	☐ Foundation	☐ Slab(s)	☐ Driveways	☐ Sidewalks

PAGE 2 OF 5 — FORM 304



☐ Walls/Fences ☐ Electrical Systems ☐ Plumbing/Sewers/Septics
☐ Other Structural Components (Describe): _____

If any of the above is checked, explain. (Attach additional pages if necessary): _____

_____ Addendum attached. [See RPI Form 250]

*Installation of a listed appliance, device, or amenity is not a precondition of sale or transfer of the dwelling. The carbon monoxide device, garage door opener, or child-resistant pool barrier may not be in compliance with the safety standards relating to, respectively, carbon monoxide device standards of Chapter 8 (commencing with Section 13260) of Part 2 of Division 12 of, automatic reversing device standards as set forth in Chapter 12.5 (commencing with Section 19890) of Part 3 of Division 13 of, or the pool safety standards of Article 2.5 (commencing with Section 115920) of Chapter 5 of Part 10 of Division 104 of, the Health and Safety Code. Window security bars may not have quick-release mechanisms in compliance with the 1995 edition of the California Building Standards Code.

C. Are you (Seller) aware of any of the following:

1. Substances, materials or products which may be an environmental hazard such as, but not limited to, asbestos, formaldehyde, radon gas, lead-based paint, mold, fuel or chemical storage tanks, and contaminated soil or water on the subject property ☐ Yes ☐ No
2. Features of the property shared in common with adjoining landowners, such as walls, fences, and driveways, whose use or responsibility for maintenance may have an effect on the subject property ☐ Yes ☐ No
3. Any encroachments, easements or similar matters that may affect your interest in the subject property ☐ Yes ☐ No
4. Room additions, structural modifications, or other alterations or repairs made without necessary permits ☐ Yes ☐ No
5. Room additions, structural modifications, or other alterations or repairs not in compliance with building codes ☐ Yes ☐ No
6. Fill (compacted or otherwise) on the property or any portion thereof ☐ Yes ☐ No
7. Any settling from any cause, or slippage, sliding, or other soil problems ☐ Yes ☐ No
8. Flooding, drainage or grading problems ☐ Yes ☐ No
9. Major damage to the property or any of the structures from fire, earthquake, floods, or landslides ☐ Yes ☐ No
10. Any zoning violations, nonconforming uses, violations of "setback" requirements ☐ Yes ☐ No
11. Neighborhood noise problems or other nuisances ☐ Yes ☐ No
12. CC&Rs or other deed restrictions or obligations ☐ Yes ☐ No
13. Homeowners' Association which has any authority over the subject property ☐ Yes ☐ No
14. Any "common areas" (facilities such as pools, tennis courts, walkways, or other areas co-owned in undivided interest with others) ☐ Yes ☐ No
15. Any notices of abatement or citations against the property ☐ Yes ☐ No
16. Any lawsuits by or against the Seller threatening to or affecting this real property, claims for damages by the Seller pursuant to Section 910 or 914 threatening to or affecting this real property, claims for breach of warranty pursuant to Section 900 threatening to or affecting this real property, or claims for breach of an enhanced protection agreement pursuant to Section 903 threatening to or affecting this real property, including any lawsuits or claims for damages pursuant to Section 910 or 914 alleging a defect or deficiency in this real property or 'common areas' (facilities such as pools, tennis courts, walkways, or other areas co-owned in undivided interest with others) ☐ Yes ☐ No

If the answer to any of these is yes, explain. (Attach additional pages if necessary.): _____

_____ Addendum attached. [See RPI Form 250]

PAGE 3 OF 5 — FORM 304

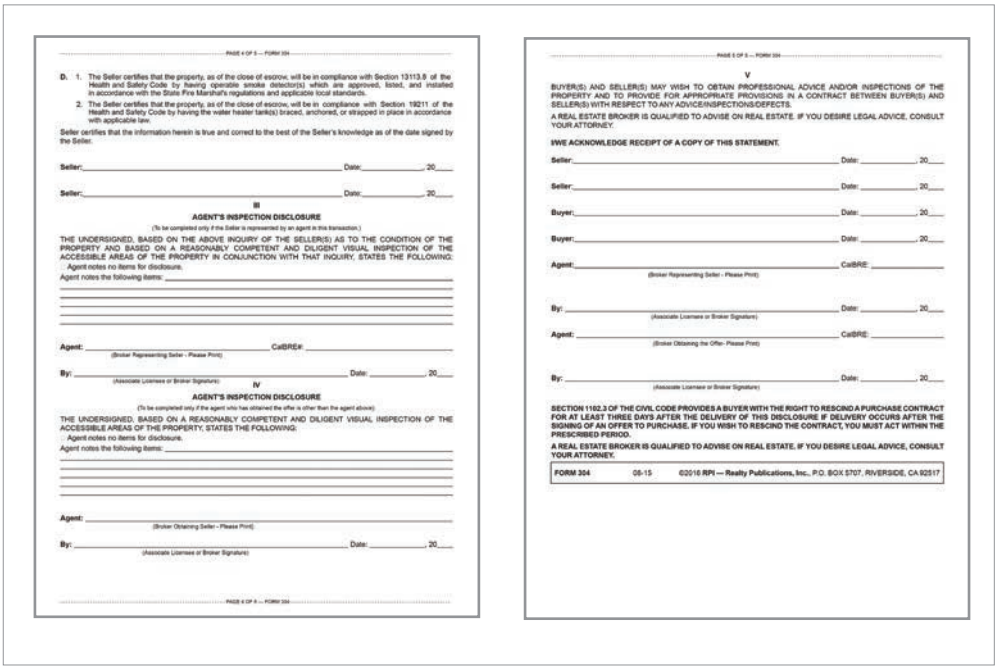
For a full-size, fillable copy of this, or any other form in this book, go to realtypublications.com/forms

Before closing, the buyer obtains a report which states the property shows signs of instability and confirms that a high groundwater level exists. The report also states the house does not show signs of cracking or distress.

During the escrow period, the seller's agent attends a meeting between area homeowners and county officials in which the geological hazards of the properties in the area and possible solutions are discussed.

The seller's agent does not inform the buyer of the occurrence of the meeting or the topics discussed since no information previously unknown to the agent and undisclosed to the buyer was released.

Later, after escrow closes, the residence slides down the hillside and is condemned by the county as uninhabitable.



D. 1. The Seller certifies that the property, as of the close of escrow, will be in compliance with Section 13113.8 of the Health and Safety Code by having operable smoke detector(s) which are approved, listed, and installed in accordance with the State Fire Marshal's regulations and applicable local standards.
2. The Seller certifies that the property, as of the close of escrow, will be in compliance with Section 19211 of the Health and Safety Code by having the water heater tank(s) braced, anchored, or strapped in place in accordance with applicable law.

Seller certifies that the information herein is true and correct to the best of the Seller's knowledge as of the date signed by the Seller.

Seller:_____ Date:_____, 20____

Seller:_____ Date:_____, 20____

III

AGENT'S INSPECTION DISCLOSURE

(To be completed only if the Seller is represented by an agent in this transaction.)

THE UNDERSIGNED, BASED ON THE ABOVE INQUIRY OF THE SELLER(S) AS TO THE CONDITION OF THE PROPERTY AND BASED ON A REASONABLY COMPETENT AND DILIGENT VISUAL INSPECTION OF THE ACCESSIBLE AREAS OF THE PROPERTY IN CONJUNCTION WITH THAT INQUIRY, STATES THE FOLLOWING:

☐ Agent notes no items for disclosure.

Agent notes the following items: _____

Agent:_____ CalBRE#:_____
(Broker Representing Seller - Please Print)

By:_____ Date:_____, 20____
(Associate Licensee or Broker Signature)

IV

AGENT'S INSPECTION DISCLOSURE

(To be completed only if the agent who has obtained the offer is other than the agent above.)

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

☐ Agent notes no items for disclosure.

Agent notes the following items: _____

Agent:_____
(Broker Obtaining Seller - Please Print)

By:_____ Date:_____, 20____
(Associate Licensee or Broker Signature)

V

BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE AND/OR INSPECTIONS OF THE PROPERTY AND TO PROVIDE FOR APPROPRIATE PROVISIONS IN A CONTRACT BETWEEN BUYER(S) AND SELLER(S) WITH RESPECT TO ANY ADVICE/INSPECTIONS/DEFECTS.

A REAL ESTATE BROKER IS QUALIFIED TO ADVISE ON REAL ESTATE. IF YOU DESIRE LEGAL ADVICE, CONSULT YOUR ATTORNEY.

I/WE ACKNOWLEDGE RECEIPT OF A COPY OF THIS STATEMENT.

Seller:_____ Date:_____, 20____

Seller:_____ Date:_____, 20____

Buyer:_____ Date:_____, 20____

Buyer:_____ Date:_____, 20____

Agent:_____ CalBRE:_____
(Broker Representing Seller - Please Print)

By:_____ Date:_____, 20____
(Associate Licensee or Broker Signature)

Agent:_____ CalBRE:_____
(Broker Obtaining the Offer- Please Print)

By:_____ Date:_____, 20____
(Associate Licensee or Broker Signature)

SECTION 1102.3 OF THE CIVIL CODE PROVIDES A BUYER WITH THE RIGHT TO RESCIND A PURCHASE CONTRACT FOR AT LEAST THREE DAYS AFTER THE DELIVERY OF THIS DISCLOSURE IF DELIVERY OCCURS AFTER THE SIGNING OF AN OFFER TO PURCHASE. IF YOU WISH TO RESCIND THE CONTRACT, YOU MUST ACT WITHIN THE PRESCRIBED PERIOD.

A REAL ESTATE BROKER IS QUALIFIED TO ADVISE ON REAL ESTATE. IF YOU DESIRE LEGAL ADVICE, CONSULT YOUR ATTORNEY.

FORM 304 05-15 ©2016 RPI — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

Figure 1

Form 304

Condition of Property — Transfer Disclosure Statement (TDS)

Page 2 of 2

A general nonfiduciary duty of disclosure

Continuing the previous example, on a complaint filed by the buyer, the California Bureau of Real Estate (CalBRE) attempts to revoke the seller's agent's license claiming the subject matter of the meeting held by county officials was itself a fact which ought to have been disclosed to the buyer by the seller's agent since the mere occurrence of the town hall meeting might have affected the buyer's decision to buy.

However, the seller's agent was the **exclusive representative of the seller** of one-to-four residential units and only had a general nonfiduciary duty of disclosure to the buyer, which is limited to:

- providing the buyer with all existing geological reports held by the seller or the agent; and
- disclosing groundwater and landslide problems known to the seller's agent which occurred on the property or in the neighboring area.

Here, the seller's agent properly disclosed the geological hazards of the property by alerting the buyer to the potential problems. The homeowners' meeting was not required to be brought to the buyer's attention since the meeting was a review of the geological hazards already known to the agent and disclosed to the buyer. Also, the buyer's independent investigation under the further-approval contingency did not deter the buyer from proceeding with the purchase of the residence.

Thus, the seller's agent did not violate the limited general nonfiduciary duty owed to the nonclient buyer to disclose sufficient information on adverse property conditions to put a prospective buyer on notice so the buyer (or the buyer's agent) can take steps to protect and care for the buyer's best interests. Thus, the CalBRE cannot revoke the seller's agent's license for limiting their disclosures to the initial notice of the defect in the property without further elaboration.[7]

7 **Vaill** v. **Edmonds** (1991) 4 CA4th 247

Chapter 9 Summary

A seller's agent owes a limited general duty to any prospective buyer to voluntarily provide information on the property which may affect its value, collectively called disclosures.

These disclosures are to be sufficient to place the buyer on notice of facts that may affect the property's value or the buyer's use. This non-fiduciary duty of good faith and fair dealing prevents the seller's agent from exploiting a prospective buyer by:

- providing less than the minimum required disclosures;
- giving unfounded opinions or deceptive responses; or
- stifling the buyer's attempts to learn more about the property.

All property information received from a seller is reviewed by the seller's agent for inaccuracies or untruthful statements. However, a seller's agent need not investigate the seller's claims any further before using the information to market the property so long as they are not known to the agent to be false.

A seller's agent owes a duty to the prospective buyer to conduct a reasonably diligent visual inspection of the property for defects which adversely affect the value of the listed property. The seller's agent notes on the Transfer Disclosure Statement (TDS) any defects observable or known to the seller's agent which are not already noted by the seller or are inconsistent with the seller's disclosures.

The TDS is handed to prospective buyers as soon as practicable, putting the buyer and the buyer's agent on notice of physical defects in the property which are observable or known to the seller or the seller's broker and their agents.

Under a solar lease, property owners enter into a lease agreement with a solar company for the installation of solar panels and equipment for the owner's use. The seller's agent needs to disclose the existence of the solar lease in the published MLS listing. This includes the details of assuming the lease, or alternatives to assuming the lease. As with all property disclosures, it's imperative that the prospective buyer and seller have the same information about the solar lease before — not after — the purchase agreement is inked.

Chapter 9 Key Terms

Chapter 10

Opinions with erroneous conclusions

Learning Objectives

After reading this chapter, you will be able to:

- distinguish between honestly held opinions, assurances and guarantees;
- recognize situations in which opinions can become assurances or guarantees;
- shield yourself from exposure to liabilities stemming from a client's reliance on an opinion;
- differentiate between estimates, projections and forecasts; and
- manage clients' expectations of future events or conditions based on opinions, estimates, projections and forecasts.

Key Terms

affirmative fraud
estimate
fact
fiduciary duty
forecast
guarantee
negative fraud
opinion
projection

When an opinion becomes a guarantee

Occasionally, a buyer will ask the seller's agent or their own agent what they *"believe, contemplate, anticipate or foresee"* will occur in the future regarding ownership of a particular property.

An honest response to such a question is naturally limited to the agent's knowledge and expertise on the subject. The opinion given in response will always be **speculation**, based on the observations, knowledge and beliefs of the agent about the likelihood an event or condition will occur in the future. Thus, statements by the buyer's agent will be either:

- couched in words such as "anticipation," "estimation," "prediction"

opinion
A statement by an agent concerning an event or condition which has not yet occurred based on readily available facts.

guarantee
An assurance that events and conditions will occur as presented by the agent.

or "projection," denoting their statement is an **opinion** about an uncertain future event; or

- worded as an *assurance* the events and conditions, as presented, will occur, a response reaching the level of a **guarantee**.

The difference between the wording used by an agent to express an *opinion* or a *guarantee* exposes the agent to liability when:

- the buyer acts in reliance on the information by making an offer or eliminating a contingency to acquire property; and
- the event or condition fails to occur.

An opinion is a statement by a broker or their agent concerning an event or condition which has not yet occurred. To be classified as an opinion, the statement developed by the agent needs to be based on readily available facts and their knowledge on the subject. However, it is the nature of an opinion that the event or conditions speculated to come about may not actually occur.

In an opinion, the event or condition expressed is not a factual representation. The event or condition expressed has not occurred and does not exist at the time the opinion is given. Alternatively, a **fact** is an existing condition, presently known or knowable by the agent, due to the ready availability of data or information.

fact
An existing condition which is presently known or readily knowable by the agent.

Facts are the subject of disclosure rules, not the rules of opinion. However, "guesstimates" and wishful assumptions are not opinion.

Special circumstances may impose liability

An *opinion* is a belief that is honestly held. It is based on a reasonable, although sometimes faulty, analysis by the agent giving the opinion of property information known or readily available. The opinion does not by itself create any liability if the event does not occur.

However, several **special circumstances** may surround an agent's giving of an opinion which creates an environment raising their statement to the status of a *misrepresentation*.

If *special circumstances* exist, the broker and their agent are *exposed to liability* for the losses caused by the failure of the predicted event, activity or condition to occur.

Special circumstances which may cause a failed prediction to be an actionable misrepresentation include:

- an opinion given by an agent to a person they owe a fiduciary duty, such as between the seller's agent and the seller or the buyer's agent and the buyer;[1]
- an opinion given to a buyer by a seller's agent who holds themselves out as **specially qualified** or possessing expertise about the subject matter of the transaction;[2]

1 **Ford** v. **Cournale** (1973) 36 CA3d 172
2 **Pacesetter Homes, Inc.** v. **Brodkin** (1970) 5 CA3d 206

- an opinion given by a seller's agent or seller who has superior knowledge on the subject matter, implying they have inside information not available to the buyer;[3] or
- an opinion given to a buyer by a seller's agent who could not honestly hold or reasonably believe the truth of their opinion due to facts known or readily available to them. [4]

An opinion based on facts

Consider a prospective buyer interested in acquiring a lot within a subdivision and constructing a home on it.

The subdivider's agent, based on subdivision maps and discussions with the subdivider, advises the buyer all the lots are going to be the same size and subject to the same use restrictions. Further, all homes built on the lots are to be worth at least $400,000.

The buyer purchases the lot and builds their home in accordance with the use restrictions.

Due to an economic downturn at the end of the current business cycle, the subdivider resubdivides the remaining unsold lots and removes the use restrictions. The resubdividing is intended to increase the marketability of the unsold lots in the tract.

The buyer now seeks to *rescind* the purchase and recover their entire investment claiming the subdivider's agent made false representations about the subdivision on which the buyer relied.

The subdivider's agent claims they honestly believed their representations that the subdivider will not alter the lots remaining to be sold.

Here, the agent's representations about the lot size were made truthfully. There was no intent to deceive the buyer. Both the agent and the subdivider had a reasonable basis for believing changes were not necessary at the time of the purchase. However, a later shift in the economy warranted the changes as necessary to prevent the tract from deteriorating in its marketability.

The seller's agent's statements about the future were *honest* at the time they were made. Thus, their statements qualify as an expression of their opinion.

Further, the buyer did not require the deed from the seller to include a grant of the promised rights that all the lots will be the same size with the same restrictions on minimum value. Thus, the buyer did not take proper action in reliance on the seller's agent's opinion when they agreed to purchase the property.[5]

Conditional opinions

Consider a developer of a residential duplex subdivision who provides their seller's agent with a schedule of **projected rents.** The agent is instructed to inform prospective buyers these rents are estimates of the amounts obtainable from the duplexes should they buy one.

3 **Borba** v. **Thomas** (1977) 70 CA3d 144

4 **Cooper** v. **Jevne** (1976) 56 CA3d 860

5 **Meehan** v. **Huntington Land & Improvement Co.** (1940) 39 CA2d 349

The developer has not developed properties in the area prior to this project. Also, they have no actual knowledge of the rents a comparable duplex might obtain in the area.

A buyer with minimal investment property experience contacts the agent asking for more information. The buyer is advised by the agent that "if you receive the rents we contemplate, it will be a good investment."

The buyer purchases a duplex, but is unable to locate tenants willing to pay the rental amounts represented in the agent's opinion. Ultimately, the buyer loses the property to foreclosure.

Readily available information

Continuing the previous example, the buyer makes a demand on the agent for the loss of their invested funds. The buyer claims the agent's statements about the property's future rental income were misrepresentations since the buyer relied on their *superior knowledge* about rental conditions in the area when purchasing the duplex.

The agent claims the statement was a mere opinion since it conditioned the investor's success on collecting the represented rent amounts.

Here, the agent's statement was only an estimate or opinion held about future anticipated rental income. As no operating history existed to draw on when making the projections, the agent's opinion was based on *all readily available information*.

Further, the developer's lack of prior rental experience in the area or knowledge of rents actually attainable by the duplexes made the statement an opinion. Thus, the buyer may not rely on the rent projections given by the adversarial seller's agent as a fact which might reasonably motivate their decision to buy.[6]

Conclusions drawn from opinions

An opinion given by a seller's agent predicting the future occurrence of an event does not impose liability on the seller's agent for erroneous conclusions if the buyer is aware of the relevant facts on which the agent's opinion is based.

A buyer who has *knowledge* of and *equal access to the same information* relied on by the seller's agent cannot later claim they acted in reliance on the seller's agent's opinion. This is especially true when the buyer has sufficient time to conduct their own independent investigation to ascertain the accuracy of the agent's opinion.

Thus, the buyer cannot ignore their own knowledge of the same facts used by the seller's agent to develop an opinion, and then claim they relied on the seller's agent's opinion as an assurance the prediction will occur.

Consider a leasing agent acting on behalf of a prospective commercial tenant in percentage rent lease negotiations. The commercial landlord is experienced and has not retained the services of a real estate agent.

6 Pacesetter Homes, Inc., *supra*

The leasing agent tells the landlord that "in my opinion" the tenant's annual gross sales receipts will be in excess of $5,000,000. A lease agreement is entered into. The lease rent is a base monthly amount plus a percentage of annual gross sales receipts over $5,000,000. The landlord pays the leasing agent's fee.

A dispute erupts between the landlord and the tenant. The landlord wants to recover the fee paid to the tenant's agent, claiming the agent represented the potential gross sales receipts as exceeding $5,000,000, an amount much higher than the sales the tenant might ever experience during the leasing period.

Here, the tenant's agent prefaced their statements with the words *"in my opinion."* Also, a landlord cannot reasonably rely on the representation of future gross sales as a condition which will actually occur.

Thus, the landlord should have known the gross receipts prediction was just an estimate honestly made by the agent who represented the tenant. They cannot treat the estimates of the adversarial agent as fact.

Further, the landlord had ample time and the means to make their own inquiries and analyze their findings. Since the landlord was not represented by an agent, they needed to conduct their own due diligence investigation if they intended to eliminate the uncertainties of estimates made on behalf of the tenant by the tenant's agent.[7]

Opinions in lieu of investigations

A prospective buyer asks the seller's agent to point out the boundaries for the lot on which the home is located. The seller's agent states the boundaries are represented by a fence surrounding the property. The seller's agent does not provide the buyer with the *metes and bounds* description or instruct the buyer to investigate the boundaries.

The seller's agent does not indicate the source of the information upon which they based their boundary opinion. The agent also does not qualify their statement with words such as "the boundaries in this subdivision *are usually* where the fence has been placed." Further, the seller's agent does not say, "in my opinion" or "I believe" to indicate any uncertainty about the location of the boundaries. The agent's statement of the boundary location was absolute — the fence surrounding the property is the boundary.

The buyer indicates they intend to build a pool on their acquisition of the property. The seller's agent does not respond to the buyer's statement about the intent to build a pool. The seller's agent has no actual knowledge of easements or zoning ordinances which could *adversely affect* implementation of the buyer's intended future use of the property. This information is readily available in the public record or from public agencies on a phone call.

Without further investigation, a purchase agreement is entered into. In preparation of the purchase agreement, the seller's agent does not include a contingency provision to provide the buyer with an opportunity to verify the location of the boundaries, or to confirm their ability to obtain a permit to build a pool as a condition for closing escrow.

7 **Foreman & Clark Corporation** v. **Fallon** (1971) 3 C3d 875

Prior to closing, the title company is not asked nor is a surveyor brought in to establish the boundaries. Neither the local planning department nor a pool contractor are consulted about the ability to build a pool.

In actual fact, the location of the rear fence is several feet beyond the property line. The misplaced fence gives the rear yard the appearance of having sufficient room to accommodate a pool, which it does not. Also, an easement for water lines and a sewer line runs across the entire rear of the property. The seller's agent has no actual knowledge of the easements.

Here, the buyer acted in reliance on the seller's agent's (and seller's) opinion about the location of the boundaries. As a result, liability for the boundary discrepancy is imposed on the seller's agent for their failure to *conditionalize their statement* about the location of the boundaries. Without qualifying their statement, the agent's comments became a misrepresentation about the actual location of the boundaries.

Lack of actual knowledge

In the previous example, the seller's agent has no liability exposure for their failure to disclose the easements due to the agent's lack of actual knowledge of the easements, even though the information was readily available on request. The seller's agent did not owe the buyer a duty to advise the buyer of the need to check title for any easements or restrictions which might interfere with the construction of a pool.

The seller's agent did conduct a visual inspection of the property and observed nothing which indicated the existence of an easement. Further, the agent knew nothing about any such easement and had no duty to investigate the condition of title or zoning since they are public records and go beyond observations resulting from a limited visual inspection.

Since the buyer made an inquiry about the boundaries of the property and announced their intention to install a pool, the subject matter of these inquiries became **material facts**. When a seller's agent responds to an inquiry by a prospective buyer without conditionalizing their statement, the buyer may rely on the information. The buyer may thus acquire the property without further confirmation of the accuracy or truthfulness of the agent's statements.

Further-approval contingency provision

In the prior scenario, the seller's agent needed to include a **further-approval contingency provision** in the purchase agreement due to the buyer's inquiry. Then, the buyer would have been required as a condition of closing to further investigate. Thus, if the results of the due diligence investigation into the feasibility of constructing a pool (and the location of the boundaries) were not satisfactory to the buyer (or waived), the buyer could have cancelled the transaction.

Without the inquiry from the buyer, the seller's agent need not volunteer their opinion about the location of the boundaries. Thus, without the inquiry, the agent would not have gone beyond the *minimum required disclosures*

about the physical condition of the property. Once the agent responded to the buyer's request, a contingency provision for further approval of the condition included in the purchase agreement would have avoided the dispute.

Opinions of the buyer's broker

A seller's broker and seller's agent have only a *general non-agency duty* to deal honestly and in good faith with a prospective buyer. As for a buyer, the seller's agent's opinions are those of an adversary.

Thus, a seller's agent's opinion cannot be reasonably relied upon by a prospective buyer as having a high probability of occurring, unless **special circumstances** exist.

In contrast, a buyer's broker and their agent have a **special fiduciary duty** to handle a buyer with the same level of care and protection a trustee exercises on behalf of their beneficiary.

fiduciary duty
That duty owed by an agent to act in the highest good faith toward the principal and not to obtain any advantage over their principal by the slightest misrepresentation, concealment, duress or undue influence.

This *special agency duty* owed to a buyer raises an opinion given to a buyer by the buyer's broker or their agent to a higher level of reliability than had the same opinion been expressed by a seller's agent acting solely on behalf of a seller. Thus, as a fiduciary, the opinion of the buyer's agent becomes an assurance the condition or event which was the subject of the opinion will occur, unless the buyer's agent *conditionalizes* their opinion.

For the buyer's agent to give their opinion to their buyer and keep it from rising to an *actionable assurance* when the predicted event fails to occur, the opinion will include a recommendation to investigate and expertly analyze relevant information to confirm the agent's opinion. Further, to mitigate risks, a *further-approval contingency provision* covering the condition or event that is the subject of the opinion needs to be included in any offer made by the buyer.[8]

Assurance of suitability without a contingency

Consider a buyer's agent who represents a prospective buyer looking for rental income property.

The buyer's agent is aware the buyer's primary purpose for acquiring property is to receive spendable income from the investment.

The agent locates a multi-unit apartment complex. The agent assures the buyer:

- monthly vacancies will only be three or four units since the apartment complex is the only complex in the area which allows children and pets;
- the complex will require very little expense to maintain; and
- the buyer will receive the amount of spendable income sought from the investment.

Even though the seller's books and records are **readily available** for inspection on request, the buyer's agent does not verify the accuracy

8 Borba, *supra*

of the seller's projected income and expense statements, or confirm the maintenance costs. The agent fills out and hands their buyer an **Annual Property Operating Data sheet (APOD)** restating the representations already made to the buyer about the agent's projections of future income. [See **RPI** Form 352]

The buyer, in reliance on their agent's predictions about the property's future operations, enters into a purchase agreement with the seller. No *contingency provisions* are included to confirm the integrity of the improvements or to investigate the income and expenses experienced by the seller.

After the buyer acquires the property, the buyer encounters higher maintenance costs and significantly lower rental income than represented by their agent. Also, the property has a high turnover rate and a large number of tenants are constantly delinquent in the payment of rent.

The buyer does not receive the sought-after spendable income projected by their agent. Soon, the property is lost to foreclosure.

The buyer makes a demand on their agent for their lost investment, claiming the agent misrepresented the operations of the property. The buyer's agent rejects the demand, claiming their comments on the property's performance were opinions, not guarantees.

Here, the buyer had the right to rely on their agent's unconditional statements of facts about the property. The buyer was further correct to treat the representations as true without concern for their verification as a fiduciary relationship existed between the buyer and their agent. Thus, the buyer's agent's predictions were **misrepresentations** since they did not come to be, and the basis for the buyer's recovery of the value of the lost investment.[9]

Expertise of the broker or agent

Agents often hold themselves out as experts with **superior knowledge** about a particular type of transaction, such as high-end residential properties, apartment projects, industrial buildings or land. Agents often claim special knowledge for reason of an *alphabet-soup-type certification* attached to their name. Prospective buyers, aware of a seller's agent's specialty, often ask the agent for their opinion about some anticipated future use or operation of the property.

Due to an agent's experience, special training and education, seller's agents may find their opinion is given extra weight by a buyer. An agent's **special qualifications** suddenly become reasonable justification for the buyer to rely on their opinion as an **assurance** the predicted event, activity or condition will be experienced as stated. Thus, a risk averse agent will express their opinion as only a *belief* or *thought*.

Consider a developer who controls a homeowners' association (HOA) which governs a countryside subdivision of homes.

9 Ford, *supra*

The developer and seller's agent hold themselves out as HOA experts when questions about HOA operations and the Covenants, Conditions and Restrictions (CC&Rs) are received from prospective buyers.

The seller's agent assures prospective buyers that the subdivision's CC&Rs protect the view from each lot, and that the architectural committee will not approve fences interfering with the view. The recorded CC&Rs contain provisions confirming the agent's statements.

However, an architectural committee is never setup. Further, all proposals for fences are reviewed and approved by the developer themselves. This fact is known to the agent, but not prospective buyers.

A prospective buyer pays a premium for a home with a view.

After acquiring the property, a neighbor erects a fence as approved by the developer. The fence blocks the buyer's view. The buyer makes a demand on the agent for their money losses brought about by a loss in value suffered by their property since the agent's statement on view rights failed to come true.

The seller's agent claims their statement about the view rights was their opinion which cannot be reasonably relied on by the buyer when making a decision to purchase the property.

Positive statement of truth

In the previous instance, the agent held themselves out as an expert on HOA and CC&Rs enforcement. The agent then stated the CC&Rs and architectural committee will maintain the view provided by the development. Further, the seller's agent knew the architectural committee had not been created and that the developer had full control.

Thus, the buyer may pursue the agent to recover their lost value, i.e., the view, due to the agent's false opinion about the HOA's ability to protect the buyer's view rights in the future, which was a misrepresentation.

When an agent holds themselves out to be *specially qualified* in the subject matter expressed in opinion, it becomes a *positive statement of truth* on which a buyer or seller of lesser knowledge can rely.[10]

Inducing reliance by assurances

All agents give opinions to buyers. However, when the opinion is *coupled with advice* expressing no further need for the buyer or others to investigate and confirm the prediction, the opinion is elevated to the level of a guarantee.

The level of assurance equivalent to a guarantee also arises when the buyer indicates they are relying on the agent:

- to analyze a qualifying property to determine the property's ability to be used or operated as the buyer has indicated; and
- to advise on whether the property is suitable and will meet the buyer's expectations.

10 **Cohen** v. **S & S Construction Co.** (1983) 151 CA3d 941

Further, any affirmative activities or statements of any agent designed to suppress the buyer's **inspection** of the property are considered assurances which make the conclusion drawn in the opinion the equivalent of a fact.

Facts not supporting the conclusion

An agent's opinion is to be **honestly held** by the agent if the agent is to avoid liability when the predicted event or condition does not occur.

For an agent to hold an honest belief, the opinion is to be based on a due diligence investigation and knowledge of all readily available facts which have a bearing on the probability of the event or condition occurring.

When facts affecting the conclusion drawn by the agent are known or readily available to the agent, the test of an *honestly held opinion* is whether the agent giving the opinion *should have known better* than to give such an opinion.

An agent who fails to conduct a due diligence investigation to determine the facts before expressing an opinion, which the investigation might have influenced, is liable for their opinion when the event fails to occur. The agent is liable no matter their wording to limit the prediction to a mere speculative opinion.

Without first having the facts on which to base an opinion, the agent's opinion is either an *unfounded guess* or an *unreasonable assumption*.

Intentional misrepresentation

Consider a seller's agent for a condominium project who advertises "luxury" condos for sale. The agent knows the condos are poorly constructed and the defects are unobservable to someone not knowledgeable in the field of construction.

A buyer contacts the agent for more information.

The agent tells the buyer that the condos are an "outstanding" investment opportunity. Unaware of the defects, the buyer purchases a condo. The buyer soon discovers the condo is in danger of falling down.

Here, the seller's agent and their broker are guilty of both *affirmative* and *negative fraud*.

affirmative fraud
Intentionally and knowingly misrepresenting information to someone.

The agent could not have honestly believed the condo was an "outstanding" investment opportunity in light of their knowledge of the construction defects. Thus, the agent's representation is an **affirmative fraud,** also called an **intentional misrepresentation.**

negative fraud
Deceitfully withholding or failing to disclose information to someone.

Also, the significant defects in the "luxury" project were **material facts** since they adversely affected the present value and desirability of the condos. Accordingly, the agent is liable for damages caused by their nondisclosure (omission) of the defects which were known to them, an example of **negative fraud,** also called **deceit**.[11]

11 Cooper, *supra*

Predicting the conduct of others

The transfer of real estate to a buyer typically involves **third parties** who are not principals or agents in the transaction. Some transactions require approval, consent, administrative review or similar conduct by others regarding some event or condition to occur before or after closing. This causes buyers to be concerned about whether the third party will respond favorably or act timely.

Thus, buyers frequently ask agents what they believe will be the *reaction of others*.

These third parties include an:

- HOA;
- water authority;
- landlord;
- contractor;
- lender;
- attorney;
- accountant;
- planning agency; or
- redevelopment agency.

Commenting on the reactions of others

Consider agricultural land listed for sale. For a buyer to receive water from the Bureau of Reclamation, the buyer is to first obtain approval of the purchase price from the Bureau.

The seller's agent locates a buyer. A purchase agreement is drawn up contingent on the Bureau's approval of the purchase price. The agent estimates the approval process will take 30 to 60 days.

The buyer, concerned with meeting the planting deadline for the season, asks the agent about the probability of the Bureau's approval.

The seller's agent consults with the seller as to whether the transaction will be approved by the Bureau since the seller has dealt with the Bureau over water issues before. The seller says "they believe" it will be approved.

The agent tells the buyer of the seller's opinion. The buyer waives the Bureau-approval contingency, stating they will get the approval later. Escrow is closed.

The buyer files for Bureau approval. During the approval process period, the property's natural well caves in. The Bureau refuses to approve the transaction and will not provide water.

The buyer seeks to recover their losses from the seller, claiming the seller's prediction of a future event (approval by the Bureau) was a fact they relied on when they purchased the property.

However, nothing suggests the seller or their agent held themselves out to be *specially qualified* on the subject of Bureau approval. Thus, the seller's erroneous prediction about the approval was not a misrepresentation of fact. Instead, it was an expression of opinion.

The seller's access to facts about the Bureau's approval process was equally available to the buyer. Furthermore, unless a *special prior relationship* exists between the seller and buyer, the buyer is not entitled to rely on the opinion of the seller (or the seller's agent) concerning the future decisions of a public body.[12]

Estimates as projections or forecasts

estimate
Prediction of future amounts which have not yet actually occurred.

Nearly every transaction offers agents the opportunity to provide **estimates** for their clients or the other principals involved. Estimates include:

- approximations;
- predictions;
- pro-forma statements;
- anticipated expenditures; and
- contemplated charges.

Estimates relate to income and/or expenditures, such as exist in:

- seller's net sheets [See **RPI** Form 310];
- buyer's cost sheets [See **RPI** Form 311];
- operating cost sheets for owner-occupied properties;
- APODs on income properties [See **RPI** Form 352];
- loan origination or assumption charges;
- lender impounds;
- rent schedules (rolls) [See **RPI** Form 352-1];
- repair costs for clearances; and
- any other like-type predictions of costs or charges.

Estimates by their nature are not facts. The amounts estimated have not yet actually occurred. The amount estimated will become certain only by its *occurrence in the future*. The amount actually experienced may or may not equal the amount estimated.

A document entitled an "estimate" is typically based on the actual amount currently experienced. Thus, estimates are expected to be fairly accurate in amount, not just guesswork. Words used in titles such as "contemplated," "pro-forma," "anticipated" or "predicted" indicate something less than an accurate estimate, and provide less basis for a buyer to rely.

12 Borba, *supra*

Making projections

Opinions voiced by agents about an income property's future performance are either **projections** or **forecasts.**

A *projection* is prepared by a seller's agent on an income property to represent its annual operations. The data is set out in an APOD sheet handed to prospective buyers to induce them to purchase the property. The data entered on the APOD is a projection based exclusively on the income and expenses actually incurred by the owner/seller of the property during the preceding 12-month period. [See **RPI** Form 352]

projection
An opinion about an income property's future performance based on its performance during the preceding 12-month period, adjusted for presently known trends.

The amounts experienced by the seller during the past year are *projected to occur* again over the next year. However these amounts are *adjusted* by the agent for any trends in income and expenses reflected by information currently available or known to the agent.

No estimations, contemplations or use of figures other than those experienced by the owner are used as a basis to prepare the projection, except for adjustments to reflect changed conditions known (or should be known due to readily available facts).

Making forecasts

A *forecast* requires the knowledge and analysis of an anticipated change in circumstances which will influence the future income, expenses and operations of a property. There anticipated changes are distinct from trend factors used for projections. Forecasts anticipate *future changes* in income and expense the preparer of the forecast believes will probably occur under new or developing circumstances.

forecast
Analysis of anticipated changes in circumstances influencing the future income, expenses and use of a property.

Changes in circumstances considered in a forecast include:

- new management;
- rent increases up to current market rates;
- elimination of deferred maintenance and replacement of obsolete fixtures/appliances;
- changes in rent control ordinances;
- new construction adding to the supply of competing income properties;
- foreclosures adding properties to an illiquid market;
- commodity market prices (natural gas, water, fuel oil, electricity, etc.);
- local and state government fiscal demands for revenue and services;
- federal monetary policy effects on short- and long-term rates;
- demographics of increasing/decreasing population density in the area immediately surrounding the property;
- traffic count changes anticipated;
- zoning changes reducing, altering or increasing the availability of comparable competitive properties;
- government condemnation, relocation or redevelopment actions;
- changes in the local employment base of employed individuals;

- on-site security measures to prevent crime;
- the age and condition of the major components of the structure;
- local socio-economic trends; and
- municipal improvement programs affecting the location of the property.

Chapter 10 Summary

Statements made by an agent to their client are expressed as either an opinion about an uncertain future event, or as an assurance the events and conditions will occur, becoming a guarantee. The difference between the wording used by an agent to express either an opinion or a guarantee exposes the agent to liability when the buyer acts in reliance on the information and the event or condition fails to occur.

In an opinion, the event or condition expressed is not a factual representation. An opinion does not create any liability if the event does not occur, so long as the agent's opinion is a belief honestly held by the agent. However, a special condition or circumstance may exist which impose liability.

Due to an agent's experience or special training in a particular aspect of a property or type of transaction, agents may find their opinion is given extra weight by a buyer. Thus, an agent's wording of their opinion needs to express that the opinion is only their belief on the matter.

To prevent an opinion from becoming an assurance, the buyer's broker needs to recommend the client investigate the terms of the opinion independently. Coupling an opinion with advice that no further investigative action is necessary elevates the opinion to the level of a guarantee.

Chapter 10 Key Terms

Chapter 11

Safety standards for improvements

Learning Objectives

After reading this chapter, you will be able to:

- identify common safety standard issues and violations found on one-to-four unit residential properties; and
- provide the terms for the remedy of safety issues in a real estate transaction.

Key Terms

safety conditions **visual inspection**

Disclosing noncompliant improvements

Consider a seller of a one-to-four unit residential property who is solicited by a seller's agent and enters into a listing agreement employing the agent's broker to locate buyers and sell the property.

The seller is asked to fill out a Transfer Disclosure Statement (TDS) and return it to the seller's agent. When the TDS is filled out by the seller and picked up by the seller's agent, the agent then conducts their mandated **visual inspection** of the property. On completion of the inspection, the agent is to note on the TDS any property defects they observed which were not disclosed on it by the seller, and sign it.[1] [See **RPI** Form 304]

visual inspection An inspection of a listed property performed by the seller's agent and undertaken to observe defects to be noted on a condition of property disclosure, called the Transfer Disclosure Statement (TDS).

During their visual inspection of the property after receipt of the TDS prepared by the seller, the agent observes several **safety conditions** which they know do not meet current building codes and the seller did not note on the TDS. These observations are noted on the seller's TDS in the space provided where the seller's agent signs the statement.

safety conditions Property conditions which do not meet current building codes and might affect property value.

The disclosure statement signed by the seller and seller's agent now reveals that the garage door closing mechanism is not equipped with an automatic reversing device, the spa does not have a locking safety cover, the pool does

1 Calif. Civil Code §2079

not have barriers restricting access, the water heater is not anchored or braced, and the security bars on the windows in one of the bedrooms do not have a release mechanism — all in violation of current safety standards.

The TDS and all other seller disclosures and property reports are included in the listing package prepared by the seller's agent. The package will be handed to prospective buyers and buyer's agents who have seen the property and seek further information on the listed property.

At an open house held on the property by the seller's agent, a visitor indicates they are interested in possibly buying the property and asks for more information about it.

By the visitor's request for additional property information, the visitor has begun *negotiations*. Thus, they have become a *prospective buyer*, entitled to a complete set of disclosures from the seller or the seller's agent — as soon as possible — before any offer is made.

The seller's agent responds to the request by handing the prospective buyer the **listing package**, sometimes called a *backup package* (to the promotional flyer on the property). The backup package includes a copy of the TDS and any home inspector's report for the buyer's review.

A demand to cure safety defects

Continuing our previous example, a purchase agreement offer is then prepared, signed by the prospective buyer and submitted to the seller. The purchase agreement includes the buyer's acknowledgement of receipt of the TDS and all other disclosures necessary for the transaction. The purchase agreement offer does not contain a provision that calls for the seller to correct any of the previously disclosed safety defects or to bring the property up to current building standards. The offer is accepted by the seller and an escrow is opened to process the transaction.

However, prior to closing, the buyer becomes concerned about the existing safety defects. Also, local ordinances can require safety defects to be eliminated before issuing the buyer a certificate of occupancy.

The buyer makes a demand on the seller to repair, replace or install an automatic reversing device for the garage door, a locking cover for the spa, barriers to restrict access to the pool, a brace or anchor on the water heater and security bar release mechanisms as necessary to meet current safety standards. The buyer claims the seller must cure the safety defects by meeting current construction standards before the seller is able to require the buyer to close escrow on the sale.

The seller refuses to cure any of the defects, claiming the buyer is obligated to close escrow since:

- the *buyer knew* the defects existed before entering into the purchase agreement; and
- the seller did not agree to correct the defects and bring the property up to current building codes.

Is the seller able to cancel or enforce the purchase agreement if the buyer does not close escrow?

Yes! The buyer knew the precise condition of the property when they agreed to the price the buyer was to pay to purchase the property.

Thus, the buyer agreed to acquire the property "as disclosed" in the seller's TDS. The buyer was on notice of the defects prior to the agreement to buy the property and did not bargain for the seller to cure the defects as a condition for paying the agreed price.

Automatic garage doors

All **automatic garage doors** installed after January 1, 1991 are required to have an automatic reverse safety device which meets code.[2]

In addition, garage door openers installed after January 1, 1993 are required to have a sensor which, when interrupted or misaligned, causes a closing door to open and prevents an open door from closing.[3]

The safety standards for garage doors are designed to prevent children from becoming trapped under closing doors. Properties constructed before 1993 likely do not meet current safety standards.

Further, when any residential garage door is serviced, the person servicing the garage door has to test whether the door reverses on contact with a two-inch high obstacle placed beneath the door.

If the door does not reverse, the repairman is required to place a warning sticker on the garage door stating the door does not reverse and is not in compliance with current safety standards.[4]

Child resistant pool barriers

A construction permit issued after 1997 for a pool at a single-family residence (SFR) requires the completed **pool** to comply with *at least one* of the following safety requirements:

- the pool is isolated from access to the house by a surrounding fence or barrier at least 60 inches in height;
- the pool incorporates up-to-code removable mesh pool fencing with a self-closing and self-latching gate that is key lockable;
- an approved safety cover is installed for the pool;
- an up-to-code surface motion, pressure, sonar, laser, or infrared swimming pool alarm is installed in the pool that sounds when it detects accidental or unauthorized entrances into the water;
- all the doors of the residence providing access to the pool are equipped with exit alarms or a self-closing, self-latching device with a release mechanism placed no lower than 54 inches above the floor; or

2 Calif. Health and Safety Code §19890(a)
3 Health & S C §19890(b)
4 Health & S C §19890(e)

- some other means of protection as determined to be adequate by an approved testing laboratory as meeting certain standards.[5]

These safety requirements do not apply to hot tubs or spas with locking safety covers.

Shared public pools

Condominium and apartment projects are not required to maintain safety barriers for pools and spas as their projects are not classified as SFRs. Also, pools in condos and apartments are considered public facilities.

However, condo projects and apartment buildings have to post signs indicating whether or not lifeguard services are available. Lifeguard services are not required, and if not provided, a sign saying so is to be posted.[6]

Public pools and spas are considered environmental hazards to a user's health if the managers do not operate and maintain them in a sanitary, healthful and safe manner.[7]

If pools and spas in multiple-housing projects are not operated or maintained in a sanitary, healthful and safe condition, the pools and spas are considered

a public nuisance and are able to be shut down by local health inspectors.[8]

Water heaters

All existing residential **water heaters** are to be anchored, braced or strapped to prevent displacement due to an earthquake.[9]

A residential seller must state whether the water heater is anchored, braced or strapped.[10]

If the water heater meets safety requirements, the seller notes the compliance by marking the box on the TDS next to "anchored, braced or strapped." No further notice is necessary as this is redundant and not required.

If the seller's water heater does not comply, the seller is advised to include a written statement on the TDS disclosing that fact.

When a prospective buyer receives the TDS before entering into a binding purchase agreement, and the TDS notes the water heater is not in compliance with safety standards, the prospective buyer has agreed to accept the property with the defect, unless a provision to the contrary is included in an addendum to the purchase agreement.

Residential security bars

Security bars on residential property are required to have release mechanisms for fire safety reasons.

---

5 Health & S C §19890(e)
6 Health & S C §§116045,116049.1(a)
7 Health & S C §116040
8 Health & S C §116060
9 Health & S C §19211(a)
10 Health & S C §19211(b)

However, the release mechanisms are not required if each bedroom with security bars contains a window or door to the exterior which opens for escape purposes.[11]

Smoke detector compliance

Smoke alarms approved and listed by the State Fire Marshal (SFM) are required in all residential properties in California.[12]

A smoke alarm installed on or after January 1, 2015, whether battery-powered or hard-wired, needs to:

- display the date of manufacture;
- provide a place where the date of installation can be written; and
- incorporate a hush feature.[13]

Additionally, since July 1, 2014, the SFM has required all battery-operated smoke alarms to be manufactured with a non-replaceable battery that lasts at least ten years.[14]

Smoke alarm enforcement is triggered:

- when a residential property owner seeks a building permit for alterations, repairs or additions costing more than $1,000, requiring the owner to provide proof that SFM-approved smoke alarms are in place and operable before being issued a building permit;[15]
- on the transfer of a single family residence (SFR), during which sellers certify the property is in compliance with smoke alarm rules on the TDS [See **RPI** Form 304];[16] and
- when a new tenancy is created for a residential rental property. [17] [See **RPI** Forms 550 §7.3 and 551 §7.2]

Operable hardwired and battery-operated smoke alarms approved when installed do not need to be replaced immediately and are considered compliant. However, when an existing smoke alarm no longer works, the replacement smoke alarm is to meet current requirements. Local ordinance can require sooner replacement.[18]

Smoke alarms are not required if a SFM-approved fire alarm system with smoke detectors is installed on the property. An existing fire sprinkler system does not exempt a residential property owner from smoke alarm installation requirements.[19]

11 Health & S C §13113.9
12 Health & S C §13113.7
13 Health & S C §13114(b)(3)
14 Health & S C §13114(b)
15 Health & S C §13113.7(a)(2)
16 Health & S C §13113.8(b)-(c)
17 Health & S C §13113.7(d)(2)(B)
18 Health & S C §§13113.7(a)(4), 13113.7(d)(3)
19 Health & S C §13113.7(a)(5)

Chapter 11 Key Terms

When the Transfer Disclosure Statement (TDS) is filled out by the seller and picked up by the seller's agent, the agent then conducts their mandated visual inspection of the property to observe any property defects and safety conditions which they know do not meet current building codes. These observations are noted on the seller's TDS.

All automatic garage doors installed after January 1, 1991 are required to have an automatic reverse safety device which meets code. In addition, garage door openers installed after January 1, 1993 are required to have a sensor which, when garage door movement is interrupted or misaligned, causes a closing door to open and prevents an open door from closing.

A construction permit issued after 1997 for a pool at a single family residence (SFR) requires the completed pool to comply with certain safety requirements such as an approved safety cover for the pool.

All existing residential water heaters are to be anchored, braced or strapped to prevent displacement due to an earthquake. A residential seller needs to state whether the water heater is anchored, braced or strapped.

Security bars on residential property are required to have release mechanisms for fire safety reasons.

Residential properties also require SFM-approved smoke alarms. If installed on or after January 1, 2015, whether battery-powered or hard-wired, smoke alarms need to:

- display the date of manufacture;
- provide a place where the date of installation can be written; and
- incorporate a hush feature.

Operable hardwired and battery-operated smoke alarms which were approved and listed when they were installed do not need to be replaced immediately and are considered compliant. However, when an existing smoke alarm no longer works, the replacement smoke alarm is to meet current requirements. Local ordinance may require sooner replacement.

Chapter 11 Key Terms

Chapter 12

The home inspection report

Learning Objectives

After reading this chapter, you will be able to:

- understand the use of a home inspection report (HIR) to mitigate risks of misrepresentation in the preparation of a seller's Transfer Disclosure Statement (TDS);
- exercise care in the selection of a qualified home inspector; and
- use an energy efficiency audit report by a Department of Energy-certified Home Energy Rater to market property.

Key Terms

California Home Energy Rating System

energy audit

home inspection report (HIR)

home inspector

material defect

Transparency by design, not default

The agent for a seller of a one-to-four unit residential property asks the seller to grant them authority to order a **home inspection report (HIR)** on the seller's behalf. [See Form 130 accompanying this chapter]

The home certification process is a cost the seller incurs to properly *market* the property if they are to avoid claims by buyers about defective property conditions after a purchase agreement is entered into.

The seller's agent explains the *HIR* is also used to prepare the seller's *Condition of Property Transfer Disclosure Statement (TDS)*. The HIR will then be attached to the seller's TDS. Both will be included in the agent's marketing package presented to prospective buyers who seek additional property information. [See **RPI** Form 304]

On receipt of the HIR, the seller may act to eliminate some or all of the deficiencies noted in the report. Sellers are not obligated to eliminate defects

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 complete a TDS and assure prospective buyers about a property's condition.

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 seller's TDS as reviewed by the seller's agent and supplemented with the HIR, is used to inform prospective buyers about the precise condition of the property before they make an offer to purchase. Thus, the seller will not be later confronted with demands to correct defects or to adjust the sales price in order to close escrow. The property will have been purchased by the buyer "as disclosed."

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's agent.[1]

Further, for the seller's agent to retain control throughout the process of marketing, selling and closing escrow with a buyer, the seller's agent needs to request and use the HIR (on behalf of the seller) to assist in the preparation of the TDS. Thus, they avoid exposing themselves and their seller to claims of misrepresentation when the buyer goes under contract without first having reviewed an HIR (or TDS). [See Form 130]

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.

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 can discuss the *home inspector's* observations and whether the *findings are material* in that they 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 may have on its content is followed up by a further discussion with the home inspector, and if necessary, an amended or new report.

A home inspector's qualifications

Any 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:

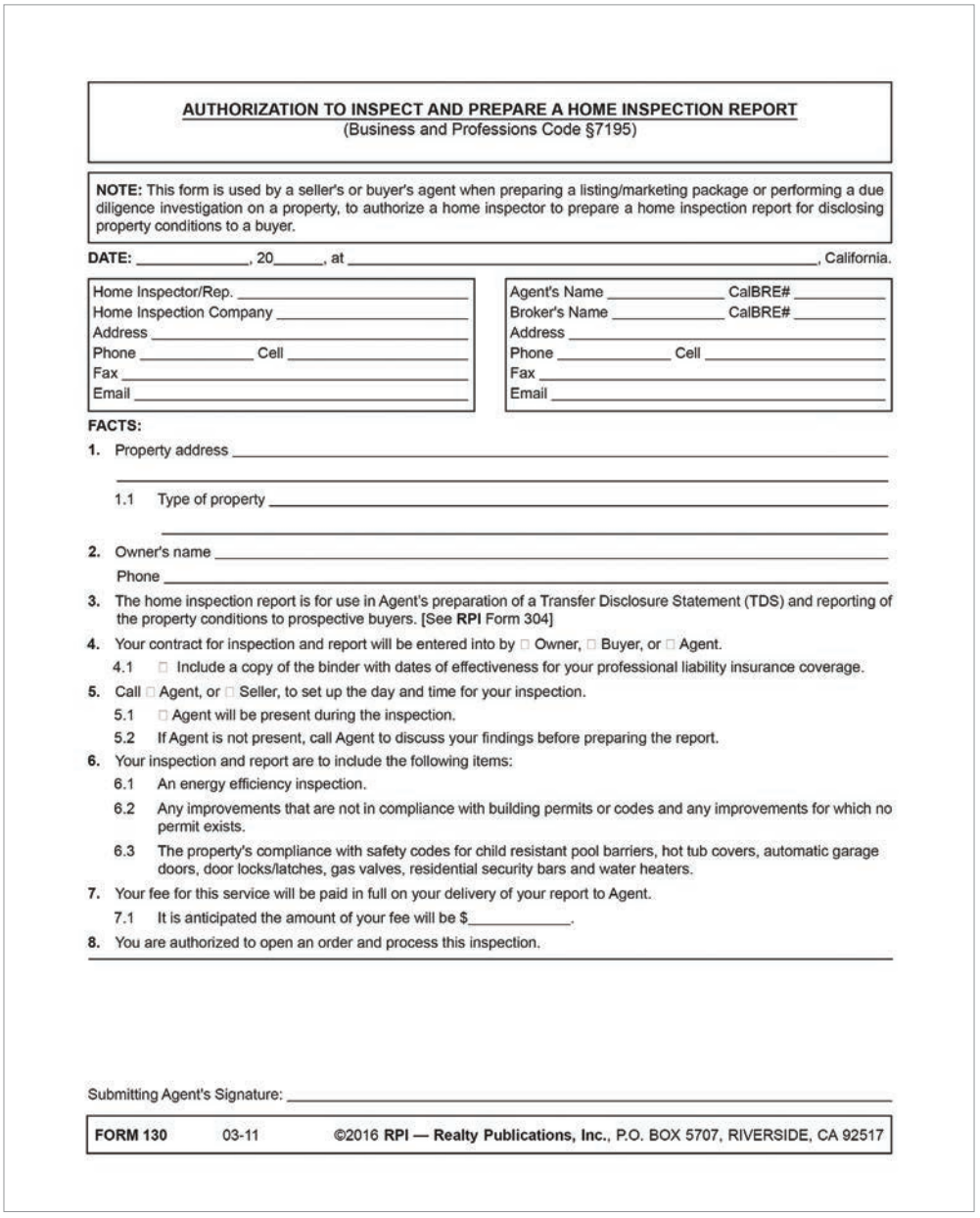
- general contractors;
- structural pest control operators;

1 Calif. Civil Code §2079

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

Form 130

Authorization to Inspect and Prepare a Home Inspection Report



AUTHORIZATION TO INSPECT AND PREPARE A HOME INSPECTION REPORT
(Business and Professions Code §7195)

NOTE: This form is used by a seller's or buyer's agent when preparing a listing/marketing package or performing a due diligence investigation on a property, to authorize a home inspector to prepare a home inspection report for disclosing property conditions to a buyer.

DATE: _____, 20_____, at _____, California.

Home Inspector/Rep. _____
Home Inspection Company _____
Address _____
Phone _____ Cell _____
Fax _____
Email _____

Agent's Name _____ CalBRE# _____
Broker's Name _____ CalBRE# _____
Address _____
Phone _____ Cell _____
Fax _____
Email _____

FACTS:

1. Property address _____
   1.1 Type of property _____
2. Owner's name _____
   Phone _____
3. The home inspection report is for use in Agent's preparation of a Transfer Disclosure Statement (TDS) and reporting of the property conditions to prospective buyers. [See **RPI** Form 304]
4. Your contract for inspection and report will be entered into by ☐ Owner, ☐ Buyer, or ☐ Agent.
   4.1 ☐ Include a copy of the binder with dates of effectiveness for your professional liability insurance coverage.
5. Call ☐ Agent, or ☐ Seller, to set up the day and time for your inspection.
   5.1 ☐ Agent will be present during the inspection.
   5.2 If Agent is not present, call Agent to discuss your findings before preparing the report.
6. Your inspection and report are 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 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 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

- architects; and
- registered engineers.

Duty of care

The duty of care expected of licensed members of these professions by prospective buyers who receive and 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 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

3 Bus & P C §7068

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. Prospective buyers who rely on home inspection reports can expect a high level of competence from experts.[4]

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

Hiring a home inspector

Sellers and seller's agents are encouraged by legislative policy to obtain and rely on the content of a home inspection report (HIR) to prepare their TDS for delivery to prospective buyers.

The buyer's reliance on an HIR at the time a purchase agreement is entered into relieves the seller and their agent of any liability for property defects they did not know about or were not observable during the mandatory visual inspection conducted by the seller's agent.

However, for the seller's agent to avoid liability in the preparation 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.

If **care in the selection** of a home inspector is lacking, then reliance on the HIR by the seller and seller's agent preparing the TDS will not relieve the broker or the seller's agent of liability for the home inspectors incompetence or error.

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

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 (E&O)* insurance covering professional liability;
- professional and client *references*; and

4 Bus & P C §7196
5 Bus & P C §7196.1
6 CC §1102.4(a)

- 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 condition of the property to prospective buyers. In turn, the HIR reduces the risk of errors.

The home energy rater

Consider a first-time homebuyer who, acting on their own and without the advice of a buyer's agent, buys a fixer-upper for a starter home. The buyer is able to foresee the costs of replacing the peeling wallpaper and obsolete bathroom fixtures, but has no practical idea about the costs of time, money and talent needed to properly renovate the home.

In the first month of residence, the uncapped air conditioning ducts, badly sealed window frames and insufficient ceiling insulation cause their utility bills to skyrocket past the pre-closing estimates for operating the property as the owner. The buyer's financial options are more limited after acquiring the property than they were when the purchase was negotiated.

As an owner, the buyer is responsible for the costs of any improvements to the home, and updating the home's energy-efficiency has the potential to become costly. Had the buyer retained a buyer's agent prior to making an offer or entering into a purchase agreement, the buyer would likely have been advised to ask for a (home) **energy audit**.

energy audit
An inspection which pinpoints a home's energy-efficient improvements and features in need of energy-efficient improvements.

With the *energy audit* in hand, a buyer can incorporate the costs of the recommended energy efficient updates into the total costs for acquisition they are willing to pay for the property. A buyer can also use that information to compare the energy-efficiency of the home in consideration to other properties before making an offer. Information is powerful corroboration for justifying the terms and conditions of an offer, but it is needed up-front to do so.

In addition to ensuring the seller has hired a competent home inspector to complete the HIR, a buyer's broker may also insist a home energy audit be performed by a competent **Home Energy Rater (Rater)**, which can be the home inspector.

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
California state system used to create a standard rating for energy efficiency and certify professional raters.

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.

Raters are trained through both classroom and field work in the theories of energy conservation and the analysis of a structure's energy related components.

After an extensive training process, the Rater is certified to do freelance energy audits, as long as the assessment of the energy conditions of the property is based on guidelines established by the HERS program. Anyone can hire a Rater to do an audit, the cost of which usually ranges between $300-$800.

Although Home Energy Raters are specially trained and certified, any home inspector may 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 report

Consider a buyer under a purchase agreement who requests a home inspection report on the property being purchased. On receipt 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 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 can now 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 ought to have known that the agent is duty bound to provide it to other prospective buyers if the buyer who ordered the report 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]

---

7 Bus & P C §§ 7199.5, 7199.7

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

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.

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 file an action to recover any money losses.[10]

Occasionally, a boilerplate provision in the home inspector's contract or the home inspection report will also attempt to limit the buyer's period for recovery to one year after the inspection occurred.

However, any such limitation the home inspector places on time periods during which the buyer must discover and make a claim is unenforceable. The statutory four-year period is needed to provide time for buyers to realize the home inspector produced a faulty report.[11]

The home inspector's malpractice insurance

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

Home inspectors who fail to detect and report a material defect or the extent of the defect may cause the buyer to incur costs to correct the significant defects. The buyer will be seriously disadvantaged in any recovery effort against the home inspector and the home inspection company unless insurance is available to pay amounts due the buyer.

Likewise, if the same defect was also missed by the seller's agent due to the agent's negligence to observe the defect during the agent's mandatory visual inspection, the broker and the seller's agent are also liable to the buyer for the costs of curing the defect — separate from the home inspector's liability.

Here, the broker and seller's agent who relied on the HIR will be able to force the home inspector to contribute to the recovery, called an indemnification claim. Unless the home inspector has insurance coverage, the ability of the seller's broker to force the home inspection company to pay the home inspector's share of the responsibility for having failed to observe the defect will be limited to the home inspector's personal assets.[12]

---

9 Bus & P C §7198

10 Bus & P C §7199

11 **Moreno** v. **Sanchez** (2003) 106 CA4th 1415

12 Leko, *supra*

The home inspection examination

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:

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

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

Defects are material if they adversely affect the price a reasonably prudent and informed buyer would pay for the property when entering into a purchase agreement. As the report may affect value, the investigation and delivery of the home inspection report to a prospective buyer is legislated to precede a prospective buyer's offer to purchase.[13]

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 which would disturb components or cause repairs to be made to remove the effects of the intrusion.[14] [See Form 130]

The inspection report

The *HIR* is the written report prepared by the home inspector which sets forth the findings while conducting the physical examination of the property. The report 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.[15]

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 will also include suspicions the home inspector might have which need to be clarified by further inspections and reports by others with more expertise.

The agent, or anyone else, may also 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 will report 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;

13 Bus & P C §7195(b)
14 Bus & P C §7195(a)(1)
15 Bus & P C §7195(c)

- 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.[16]

The home inspector's conflicts of interest

The home inspector who prepares a HIR, the company employing the home inspector and any affiliated company may not:

- 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; or
- inspect any property in which they have a financial interest in its sale.[17]

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

Chapter 12 Summary

A seller, through their agent, requests the preparation of a home inspection report (HIR) to be used to prepare the mandatory seller's Transfer Disclosure Statement (TDS). Both will be handed to prospective buyers in a marketing package. The TDS and HIR inform prospective buyers about the precise physical condition of the improvements on the property before an offer to purchase is made.

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.

The home inspection describes any observed or suspected material defects, and makes recommendations for each condition. Defects are

material if they adversely affect the price a reasonably prudent and informed buyer would pay for the property when entering into a purchase agreement.

Reliance on an HIR prepared by an inspector relieves the seller and the seller's broker from liability for errors in the TDS which are unknown to them to exist. Qualifications to look for in a home inspector include:

- educational training in home inspection;
- the length of time in the home inspection business or a closely related field;
- errors and omissions insurance coverage;
- professional and client references; and
- membership in a recognized association of professional home inspectors.

A buyer and their agent may also wish to assess the energy efficiency of the property and the costs of making energy efficiency upgrades. A home energy audit is performed by a Department of Energy-certified Home Energy Rater.

Chapter 12 Key Terms

Chapter 13

Verify property disclosures: retain a home inspector

Learning Objectives

After reading this chapter, you will be able to:

- confirm the condition of a property as disclosed by a seller when entering into a purchase agreement;
- require a seller to cure any material defects that were not disclosed at the time the agreement was entered into; and
- provide in-contract for a buyer to either require a seller to correct defects undisclosed on entering into a purchase agreement, or for the buyer to recover the costs of correction from the seller.

Key Terms

home inspection report (HIR) **price adjustment provision** **material defect**

Protecting the prospective buyer

Protecting the prospective buyer In the process of purchasing a home, a buyer's due diligence investigation includes the right to conduct a *home inspection*. Too often, the seller's agent fails to anticipate this right by ordering a home inspection report for inclusion in their package for marketing the property and presentation to prospective buyers on commencement of negotiations — before an offer is submitted.

Without a **home inspection report (HIR)** delivered by the seller or seller's agent, a buyer's agent becomes duty bound to request one before submitting an offer. If not available, they then advise the buyer on the need for an HIR contingency provision in their purchase agreement offer. On entering into the purchase agreement, the buyer's agent assists in the selection of a home inspector and ordering of an HIR — if the seller will not provide one.

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 complete a TDS and assure prospective buyers about a property's condition.

The purpose of the home inspection is to have an independent, neutral, third party conduct an investigation and prepare an HIR on the physical aspects of improvements on the property. An HIR from a competent inspector assures

a prospective buyer the property is free of defects, except those listed on their inspection report. The report adds a minimum level of care for the prospective buyer needed to protect the seller and their agent from claims by a buyer for their failure to properly disclose.

The buyer's agent is to advise the buyer on the advantages of selecting an experienced, qualified and preferably certified home inspector. Providing expertise regarding the home inspection process and selection of a qualified home inspector when an HIR has not been obtained by the seller's agent fulfills the duty owed the buyer by the buyer's agent.

Property conditions in marketing packages

Consider a buyer who, with the assistance of their agent, locates a one-to-four unit residential property suitable for the buyer's housing objectives. Both the buyer and their agent walk through the property and confirm the property fits the buyer's needs.

The buyer's agent contacts the seller's agent and informs them they have a prospective buyer who is interested in the property. The buyer's agent requests additional information on the property to begin negotiations, including a title profile, a **Transfer Disclosure Statement (TDS)** and an HIR, among other required disclosures. The seller's agent responds by suggesting the buyer's agent submit a purchase agreement offer. The seller's agent assures them that after an offer is accepted by the seller, the "necessary disclosures for closing" will be delivered. [See **RPI** Form 304]

The indication the buyer's agent gets is the seller's agent has not prepared a package for marketing the property and no information on the property is going to be made available to prospective buyers until it is time to close escrow.

The buyer agrees with their agent to proceed with an offer at a price and on terms which the agent believes are justified. The agent has checked out comparable sales information provided by the title company and already has working knowledge of properties in the immediate area. They know of no problems presented by the physical condition of the property.

An offer is prepared with contingency provisions regarding the condition of the property. The buyer's only information on the condition of the property is from their observations during the walk-through with their agent to determine whether the arrangement of the space within the structure was suitable.

Condition of property contingencies

Contingency provisions included in the purchase agreement, among others, when prior disclosures have not been made, call for:

- the seller to furnish an *HIR* prepared by an insured home inspector showing the land and improvements are free of material defects [See **RPI** Form 150 §11.1(b)];

- the seller and the seller's agent to prepare, sign and deliver a *TDS* [See **RPI** Form 150 §11.2]; and
- the *buyer to inspect* the property twice — once to initially confirm the condition of the property and again before closing escrow to confirm maintenance has not been deferred and **material defects** discovered *after entering* into the purchase agreement have been corrected or eliminated. [See **RPI** Form150 §11.4]

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

The offer is submitted and promptly rejected by the seller. Eventually, a purchase agreement is entered into which eliminates the provision calling for the seller to furnish an HIR. No previous offer has been submitted to the seller by other prospective buyers who obtained an HIR on the property.

The buyer authorizes their agent to immediately obtain an HIR, which the buyer's agent orders. The inspection takes place and the HIR is received by the buyer's agent and reviewed with the buyer. The seller and the seller's agent have not delivered a TDS or any of the other seller disclosures or inspection reports which both the seller and the seller's agent are duty bound to deliver to a prospective buyer.[1]

The home inspector's written report lists numerous significant defects the inspector observed during their physical inspection of the property's condition. Repair/replacement costs are estimated at $2,500 to eliminate the defects not disclosed by the seller or observed by the buyer or the buyer's agent on their cursory review of the space within the structure.

Demands follow discovery of defects

The buyer makes a written demand on the seller to cure the defects discovered by the home inspector based on the terms agreed to in the purchase agreement. [See **RPI** Form 150 §11.4 and Form 269 accompanying this chapter]

A copy of the HIR and a contractor's estimate of the cost to cure the defects are attached to the buyer's request for repairs. Thus, the buyer substantiates their demand on the seller to cover previously undisclosed defects, whether intentional or negligent.

The seller and their agent prepare a TDS and note all the defects listed in the HIR and on the buyer's notice demanding repairs. The seller then refuses to make any of the corrections, claiming they have disclosed the defects in the TDS as agreed in the purchase agreement. Eventually, the buyer is told to either close escrow or cancel.

Is the buyer able to require the seller to cure the *material defects* found by the home inspector and close escrow?

Yes! The seller has to deliver the property to the buyer **as disclosed** by the seller and the seller's broker and observed by the buyer at the time the buyer's purchase agreement offer was accepted, not in the condition stated in an untimely disclosure made in the seller's TDS during escrow.

1 Calif. Civil Code §§1102, 2079

The seller's and their agent's failure to disclose prior to acceptance is an omission of facts, called *negative fraud, deceit* or *misrepresentation by omission*.

The most significant issue arising out of these discoveries concerns the price the buyer agreed to pay in the purchase agreement. The seller and buyer agreed on a price for the property based on the conditions *disclosed and known* to the buyer at the time the offer was accepted.

The key: the price represents the agreed value of a used, but defect-free property, except for any defects observed by the buyer or disclosed to the buyer prior to entering into the purchase agreement. The price exceeded the property's fair market value by the amount of the costs which will be incurred to cure the defects and deliver the property "as disclosed" prior to acceptance.

Confirm the seller's disclosures

A seller and the seller's broker need to disclose to a prospective buyer all known and observable property conditions which adversely affect the value of the property.

A TDS completed by the seller and seller's agent, without the benefit of an HIR, typically does not accurately or fully reveal the significant property defects or code violations which actually exist, whether or not known to the seller or seller's agent.

When the seller has not obtained or refuses to authorize the preparation of an HIR prior to entering into a purchase agreement, the buyer is well-advised to order one on opening escrow to confirm the condition of the property before the expiration of any cancellation period.

A buyer needs to undertake an inspection and receive an HIR in the interest of avoiding:

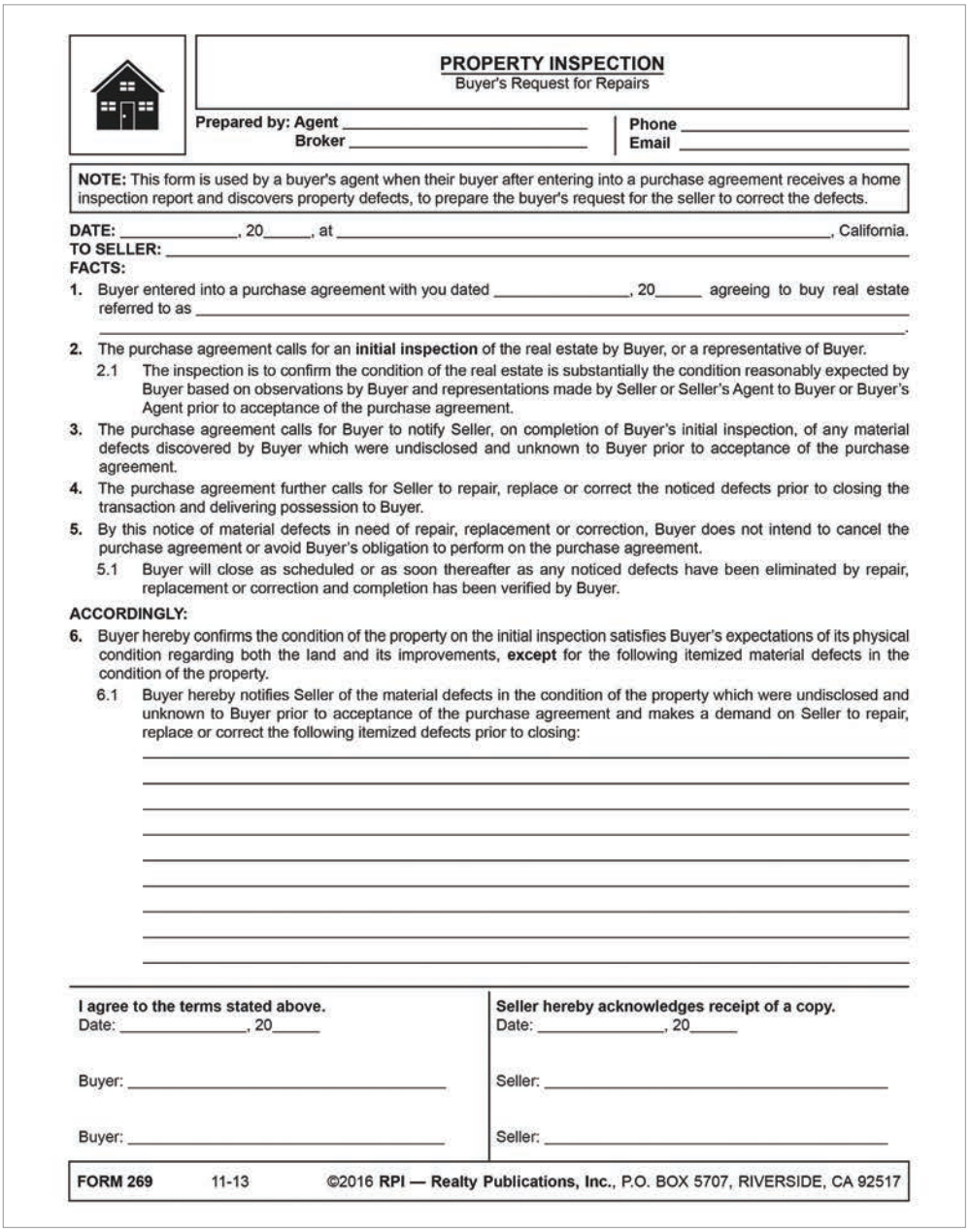
- after-closing discoveries of defects which require correction; and
- after-closing claims made against the seller to recover the value lost or the costs incurred to correct the defects.

The buyer's discovery of defects after acceptance of the purchase agreement and *prior to closing* — whether by the buyer's investigation or by the seller's tardy disclosure — does not alter the buyer's right to close escrow, acquire the property and pursue the recovery of costs or the loss of value due to undisclosed *defects known* to the seller or the seller's agent.

Armed with an HIR containing findings of material defects not known to the buyer or disclosed at the time the purchase agreement was accepted, the buyer is able to make the necessary demands on the seller. Thus, the buyer

Form 269

Property Inspection — Buyer's Request for Repairs



PROPERTY INSPECTION
Buyer's Request for Repairs

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

NOTE: This form is used by a buyer's agent when their buyer after entering into a purchase agreement receives a home inspection report and discovers property defects, to prepare the buyer's request for the seller to correct the defects.

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 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.

ACCORDINGLY:

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.
Date: _____, 20_____

Buyer: _____

Buyer: _____

Seller hereby acknowledges receipt of a copy.
Date: _____, 20_____

Seller: _____

Seller: _____

FORM 269 11-13 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

ensures the property is delivered in the condition *as disclosed* by the seller on entering into the purchase agreement, whether or not a TDS was received prior to acceptance of the buyer's offer.

The buyer's remedies for deceit

If a home inspection report reveals property defects unknown and previously undisclosed to the buyer, the buyer may:

- **make a demand** on the seller to correct or eliminate the defects, and refuse to close escrow until the seller has either complied or agreed to an adjusted price [See Form 269];

Form 270

Final Walk-Through Inspection

FINAL WALK-THROUGH INSPECTION
Final Condition-of-Property Confirmation

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

NOTE: This form is used by a buyer's agent when the buyer conducts a final walk-through inspection at the time for closing escrow and observes that requested repairs have not been completed, to make a demand on the seller to complete the repairs.

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 a **final walk-through inspection** of the real estate by Buyer, or a representative of Buyer.
   2.1 The purpose of the final walk-through is to verify that the condition of the real estate at the time of closing 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 final walk-through inspection of the following:
   3.1 any lack of maintenance during the escrow period; or
   3.2 failure of Seller to make repairs and correct defects, which Seller was given notice of after Buyer's receipt of the Condition of Property Transfer Disclosure Statement (TDS) and Property Inspection — Request for Repairs. [See **RPI** Forms 304 and 269]
4. By this notice of the need for repair or maintenance, Buyer does not intend to cancel the purchase agreement or avoid Buyer's obligation to perform on the purchase agreement.
   4.1 Buyer will close as scheduled or as soon thereafter as completion of any repairs and maintenance can be verified by Buyer.

ACCORDINGLY:

5. Buyer hereby confirms the condition of the property on the final walk-through inspection satisfies Buyer's expectations of its physical condition regarding both the land and its improvements, except for the following list of items regarding the condition of the property.
   5.1 Buyer hereby notifies Seller of the condition of the property which is not in working order or has not been corrected as previously requested and makes a demand on Seller to repair, replace or correct the following itemized condition(s) 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 270 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

- **refuse to close escrow** for lack of seller compliance to the demand for corrections and enforce the agreement and its price correction provisions by *specific performance*; or
- **close escrow** and make a money demand on the seller for the difference between the purchase price set in the purchase agreement and the price as adjusted for the undisclosed defects as called for in the purchase agreement.

price adjustment provision
A provision contained in a purchase agreement calling for an adjustment in the price paid for a property to cover the costs necessary to bring the property into the condition as disclosed at the time of acceptance.

If the purchase agreement entered into by the seller and buyer contains a **price adjustment provision**, the buyer is able to enforce a reduction of the purchase price before closing. The *price adjustment* is to be for the amount of the costs necessary to bring the property into the condition as disclosed by the seller or the seller's broker and known to the buyer at the time of acceptance. [See **RPI** Form 150 §11.2(c)]

Also, by the seller failing to deliver the property in the condition disclosed prior to acceptance, the seller has failed to convey the property as agreed. Thus, the buyer is justified in refusing to close escrow until the seller compensates the buyer for, or corrects, the defects discovered during escrow.

However, if the buyer is made aware of facts about the condition of the property at the time the buyer enters into the purchase agreement, which puts a buyer on notice to investigate into their consequences, the buyer has no grounds for claiming a loss for the condition they knew about.[2]

Final pre-closing inspection

A buyer needs to personally re-inspect the property just before close of escrow to confirm:

- the quality of any repairs made by the seller; and
- the general condition and maintenance of the property after entering into the purchase agreement.

The buyer's right to a final pre-closing inspection of the property is agreed to in the purchase agreement. [See **RPI** Form 150 §11.4(b)]

On final inspection of the property, the buyer lists any property defects not already addressed, such as equipment and fixture malfunctions or deferred maintenance, on the final walk-through inspection statement. [See Form 270 accompanying this chapter]

2 **Jue** v. **Smiser** (1994) 23 CA4th 312

Chapter 13 Summary

A Transfer Disclosure Statement (TDS) completed by the seller and seller's agent, without the benefit of an home inspection report (HIR), typically does not accurately or fully reveal the significant property defects or code violations which actually exist, whether or not known to the seller or seller's agent.

When the seller has not obtained or refuses to authorize the preparation of an HIR prior to entering into a purchase agreement, the buyer is well-advised to order one — with the guidance of their agent — on opening escrow to confirm the condition of the property before the expiration of any cancellation period.

The purpose of the home inspection is to have an independent, neutral, third party conduct an investigation and prepare an HIR on the physical aspects of improvements on the property. An HIR from a competent inspector assures a prospective buyer the property is free of defects, except those listed on their inspection report.

If a home inspection report reveals property defects unknown and previously undisclosed to the buyer, the buyer may:

- make a demand on the seller to correct or eliminate the defects, and refuse to close escrow until the seller has either complied or agreed to an adjusted price;
- refuse to close escrow for lack of seller compliance to the demand for corrections and enforce the agreement and its price correction provisions by specific performance; or
- close escrow and make a money demand on the seller for the difference between the purchase price set in the purchase agreement and the price as adjusted for the undisclosed defects as called for in the purchase agreement.

If the purchase agreement entered into by the seller and buyer contains a price adjustment provision, the buyer is able to enforce a reduction of the purchase price before closing.

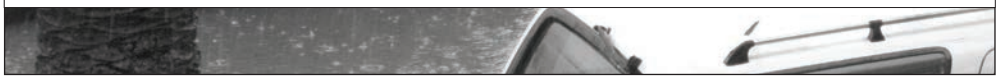
A buyer then needs to personally re-inspect the property just before close of escrow to confirm:

- the quality of any repairs made by the seller; and
- the general condition and maintenance of the property after entering into the purchase agreement.

Chapter 13 Key Terms

Chapter 14

Natural hazard disclosures by the seller's agent



Learning Objectives

After reading this chapter, you will be able to:

- identify natural hazards which need to be disclosed;
- comply with mandated disclosures of natural hazards on all types of property; and
- avoid liability by use of a natural hazard expert to investigate the public record for known hazards.

Key Terms

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

A unified disclosure for all 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 might 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.

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

1 Calif. Civil Code §1103(c)

Natural Hazard Disclosure Statement (NHD) 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 **RPI** Form 314]

Whether a seller lists the property with a broker or markets the property themselves, the seller is to disclose to prospective buyers 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 buyers concerning natural hazards which affect a property, the California legislature created a statutory form entitled the **Natural Hazard Disclosure Statement (NHD)**. [See Figure 1, **RPI** Form 314]

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 Figure 1, **RPI** 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 buyers 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 buyer to agree to waive their right to receive the seller's NHD statement is void as against public policy.[3]

Regarding sellers who are excluded from using the form, they still need to make the disclosures reference in the NHD. It is that they do not need to use the statutory NHD Statement to make those disclosures. Thus for excluded sellers, the NHD is the **optional** method for making the mandatory disclosure of natural hazard information to their buyers.

Mandated delivery of NHDs

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 buyer's agents involved, have a general duty owed to prospective buyers to disclose conditions on or about a property which are **known to them** and might adversely affect the buyer's willingness to buy or influence the price and terms of payment the buyer is willing to offer.

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

---

2 CC §1103.2

3 CC *§1103(d)*

4 CC §1103.1(b)

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 buyer before they enter into a purchase agreement on the property. If not disclosed, the buyer may cancel the transaction, called **termination**. And if the transaction has closed escrow, the buyer may **rescind** the sale and be **refunded** their investment, called **restoration**.[5]

termination
The cancellation of a transaction before escrow has closed or a lease has ended.

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. If not prepared, the seller's agent will be 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.

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

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 the buyer will pay.[6]

Investigating the existence of a hazard

Natural hazard information is obtained from the **public records**. If not retrieved by someone, the seller and seller's agent cannot make their required disclosures to prospective buyers.

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);
- **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 buyers or buyer's agents.[8]

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)
8 CC §1103.2(f)(2)

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**.

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

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 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 an agent is not mandated to use of 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 buyers before going under contract.

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

Avoiding liability for errors

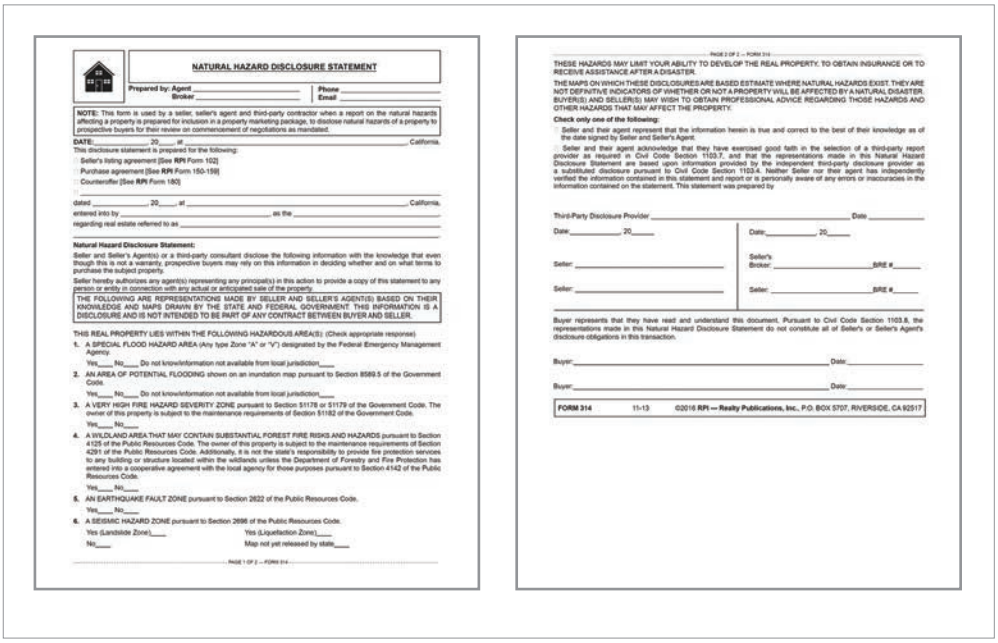
Neither the seller nor the seller's agent need enter into an **indemnification agreement** with the natural hazard expert to avoid liability for errors. By statute, the expert who prepared the NHD is liable for any errors, not the seller or seller's agent who relied on the report of a non-negligently selected expert to fulfill their duty to check the public records.

However, if a buyer 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, will cover the cost of any litigation which might unnecessarily haul the broker into court. [See **RPI** Form 131]

---

9 CC §1103.4(c)

10 CC §§1103.4(a), 1103.4(b)



NATURAL HAZARD DISCLOSURE STATEMENT

Prepared by: Agent _____ Phone _____
Broker _____ Email _____

NOTE: This form is used by a seller, seller's agent and third-party contractor when a report on the natural hazards affecting a property is prepared for inclusion in a property marketing package, to disclose natural hazards of a property to prospective buyers for their review on commencement of negotiations as mandated.

DATE: _____, 20____, at _____, California.
This disclosure statement is prepared for the following:
☐ Seller's listing agreement [See **RPI** Form 102]
☐ Purchase agreement [See **RPI** Form 150-159]
☐ Counteroffer [See **RPI** Form 180]

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____
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____

PAGE 1 OF 2 — FORM 314

PAGE 2 OF 2 — FORM 314

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: _____ Seller: _____ BRE #_____

Buyer represents that they have read and understand 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: _____

FORM 314 11-13 ©2016 **RPI** — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

Figure 1

Form 314

Natural Hazard Disclosure Statement

Caution: The seller's agent's **dilatory delivery** of an expert's NHD to the buyer or the buyer's agent, after the offer has been accepted, will not protect the broker from *liability* for the buyer's lost property value due to the nondisclosure before acceptance. If the agent **knew or ought to have known** 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 buyer 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 might 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 and seller's agent to deliver the NHD Statement to the buyer is required to be documented by a provision in the purchase agreement.[13] [See **RPI** Form 150 §11.5]

11 CC §1103.13
12 CC §1103.2(g)
13 CC §1103.3(b)

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, their seller is **statutorily penalized**.

The buyer 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 when the NHD Statement was handed to the buyer; or
- a five-day right of cancellation when the NHD Statement was mailed to the buyer.[14]

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

Delivery of the NHD to the buyer

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

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

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

However, the seller's agent, unlike the buyer's agent, when in direct contact with the prospective buyer has no duty and is not required to explain the effect hazards have on the property or the buyer. Also, the seller's agent has absolutely no duty to voluntarily explain to a prospective buyer the effect a known natural hazard (which is itself disclosed) might have on the property or the buyer.

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

---

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 buyer.[18]

Sellers occasionally act as *"For Sale By Owners" (FSBOs)* and directly negotiate a sale of their property with buyers and buyer's agents. Here, the seller is responsible for preparing or obtaining an NHD statement and delivering the NHD Statement to the prospective buyer – 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 buyers 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 buyer is to be handed the information before the price and terms are set if the seller's agent is to avoid misleading the buyer, called **deceit**.[19]

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

Good brokerage practice arranges for delivery of the NHD to the prospective buyer before an offer is made or a counteroffer accepted. At that moment in time, the buyer remains the prospective buyer 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.

As a matter of proper 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 (ad TDS/etc.) law.

As for an **escrow officer** handling a sale in which the seller's agent fails to provide the buyer's agent or the buyer with the NHD prior to opening escrow, the escrow officer has no duty to the seller or buyer to prepare, order out or deliver the NHD (or the TDS or other reports) to the buyer. 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

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 natural 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, will 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 statement as part of their report.[23]

Seller's agent's duties on non-targeted transactions

On non-targeted transactions, 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 (preferably 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 buyers; and
- does all this before an offer is accepted or a counteroffer submitted to a prospective buyer.

Other disclosure statements distinguished

The NHD Statement handed to a prospective buyer 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 **RPI** Form 304 §C(1); see Chapters 9 and 16]

---

21 CC §1103.1(a)
22 CC §1103.1(b)
23 CC §1103.2(f)(2)

The TDS and purchase agreement provisions disclose health risks resulting from **man-made** physical and environmental conditions affecting the use 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 Figure 1, **RPI** 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.

Information about flood hazard areas and zones come from:

- city/county planners and engineers;

24 CC §1103.2

- county flood control offices;
- local or regional FEMA offices; and
- the U.S. Corps of Engineers.

Flood zone resources

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: *fema.gov*.

Flood Insurance Rate Maps and Flood Hazard Boundary Maps are all available at the FEMA Flood Map store by calling (877) 336-2627 or via the web at: *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 Figure 1, **RPI** 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 buyer's agent is to inquire further to learn the significance of the disclosure to the buyer.

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 buyer. [See Figure 1, **RPI** 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 buyer on the type of maintenance and the consequences of owning property subject to the maintenance are the duties of the buyer's agent, if they have an agent.

For example, a buyer occupying a residence located in a very high fire hazard severity zone is advised by the buyer's agent that as the new owner, the buyer is to, among other things:

25 Calif. Government Code §8589.5(a)
26 Gov C §51179

- 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
- 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 buyer's agent ought 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 Figure 1, **RPI** Form 314 §4]

In addition, the NHD Statement advises the prospective buyer 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 Figure 1, **RPI** Form 314 §4]

However, if property disclosures place the property in a wildland area, the buyer's agent has the duty to advise the buyer 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.

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

The maps are used to identify whether the listed property is located within one-eighth of a mile on either side of a fault.

Also, the NHD Statement requires both the seller and the seller's agent to disclose to a prospective buyer or the buyer's agent whether they have knowledge the property is in a fault zone. [See Figure 1, **RPI** 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, **RPI** 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: *conservation.ca.gov/cgs/shzp/Pages/Index.aspx*.

If the NHD indicates a seismic hazard, the buyer's agent is to then determine which type of hazard, the level of that hazard and explain the distinction to the buyer, or be certain someone else does. The seller's agent has no such affirmative obligation to explain the impact of the disclosures to the buyer.

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 buyer'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.

Additional seismic hazards

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.

---

33 Pub Res C §2692(a)

34 Pub Res C §2692.1

35 Pub Res C §2692(c)

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.

Tsunami inundation maps are available from the California Department of Conservation at: *conservation.ca.gov/cgs/geologic_hazards/Tsunami/Inundation_Maps*.

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 will be flooded 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 14 Summary

The existence of a hazard due to the geographic location of a property affects its desirability, and thus its value to prospective buyers. 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 buyer. Natural hazards are disclosed using the statutory Natural Hazard Disclosure Statement (NHD).

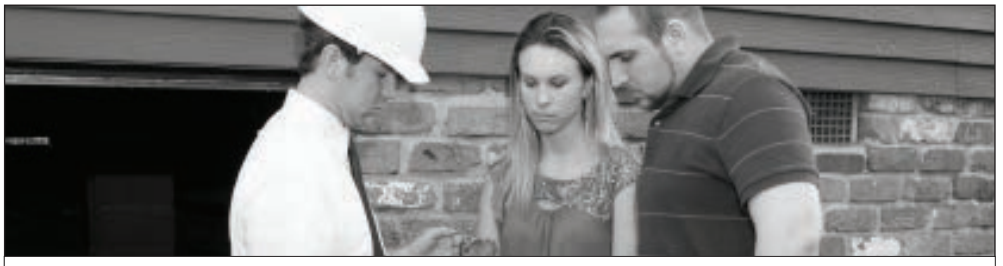
The NHD Statement discloses risks to life and property which exist in nature due to the property's location, risks known and readily available from the public records (planning department) and are unrelated to the risks to life and property from man-made physical and environmental conditions disclosed by a TDS. The NHD assists buyers 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 buyers, 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 14 Key Terms



Chapter 15

Structural pest control reports and repairs

Learning Objectives

After reading this chapter, you will be able to:

- advise sellers and buyers on their respective responsibilities for removal of pests and needed repairs;
- explain the contents and consequences of information in a Structural Pest Control report (SPC); and
- manage the role of an SPC provider in real estate transactions.

Key Terms

certificate of clearance
inaccessible areas
Pest Control Certification
separated report
Structural Pest Control report (SPC)

Pricing and asymmetric information

When a home with wood components goes on the market, the war over the Wood Destroying Pests and Organisms Inspection Report, commonly called a **Structural Pest Control report (SPC)**, and the repairs begins.

First, in one corner is the seller. The seller will tell the seller's agent that they have seen neither hide nor hair of anything resembling a termite infestation. Thus, there is no need for either a report or a clearance. As for repairs, the seller is all for selling the property in an "as the buyer sees things" condition.

The seller's paladin on this field of battle is the seller's agent. Conscientious seller's agents will push their sellers to order out the *SPC report* and repair any fixable conditions now in the name of **transparency**—and an earlier and better priced sale.

Armed with a pest control operator's **certificate of clearance**, the seller's agent will be better able to get the listing price for the property. Later

Structural Pest Control report (SPC) A report disclosing any active infestations, damage from infestations or conditions which may lead to infestations.

renegotiations of the sales price due to a delayed, in-escrow disclosure of discoverable material defects like wood-destroying infestations and infections is avoided.

Others, of course, prefer to do nothing and let sleeping termites lie, just as the sellers want. Thus, the uncertainty of a risk of loss is shifted to the buyer, letting buyers check out the property to see what they may find.

The buyer's agent as champion

In the other corner is the prospective buyer. During their observations of the property, buyers are likely blind to all that moves (like termites) beneath the painted surface. Buyers want to purchase a sound home, but do not know all the right questions to ask, or worse, all the silence games the multiple listing service (MLS) gatekeepers have learned to play as seller's agents.

Here, the buyer's champion is the buyer's agent. It is the buyer's agent who is burdened with the mission of fighting industry-wide **seller bias** by:

- ferreting out the *undisclosed facts known or readily available* to the seller and the seller's agent;
- determining the *veracity of the disclosures* they do receive; and
- reviewing a *due diligence checklist* with the buyer to make sure the buyer takes the necessary steps so the buyer's purchase is, among other things, free of termites.

The seller who gets their way

Sellers are occasionally allowed to control the conversation with their agent at the listing stage and take a pass on the opportunity to order an SPC report and clearance. When termites are later disclosed to the buyer after acceptance of an offer to purchase, no one wins and ill-will is spread all around.

Consider an SPC report first delivered to the buyer *after* entering into a purchase agreement. It discloses the existence of termites or structural damage due to a termite infestation or a fungi infection which the buyer was not previously made aware of. The buyer was not told about their existence and did not observe termite conditions on the various walk-through reviews of the premises prior to the seller accepting the buyer's purchase agreement offer.

Upon finding out, the buyer feels taken. The seller is irritated, either at being found out or at not being properly advised by their agent on the likely need for a report. To keep the deal together, the two agents must now engage in testy negotiations over who is to pay for the corrections and the issuance of a **certificate of clearance**, and resolve an issue that need not have existed in the first place.

certificate of clearance
A document certifying a property has been cleared of all infestations and all repairs necessary to prevent infestations have been completed.

The real irritation for the buyer is the concept of **buyer responsibility** fostered by the pest control provisions in the real estate trade association purchase agreement forms when their agent chose to use that form over others.

The provisions require the buyer to consider paying for repairs and clean-up in order to get a *certificate of clearance*—a contingency in the purchase agreement. But existing pest control issues adversely affect the value of the seller's property and the price the buyer will pay.

Full transparency in marketing

In **boom times**, sellers get their way since they can demand top dollar, not disclose property defects until just prior to closing, refuse to correct any of those deficiencies and, by agreement, force buyers to incur the cost if they are going to finance and buy the property. Using a trade association purchase agreement with such termite provisions places the buyer at a serious disadvantage.

Worse yet, no *contractual relief* exists for the buyer when the seller knows termites exist before accepting a purchase offer, repairs are needed to obtain a clearance and the seller refuses the buyer's demands for the seller to get a clearance by removing the termites and their damage.

In **bust times**, such as experienced during the recovery from the 2008 recession and financial crisis, it's the buyers who get all they demand (except for 2009 and 2013 price bounces).

With *full transparency* at the marketing stage when the prospective buyer is first exposed to the property instead of a belated disclosure of the defects after the buyer's purchase offer has been accepted, the seller avoids all the in-escrow demands to get the defects repaired, the property maintained, and most importantly, the price reduced for any minor dislikes threatening the close of the deal.

Eliminate the risk

Unlike a **Transfer Disclosure Statement (TDS)** or a **Natural Hazard Disclosure Statement (NHD)**, an SPC report is not a legislatively mandated disclosure in a California real estate transaction. Most conventional lenders do not require a report or clearance. [See Chapters 9 and 14]

Since 2005, the FHA has not required automatic SPC inspections, reports and clearances for every home sale involving an FHA-insured mortgage. In an effort to minimize the drop in U.S. homeownership, the requirements for obtaining maximum purchase-assist financing insured by the FHA now require an inspection only if:

- it is customary for home sales in the area;
- an active infestation is observed on the property;
- it is mandated by state or local law; or
- it is called for by the lender.[1]

A prudent buyer's agent is alert to the rule they are duty-bound to act in the best interests of their buyers. Thus, as a matter of good practice, buyer's agents simply prepare purchase agreement provisions to include a call for the seller to provide an SPC inspection, report and certification. Thus, an **SPC**

1 Mortgagee Letter 05-48

contingency provision is placed in the purchase agreement to eliminate uncertainty about the property's condition, regardless of the nature of the buyer's purchase-assist financing. [See **RPI** Form 150 §11.1(a)]

Seller's agents acting in the best interest of their sellers will urge their sellers to authorize a prompt inspection and report upon taking the listing. The report, or better yet the clearance after all recommended repairs are completed, will be included in the seller's agent's **marketing package**.

Upfront disclosure before the seller accepts an offer promotes **transparency** in real estate transactions. *Transparency* avoids personal liability for withholding information about a material fact known to the seller or the seller's agent before acceptance of an offer from a prospective buyer – conduct called **deceit**.

When to deliver the SPC report

The existence of pests such as termites **adversely affects** the value of property. Since these facts relate to value, disclosure is compelled before the buyer sets the price and closing conditions in an offer submitted to the seller.

In a transparent real estate market, the report and clearance are part of the *marketing package* a prudent seller's agent gives to prospective buyers. A request for further information by a prospective buyer constitutes the **commencement of negotiations** for the purchase of a property. Property disclosures are mandated to be made on *commencement of negotiations*.

Delivery ASAP

To best comply with pest control disclosure, a copy of the SPC report is delivered to the prospective buyer or buyer's agent by the seller or their agent **as soon as practicable** (ASAP). If the SPC report is available, ASAP means the SPC report is to be provided at the time the prospective buyer inquires further into the property.

This always occurs prior to the seller accepting or countering a purchase agreement offer submitted by a buyer. Delivery of the SPC report after acceptance of the offer is deficient. Not only is this delivery tardy based on the "ASAP" guideline, but the price has been set without the buyer's full knowledge of the facts adverse to value.

However, if the SPC report is not available and cannot be handed to the prospective buyer until after the seller's acceptance of the purchase offer, closing is automatically contingent on the buyer's right to cancel the purchase transaction.[2]

The term "as soon as practicable" actually carries the same meaning as does the term "as soon as possible." Thus, ASAP means an existing termite report will be delivered to the *prospective buyer* when the seller's agent involved become aware the buyer is going to submit an offer, whether or not it will call for an SPC report or for financing which requires an SPC report.

2 Calif. Civil Code §1099(a)

When an offer is submitted to the seller without prior indication the buyer will require an SPC report, a counteroffer may be made. The counteroffer would deliver the SPC report, and if not available, advise the buyer in the counter of the termite information known to the seller or the seller's agent.[3]

A counteroffer is best used even if its sole purpose is to make the SPC disclosure, without needing to change the terms of the buyer's offer. Disclosure is always most **practical** before the acceptance occurs—ASAP—to determine if the buyer's knowledge of the contents of a report or other knowledge of the termite conditions causes the buyer to reconsider the price or terms of the offer.

Failure to disclose

The **failure to disclose** before the seller accepts the buyer's offer is the result of one of two situations:

1. No one knows about the existence of termites or the damage they created because the readily available inspection and report was not ordered and the discovery was not made before the property was put under contract with the buyer.

2. The seller or the seller's agent resorts to deceit as the existence of a condition which adversely affects value is known to the seller or the seller's agent and not disclosed before the seller accepts the buyer's purchase offer.

The second situation is fraudulent and allows the buyer to pursue the seller and the seller's broker/agent to recover the **cost of repairs**. Contract provisions in the purchase agreement allowing the seller to entirely avoid the cost of termite clearance and repairs are not enforceable when known defects go undisclosed at the time the buyer goes under contract.[4]

A separated SPC report

The custom brought about by the bifurcated pest control handling through an addendum to purchase agreements supplied by the trade associations causes agents to request the SPC company to prepare a **separated report**. The SPC company is occasionally asked by seller's agents to separate their findings and recommendations into two categories:

separated report
A report issued by a structural pest control company which is divided into Section I items, noting active infestations, and Section II items, noting adverse conditions which may lead to an infestation.

1. **Section I items**, listing items with visible evidence of active infestations, infections, or conditions that have resulted in or from infestation or infection; and

2. **Section II items**, listing conditions deemed likely to lead to infestation or infection but where no visible evidence of infestation or infection was found.

3 Calif. Attorney General Opinion 01-406 (August 24, 2001)

4 **Jue** v. **Smiser** (1994) 23 CA4th 312

However, sellers need to order the inspection and report when the property is listed so any necessary repairs will become known, the cost for any correction ascertained, and any repairs completed before a prospective buyer is located. Misrepresentations of the property's condition will not then become surprises during escrow.

On the other hand, it is the intention of some sellers to contract for the buyer to be responsible for the structural pest control clearance, a scenario which easily leads to nondisclosure.

These "defective" conditions of termites and their damage to the property are owned by the seller. In a bust market, the buyer with a buyer's agent whose duty of care it is to protect the buyer is not about to let the seller pass any sort of deficiency which adversely affects the value of the property onto the buyer.

Thus, requesting a separated report in the current climate is misdirected. The intent of a separated report is to divide the type of conditions and, more importantly, to shift the responsibility which is the seller's alone to an unsuspecting buyer.

More to the point, why risk having prospective buyers walk away from your listing, especially in a buyer's market, just because a termite-free home with a clearance and certainty of risk is available around the corner to the risk-averse buyer?

A certificate of clearance

An active termite infestation or fungus infection is occasionally found on an inspection prior to marketing the property. The seller then needs to consider taking corrective measures to both protect the property from further damage and ready it for a prospective buyer by eliminating the issue of termites.

Pest Control Certification
A certificate of clearance by the Structural Pest Control company indicating the property is free of pest infestation or infection in the visible and accessible areas, commonly called a termite clearance.

A **Pest Control Certification**, a certificate of clearance by the SPC company indicating the property is free of infestation or infection in the visible and accessible areas, will then be issued. This certification is commonly called a termite clearance. However, if any signs of infestation or infection **have not been corrected**, it will be noted in the certification.[5]

Section 2 conditions which may lead to future infestations or infections will be noted on the Pest Control Clearance so the SPC company will not be liable for the costs incurred to eliminate those conditions. Section II conditions usually are only observed in homes that do not have a slab foundation and have a crawl space beneath the floor of the structure.[6]

What and when to disclose

Consider a one-to-four unit residential property of wood frame construction listed with a broker who is employed to locate a buyer.

5 Calif. Business and Professions Code §8519
6 Bus & P C §§8516(d), 8519

The seller's agent explains they want the seller to order an SPC inspection and report at the time of the listing since any prospective buyer will want an SPC Report and Pest Control Certification before escrow can close.

The seller's agent receives **written authorization** from the seller and orders an inspection and separated report from an SPC company known to the seller's agent to be competent and diligent. [See Form 132 accompanying this chapter]

The inspection report received from the SPC company states conditions exist which will likely lead to an active termite infestation (Section II items) and recommends repairs and further inspection into inaccessible areas.

Unhappy with the report and the estimated cost of repairs, the seller has the seller's agent get a second opinion from a different SPC company.

The second company states there is an active termite infestation (a Section I item) and lists estimates for repair more extensive than the first company's estimates.

Seller's agent's delivery of all inspection reports

Continuing our previous example, a buyer is located for the property. Deciding to go with the first SPC company's report, the seller completes the repairs recommended by the first company. The seller's agent delivers a copy of the first company's inspection report to the buyer (or buyer's agent), but does not inform the buyer or the buyer's agent of the second inspection report.

Escrow closes and the buyer moves in. The buyer discovers termites and the existence of the second inspection report. The buyer, after paying for extensive repairs and corrective measures, makes a demand on the seller's agent for the costs to correct the damage, claiming the seller's agent was liable since the agent knew about the second report and the termite infestation, a material fact the agent did not disclose.

Is the seller's agent liable for the costs the buyer incurred to cure the termite damage since the agent knew about the second report and the termite damage and failed to disclose the report or its contents?

Yes! The existence of the second report disclosing an active infestation is a material fact requiring its disclosure to the buyer. Here, the condition adversely affected the value and desirability of the property. The seller's agent is responsible to ensure the delivery of all known inspection reports to a buyer. The seller's agent cannot pick and choose which reports to deliver.[7]

Choosing the right company

When choosing an SPC company, the seller's agent needs to protect their client and verify the individual or company's license, the company's registration, and the individual's or company's complaint history by calling the SPC Board at 916-561-8708 (in Sacramento) or 800-737-8188 ext. 2 (outside Sacramento), or at *pestboard.ca.gov*.

7 **Godfrey** v. **Steinpress** (1982) 128 CA3d 154; Department of Real Estate Bulletin, Summer 2004

The Board maintains a two-year history of complaints against every SPC company and information on the company's bond and insurance.[8]

Every company registered with the SPC Board must maintain a $4,000 bond. The bonds are in favor of the State of California for the benefit of any person who, after entering into a contract with a registered, licensed company, is damaged by:

- fraud; or
- dishonesty.[9]

Further, the bonds also protect any person who is damaged as a result of any violation of the SPC Act by a registered and licensed SPC company.

Each company must also have general liability insurance with a minimum of:

- $25,000 for bodily injury; and
- $25,000 for property damage per loss.

The general liability insurance covers financial loss due to:

- property damage;
- public injury; and/or
- illness as a result of the company's actions.

The original inspection and report

The individual or company who does the inspection and issues the report holds a Branch 3 Wood-Destroying Pest and Organisms License/Registration. Those with a **Branch 3 license** may:

- **perform inspections** for wood-destroying pests and organisms;
- **issue inspection reports** and completion notices;
- **conduct treatments**; and
- **perform any repairs** recommended on the inspection report.

An inspection will cover all *accessible areas* to determine whether an active infestation or infection exists or if conditions which will likely lead to future infestations or infections exists. **Inaccessible areas** do not need to be covered in an inspection.

inaccessible areas
Areas of a structure which cannot be inspected without opening the structure or removing the objects blocking the opening, such as attics or areas without adequate crawl space.

An area is considered *inaccessible* if it cannot be inspected without opening the structure or removing the objects blocking the opening. Examples of inaccessible areas are:

- attics or areas without adequate crawl space;
- slab foundations without openings to bathroom plumbing;
- floors covered by carpeting;
- wall interiors; and
- locked storage areas.

8 Bus & P C §8621

9 Bus & P C §§8697, 8697.2

Standardized report

All SPC companies use a **standardized inspection report** form. An inspection report includes, among other elements:

- the inspection date and the name of the licensee making the inspection;
- the name and address of the person ordering the report;
- the address or location of the property;
- a general description of the building or premises inspected;
- a diagram detailing every part of the property checked for infestation or infections;
- a notation on the diagram of the location of any wood-destroying pests (termites, wood-boring beetles, etc.) or fungus present, and any resulting structural damage visible and accessible on the date of inspection, called **Section I items** if a separated report is requested;
- a notation on the diagram of the location of any conditions (excessive moisture, earth-to-wood contact, faulty grade levels, etc.) considered likely to lead to future wood-destroying pest infestations or infections, called **Section II items** if a separated report is requested;
- one of the following statements:
    - **"The exterior surface of the roof was not inspected. If you want the water tightness of the roof determined, you should contact a roofing contractor who is licensed by the Contractors' State License Board."**
    - **"The exterior surface of the roof was inspected to determine whether or not wood destroying pests or organisms are present."**
- a statement of which areas have not been inspected due to in accessibility with recommendations for further inspection of these areas if practical;
- recommendations for treatment or repair;
- information regarding the pesticide(s) to be used, if necessary;
- that a reinspection will be performed if an estimate for making repairs is requested by the person ordering the original report; and
- the following bold-type statement:
    - **"NOTICE: Reports on this structure prepared by various registered companies should list the same findings (i.e., termite infestations, termite damage, fungus damage, etc.). However, recommendations to correct these findings may vary from company to company. You have a right to seek a second opinion from another company."**[10]

10 Bus & P C §8516(b); 16 Calif. Code of Regulations §1990

Standardized report cont'd

Further, the following statement appears prior to the first finding/recommendation on a separated report:

- **"This is a separated report which is defined as Section I/Section II conditions evident on the date of the inspection. Section I contains items where there is visible evidence of active infestation, infection or conditions that have resulted in or from infestation or infection. Section II items are conditions deemed likely to lead to infestation or infection but where no visible evidence of such was found. Further inspection items are defined as recommendations to inspect area(s) which during the original inspection did not allow the inspector access to complete the inspection and cannot be defined as Section I or Section II."**

The SPC chosen furnishes the individual who ordered the inspection a copy of the report within 10 business days of the inspection.[11]

All original inspection reports are maintained by the SPC company for three years.[12]

All SPC companies also post an **inspection** tag in the attic, subarea, or garage on completion of an inspection. The tag includes the company's name and the date of inspection.[13]

Reinspections for corrections made

If an estimate for corrective work is not given by the SPC, the company is not required to perform a reinspection. A reinspection is mandated when a separated report is requested. The separation requires an estimate for repairs to allocate the costs to perform each and every recommendation for corrective measures for Section I and II items.

The **reinspection** is performed within 10 days of a requested inspection. A simple reinspection and certification will occur at that time. However, if more than **four months have passed** since the original inspection and report, a reinspection will not suffice. A full (original) inspection is then completed and a new (original) inspection report is issued.[14]

Work completion and certifications

The person who ordered the report is never required to hire the SPC company that inspected the property to perform any corrective measures. For instance, a second SPC company can be called in to work on the structure. However, this second company sends a Branch 3 licensee to inspect the property since they may not rely on the report furnished by the original SPC company to perform repair work.[15]

Further, the owner may not want to use an SPC company to perform the **corrective work**. Here, the owner may hire a licensed contractor to remove

11 Bus & P C §8516(b)
12 Bus & P C §8516(b)
13 16 CCR §1996.1
14 Bus & P C §8516(b); 16 CCR §1993
15 Bus & P C §8516(b); **Pestmaster Services, Inc.** v. **Structural Pest Control Board** (1991) 227 CA3d 903

and replace a structure damaged by wood-destroying pests or organisms if the work is incidental to other work being performed or is identified by an SPC inspection report. A licensed contractor cannot perform any work that requires an SPC license to complete.[16]

However, when the original SPC company gives an estimate or makes a bid to undertake corrective measures and the owner hires someone else to perform the corrective measures, the original SPC company will need to **return and reinspect** the property before issuing a certification. The original SPC company will not certify treatments performed by another SPC company without a reinspection.[17]

Notice of Work Completed

An SPC company is required to prepare a **Notice of Work Completed and Not Completed** for any work they undertake on a structure. The notice is given to the owner or the owner's agent within 10 working days after completing any work. The notice includes a statement of the cost of the completed work and the estimated cost of any work not completed. A copy of the Notice of Work Completed and Not Completed is delivered by the seller or seller's agent to the buyer or buyer's agent as soon as possible.[18]

If the property is fumigated, the fumigation company (which needs to hold a Branch 1 license) will issue a certification of fumigation within five days.

After any SPC company completes treatment or repairs, a **completion tag** must be placed next to the inspection tag. The completion tag must display:

- the name of the company;
- the date of completion; and
- the name of any chemicals used.[19]

An SPC company is only required to certify its inspection and repair work if requested by the person ordering the report. The company, after completing the inspection or work, will **certify upon request** that:

- the inspection disclosed no evidence of active infestations or infections in the visible and accessible areas;
- the inspection disclosed evidence of active infestations or infections and that they have been corrected; or
- the property is free of active infestations or infections in the visible and accessible areas.

Teaching your seller to "own it"

In a buyer's market and the years immediately following, seller's agents are going to need to school their sellers on what a buyer will and will not tolerate and get their seller's authorization to hire a structural pest control operator. When it comes to the SPC inspection, report, repair and certification, they all

16 Bus & P C §8556
17 Bus & P C §8516(b)
18 Bus & P C §8518; 16 CCR §1996.2; CC §1099(b)
19 Bus & P C §8518; 16 CCR §1996.1

Form 132

Authorization to Structural Pest Control Operator

AUTHORIZATION TO STRUCTURAL PEST CONTROL OPERATOR
(California Business and Professions Code §8516)

NOTE: This form is used by a seller's or buyer's agent when preparing a listing/marketing package or performing a due diligence investigation on a property, to authorize a Structural Pest Control operator to prepare a Structural Pest Control Report for disclosing property conditions to a buyer.

DATE: _____, 20_____, Prepared by _____.

TO STRUCTURAL PEST CONTROL OPERATOR:
Rep's Name _____
Company Name _____
Address _____
_____
Phone _____ Cell _____
Email _____

FROM AGENT/BROKER:
Agent's Name _____
Broker's Name _____
CalBRE# _____
Address _____
_____
Phone _____ Cell _____
Email _____

1. Property address _____
   1.1 Type of property _____
2. Owner's Name _____
   Address _____
   _____
   Phone _____
3. **Inspection**: ☐ Please inspect the property for Structural Pest Control Report purposes, and prepare and deliver your report with any recommendations for necessary corrective work to the above Agent/Broker.
   3.1 Should the property be free of any pest control conditions requiring corrective work, please also issue a Certificate of Corrective Conditions.
4. **Reinspection:** ☐ Please reinspect the property for completion of corrective work and issue your Certificate of Corrective Conditions.
5. Your contact to se the day and time for access to the property is ☐ Agent/Broker, or ☐ Owner.
   5.1 ☐ Agent will be present during the inspection.
   5.2 ☐ If Agent is not present during the inspection, call Agent to discuss your findings before preparing your report.
6. The Structural Pest Control Report or Certificate of Corrective Conditions you prepare and delivier will be used to market the property to prospective Buyers.
7. The fee for your service will be paid by ☐ Owner, ☐ Buyer, or ☐ Agent/Broker.
   7.1 Please submit your billing as follows:
      a. ☐ To Agent/Broker for payment in full on completion of your services and, if applicable, delivery of any reports or documents.
      b. ☐ To Escrow, for payment on the closing of the pending sale.
         Escrow Company _____
         Escrow Office _____
         Escrow Number _____
         Address _____
         phone _____ Fax _____
         Email _____
   7.2 It is anticipated the amount of the fee for your services will be:
      a. Structural Pest Control Report $_____.
      b. Certificate of Corrective Conditions $_____.

Date: _____, 20_____

Submitting Agent's Signature: _____

FORM 132 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

initially belong to the seller. Further, the obligation usually remains with the seller since no buyer's agent worth their salt is going to allow their buyer to purchase termites or their breeding grounds. [See Form 132]

In a seller's market, a seller may be able to make a buyer pay for the seller's termite problem, leave conditions that may lead to future infestations and infections unfixed, and still command a price at a multiple of the amount they paid for the property.

Seller's brokers and agents need to make sure sellers understand that if they don't want to continue "owning" the termites (and the property), they need to fix and maintain the property in a marketable condition. If not, they need to be prepared to fight over the price they want for their home, and most likely lose that battle.

Chapter 15 Summary

Unlike a Transfer Disclosure Statement (TDS) or a Natural Hazard Disclosure Statement (NHD), Structural Pest Control report (SPC) is not a legislatively mandated disclosure in a California real estate transaction. However, the existence of termites adversely affects the value of property. Thus, disclosure is compelled before the buyer sets the price and closing conditions in an offer submitted to the seller.

An SPC report prepared by a pest control operator discloses any active infestations, damage from pest infestations or conditions which may lead to infestations. Once a property has been cleared of all infestations and all repairs necessary prevent infestations have been completed, a certificate of clearance is issued.

In a transparent real estate market, the report and clearance would be part of the marketing package given to any prospective buyer who seeks more information on the property. However, sellers occasionally pass on the opportunity to order an SPC report and clearance during the listing stage. When termites are later disclosed to the buyer after acceptance of an offer to purchase, no one wins.

Purchase agreements frequently include SPC provisions in the terms of purchase or as a condition of financing. When a purchase agreement requires an SPC report, a copy of the SPC report must be delivered to the prospective buyer or buyer's agent by the seller or the seller's agent as soon as possible (ASAP). Contract provisions in the purchase agreement allowing the seller to entirely avoid the cost of termite clearance and repairs are not enforceable when known defects go undisclosed at the time the buyer goes under contract.

In the SPC report, the pest control operator separates their findings and recommendations into two categories:

- items with visible evidence of active infestations, infections; or
- items with conditions deemed likely to lead to infestation or infection but where no visible evidence of infestation or infection was found.

A Pest Control Certification is a statement by the SPC company indicating the property is free of infestation or infection in the visible and accessible areas.

An inspection will cover all accessible areas to determine whether an active infestation or infection exists or if conditions which will likely lead to future infestations or infections exists. Inaccessible areas do not need to be covered in an inspection. An SPC company is required to prepare a Notice of Work Completed and Not Completed for any work undertaken on a structure.

Chapter 15 Key Terms

Chapter 16

Environmental hazards and annoyances

Learning Objectives

After reading this chapter, you will be able to:

- identify man-made environmental hazards which exist on a property, such as asbestos-containing building materials, radon gas or smoke;
- distinguish environmental hazards which exist off a property, such as military ordinance sites and airport influence areas;
- advise on the effect an environmental hazard has on the value and desirability of a property; and
- apply the rules for disclosure of environmental hazards to prospective buyers.

Key Terms

carcinogen
environmental hazards
hazardous waste

Noxious man-made hazards

Environmental hazards are noxious or annoying conditions which are **man-made hazards**, not natural hazards. As *environmental hazards*, the conditions are classified as either:

- **injurious** to the health of humans; or
- an **interference** with an individual's sensitivities.

In further analysis, environmental hazards which affect the occupant in **use and enjoyment** of the property are either:

- located on the property; or
- originate from sources located elsewhere.

environmental hazards
Noxious or annoying man-made conditions which are injurious to health or interfere with an individual's sensitivities.

Environmental hazards on a property

Environmental hazards **located on the property** which pose a direct health threat on occupants due to construction materials, the design of the construction, the soil or its location, include:

- *asbestos-containing* building materials and products used for insulation, fire protection and the strengthening of materials;[1]
- *carbon monoxide* from the combustion of materials, products, supplies or substances located on or within the building;[2]
- *formaldehyde* used in the composition of construction materials;[3]
- *hazardous waste* from materials, products or substances which are toxic, corrosive, ignitable or reactive;[4]
- *radon gas* concentrations in enclosed, unventilated spaces located within a building where the underlying rock contains uranium;[5]
- *toxic mold*;[6] and
- *lead*. [See Chapter 17]

Environmental hazards off a property

Unique factors and conditions **located off the property**, but which have an adverse effect on the use of the property due to noise, vibrations, odors or some other ability to inflict harm, include:

- *military ordnance* sites within one mile of the property;[7]
- *industrial zoning* in the neighborhood of the property;[8]
- *airport influence* areas established by local airport land commissions;[9]
- *mining operations* within one mile of the property;[10] and
- *contamination of a controlled substance* on or within the immediate vicinity of the property. [See **RPI** Form 308]

Criminal activity and a property's value to a buyer

Another hazard seldom disclosed to prospective buyers which has an adverse effect on the property's value is **criminal activity** that may have occurred or is currently occurring on or near the property.

The seller's **neighborhood security disclosure** is used by a seller's agent when preparing a marketing package with information addressing security on or about a property they have listed for sale or lease, or on demand from a prospective buyer/tenant or their agent, to prepare a disclosure for delivery to prospective buyers of facts known or readily available about security conditions on or in the area of the property. [See **RPI** Form 321]

---

1 Calif. Health and Safety Code §§25915 et seq.
2 Health & S C §§13113.7, 13113.8
3 Calif. Civil Code §2079.7(a); Calif. Business and Professions Code §10084.1
4 Health & S C §25359.7; Bus & P C §10084.1
5 CC §2079.7(a); Bus & P C §10084.1
6 Health & S C §§26140, 26147
7 CC §1102.15
8 CC §1102.17
9 CC §§1103.4(c), 1353; Bus & P C §11010(b)(13)
10 Calif. Public Resources Code §2207

Although the disclosure of security conditions which exist on and around a property is not statutorily mandated, timely disclosure provides material information to the buyer under case law when information is "readily available" and "relevant to a buyer's decision."

When a buyer's agent reviews the seller's neighborhood security disclosure with their buyer, the buyer's agent will discuss any disclosures or findings they have made with the buyer. Any costs of providing additional security for their use of the property are then pointed out. Such items include the installation of:

- extra lighting;
- a security system;
- security gates; and
- fences and walls.

The effect on value and desirability

Environmental hazards have an **adverse effect** on a property's value and desirability. Thus, they are considered defects which, if known, are disclosed as *material facts:* the hazards might affect a prospective buyer's decision to purchase the property.

The disclosure to prospective buyers of environmental hazards related to a property known to a seller's and seller's agent is required on the sale, exchange or lease of all types of property.

While the disclosure of an environmental hazard is the obligation of the seller, it is the seller's agent who has the agency duty of care and protection owed to the seller to place them in compliance with the environmental hazard disclosure requirements.

Further, and more critically, the seller's agent also has an additional, more limited duty owed to prospective buyers of the listed property. The seller's agent on taking a listing will personally conduct a *visual inspection* of the property for environmental hazards (as well as physical defects), and do so with a level of competence equal to that of their broker. In turn, the seller's agent uses a **Transfer Disclosure Statement (TDS)** form to advise prospective buyers of their observations (and knowledge) about conditions which constitute environmental hazards.[11] [See Chapter 9]

Environmental hazard booklet

To conclude the seller's agent's disclosure of environmental hazards and eliminate any further duty to advise the prospective buyer about the environmental hazards, the seller's agent delivers, or confirms the buyer's agent has delivered a copy of the **environmental hazard booklet** approved by the California Department of Health and Safety (DHS) to the buyer.

Delivery of the booklet is confirmed in writing through a provision in the purchase agreement. [See **RPI** Form 150 §11.6; see **RPI** Form 316-1]

11 CC §2079

However, the seller's agent might be subjected to an inquiry by either the prospective buyer or the buyer's agent about environmental hazards on or about the property. Here, the seller's agent is duty bound to respond fully and honestly to the inquiry.

Method of disclosure

The notice of any environmental hazard to be delivered to a buyer by a seller is delivered in writing. No special form exists for giving the buyer notice of environmental hazards, as is provided for natural hazards. Until the real estate industry or the legislature develops one, the *TDS* and the purchase agreement are currently used as the vehicles for written delivery.

The TDS is delivered at the time a prospective buyer inquires further about a listed property; a counter offer may be needed to make the additional disclosures covered by purchase agreement provisions.

Some environmental hazards are itemized in the TDS, such as a direct reference to hazardous construction materials and waste, contamination on the property and an indirect reference to environmental noise. [See **RPI** Form 304 §§A and C]

All other known environmental hazards are added by separate itemization in the TDS. As for environmental hazards emanating from off-site locations, they are disclosed through provisions in the purchase agreement since they are typically known to buyer's agents who are familiar with the area. [See **RPI** Form 150 §11.7]

*Editor's note — The environmental hazard booklet is not a disclosure of known defects on the property. The booklet merely contains general information on a few environmental hazards, none of which might actually exist on the property. It is voluntarily delivered to the buyer by an agent, but with no legal mandate to do so. [See **RPI** Form 316-1]*

Regardless of the method of delivery, the seller's agent is to give the environmental hazard disclosures to the prospective buyer as soon as practicable, meaning **as soon as reasonably possible**. As with the disclosure of natural hazards, the legislature intended for the environmental hazard disclosures to be made prior to entry into a purchase agreement.[12]

Need and motivation for disclosure

For the seller's agent to properly anticipate the need to have the disclosures available to deliver to prospective buyers, the effort to promptly gather the information from the seller begins at the moment the listing is solicited and entered into.

The seller and the seller's agent have numerous good reasons to fully comply at the **earliest moment** with the environmental hazard disclosures (as well as all other property-related disclosures). The **benefits of a full disclosure**, up front and before the seller accepts an offer or makes a counteroffer, include:

- the prevention of delays in closing;

12 Attorney General Opinion 01-406 (August 24, 2001)

- the avoidance of cancellations on discovery under due diligence investigation contingencies;
- the elimination of likely renegotiations over price or offsets for corrective costs due to the seller's agent's dilatory disclosure or the buyer's discovery during escrow;
- the shortening of the time needed for the buyer to complete their due diligence investigation; and
- control by the seller of remedial costs and responsibilities by terms included in the purchase agreement, not by later offsets or demands by the buyer or a court.

The seller's agent needs to document in writing (for the agent's file only) the agent's inquiry of the seller about environmental hazards which are known or may be known to the seller. The agent's list is to itemize:

- all the environmental hazards which might possibly exist on or about a property and the construction materials which contain them;
- the age or date of construction to elicit a review of probable hazardous construction materials used at the time of construction; and
- information known about the property on disclosures the seller received when the seller purchased the property or were brought to the seller's attention on any renovation of the property.

Also, the seller's agent's inquiry into hazardous materials ought to precede the seller's preparation of the TDS. Thus, the seller is mentally prepared to release information about knowledge of defects in the condition of the property. Finally, the seller's agent's visual inspection needs to be conducted before the seller prepares the TDS so the observations may be discussed.

No expert required

The seller has **no obligation to hire an expert** to investigate and report on whether an environmental hazard is present on or about the property. The seller is also not obligated to remove, eliminate or mitigate an environmental hazard, unless the seller becomes obligated under the terms of the purchase agreement with the buyer.

It is the seller's and the seller's agent's knowledge about the property which is disclosed on the TDS. The off-site environmental hazards which affect the use of the property are generally well known by the buyer's agent for inclusion in the purchase agreement. If not included in the TDS or the purchase agreement, a counteroffer by the seller is necessary to disclose — as soon as possible — the seller's and the seller's agent's knowledge of environmental hazards located both on and off the property.

Asbestos in construction materials

Asbestos is any of a diverse variety of *fibrous mineral silicates* which are commercially mined from natural deposits in the earth. In the 1940's manufacturers began mixing asbestos fibers with substances commonly used to produce materials for the construction of residential and non-residential real estate improvements, such as cement, plastic, stucco, vinyl, insulation

and felt roofing materials. Asbestos fibers added greater tensile strength, insulation qualities and fire protection to the construction materials which included them.[13]

carcinogen
A substance which causes cancer in human beings.

However, asbestos is a known **carcinogen**. As an occupant of a building continues to inhale asbestos fiber, they increases their risk of developing negative health conditions.

Construction materials which contain *friable asbestos* are those that can be crumbled, pulverized or reduced to powder by hand pressure when dry. Examples of friable material include:

- the acoustic popcorn ceilings in homes, apartments and offices;
- thermal insulation on pipes and hot water heaters;
- wall texturing compounds; and
- sheet rock joint compounds, called "mud."

Construction materials which contain *non-friable asbestos* cannot be crushed by hand pressure. Examples of non-friable material include vinyl, asphalt or cement items, such as stucco plaster, vinyl tiles and asphalt roofing felts. Of course, on the removal of stucco or plaster, the asbestos may **become friable** since the material is disturbed and broken down for removal, creating particles which may become airborne and inhaled.

The dangers of asbestos

Asbestos is only harmful to humans when the fibers are inhaled and accumulate in the lungs producing, over time and with continuous exposure, an increased risk of cancer.

Thus, asbestos-containing material used in the construction of a building is best left undisturbed by avoiding renovation or demolition. If the material is in good condition (not crumbling or deteriorating), it is best to leave it in place when redecorating or renovating a property.

The seller of a property constructed with asbestos-containing building materials is under no obligation to investigate or have a survey conducted to determine the existence of asbestos on the property — whether friable or non-friable.

Further, the seller is not obligated to remove or clean up any adverse asbestos condition. However, the condition, if known, **will be disclosed**. As a result, a prospective buyer may well condition the purchase of a property containing friable asbestos on its clean up and removal by the seller.

Asbestos fibers have not been used in molded thermal insulation material in spray applications for textured ceilings since 1978.

From 1940 to 1996, some homes were built with materials containing asbestos mixed with other components, such as vinyl floor tiles, backings for linoleum, HVAC duct wrapping, hot water pipe insulation, cement siding and pipes,

13 Health & S C §25925

stucco, plaster, asphalt roofing felts, ceiling and wall insulation, and taping compounds. Any removal of these components requires notification to the local air quality management district and the use of a registered contractor.

Formaldehyde gas emissions

Formaldehyde is a colorless, pungent gas contained in most organic solvents which are used in paints, plastics, resins, pressed-wood fiberboard materials, urea-formaldehyde foam insulation (UFFI), curtains and upholstery textiles. Gas emitted from these materials and products contains *formaldehyde*.

Formaldehyde is a *probable carcinogen* which is likely to cause cancer in humans who inhale the gas emitted by formaldehyde-containing material.

The use of UFFI occurred in construction during the 1970s and was banned in residential property constructed after 1982. However, formaldehyde emissions decrease over time. As a result, properties built during the 1970s and early 1980s with formaldehyde-containing materials give off levels of formaldehyde no greater than newly constructed homes. Over time, emissions decrease to undetectable levels. However, an increase in humidity and temperature will increase the level of emissions.

Radon gas in the soil

Radon is a naturally-occurring radioactive gas. It is not visible, cannot be tasted and has no odor. Detection is by instruments only. *Radon gas* is located in soils with a concentration of uranium in the rock, e.g., granite or shale, beneath it.

Radon is a known human *carcinogen*. The health risk for humans is lung cancer. For smokers, the risk of cancer is substantially increased by radon gas exposure.

Radon gas enters a building from the soil beneath the structure, be it a home, apartment building or nonresidential improvement. Cracks and openings for plumbing in concrete slabs and the porous nature of concrete block basement walls allow the gas from the soil to enter space at or below ground level. Thus, radon is rare in buildings of two or more floors in elevation, except for the ground floor and underground areas.

Radon is sucked into ground floor residential space by interior heating on cold weather days and the use of exhaust fans in the kitchen and bathrooms since these conditions create a vacuum within the lower area of the structure.

However, California residences rarely experience elevated and harmful levels of radon gas emission. Radon does appear in approximately **1% of housing** in California. Proper ventilation avoids the buildup of harmful concentrations of radon in a home or other enclosed space, a function of its design and operation.

Hazardous waste on site

hazardous waste Any products, materials or substances which are toxic, corrosive, ignitable or reactive.

Waste is hazardous if it has the potential to harm human health or the environment. **Hazardous waste** is released into the environment, primarily the soil, by the leaking of underground storage tanks, drum containers, poorly contained landfills or ponds, accidental spills or illegal dumping.

Hazardous waste materials include any product, material or substance which is **toxic**, **corrosive**, **ignitable or reactive**, such as is generated by oil, gas, petrochemical and electronics industries, and dry cleaner and print shops.

Information is available to prospective buyers on their inquiry into the location and status of hazardous waste sites in the vicinity of a home from the "Cortese list" maintained by the California Environmental Protection Agency (EPA).

Mold: the rogue in vogue

Mold produces spores which become airborne. The spores are inhaled by humans who enter or occupy the space within the area generating the spores. There are many different kinds of spores, each having differing effects, if any, on humans. Some may be a mere annoyance, irritating the sensitivities of an individual. Others might be a threat to the health of those who inhale them.

The uncertainty of the toxic nature of mold spores has led to a sort of intellectual moratorium on determining just what kinds of molds have an adverse or harmful effect on humans.

It has also spawned a number of lawsuits as the unknown nature of "toxic mold" has been allowed by politicians and lawyers to stir the fears of the general public.

Inspection for toxic mold

Consider an inspection of a residential unit with conditions conducive to mold (prior dampness) which reveals the presence of mold, including an insignificant amount of **toxic mold** varieties.

The tenant occupying the unit goes to a doctor after suffering from a range of health problems. The doctor, on review of the mold report, attributes the ailments to the existence of toxic mold in the unit.

A second inspection is ordered which confirms the first inspection; the preponderance of the mold present is non-toxic and the amount of toxic mold found is typical of normal conditions and is of a level which does not contribute to health problems.

The tenant seeks compensation for health problems, claiming the landlord neglected their duty to provide a healthful environment since they allowed the development of mold which the doctor says led to the tenant's health issues.

Based on the insignificant amount of toxic mold, is the landlord liable for the tenant's illness?

No, the insignificant amount of toxic mold existing in the unit and the doctor's conclusion that the tenant's health problems are connected to toxic mold do not justify holding the landlord liable.[14]

*Editor's note—The holding of the **Dee** case is apparent from the first line of the opinion, which made it clear that mold is everywhere, in every breath we breathe.*

Mold investigation and disclosure

Sellers are under no obligation to investigate whether the improvements contain mold. If it is known the structure does contain mold, the seller has no obligation to determine if the mold is a threat to human health.

The DHS has not yet set any **standards** for disclosures regarding the existence of mold or **guidelines** for the remediation of mold threats. However, the DHS has published multiple **consumer-oriented booklets** on mold on its website at *www.cdph.ca.gov*.

Until uniform disclosure standards are produced and implemented, the prospective buyer will receive only a generic informational brochure and a writing from the seller and the seller's agent in the form of a TDS advising the buyer of any awareness or knowledge the seller or the seller's agent may have that mold exists on the property. No common knowledge exists for sellers or seller's agents to visually distinguish between harmful and benign molds.

If the seller is aware of mold, regardless of type, the seller is to disclose any awareness of the mold's existence, as well as any other reports or knowledge about the variety of mold which exists.

To produce mold standards and guidelines, the DHS must assemble a **task force** to investigate, review and recommend the content of the standards and guidelines. The DHS anticipates that once the task force is selected, recommendations will not be forthcoming for two additional years. Thus, with the exception of the general booklets, no specific disclosure guidance from the state will likely be available to brokers, agents and sellers to deliver to buyers in the foreseeable future.

14 **Dee** v. **PCS Property Management, Inc.** (2009) 174 CA4th 390

Chapter 16 Summary

Environmental hazards are noxious or annoying conditions which are man-made hazards, not natural hazards. As environmental hazards, the conditions are classified as either:

- injurious to the health of humans; or
- an interference with an individual's sensitivities.

Environmental hazards are defects which, if known, are disclosed as material facts as the hazards might affect a prospective buyer's decision to purchase the property, and on what terms.

The seller's agent must competently conduct a visual inspection of the property for environmental hazards before preparing the Transfer Disclosure Statement (TDS) and advise prospective buyers of their observations (and knowledge) about conditions which constitute environmental hazards. The notice of any environmental hazard to be delivered to a buyer by a seller is delivered in writing. The TDS and purchase agreement are currently used as the vehicles for written delivery.

Further, the seller's agent delivers, or confirms the buyer's agent has delivered a copy of the environmental hazard booklet approved by the California Department of Health and Safety (DHS) to the buyer.

The seller has no obligation to hire an expert to investigate and report on whether an environmental hazard is present on or about the property. It is the seller's and the seller's agent's knowledge about the property which is disclosed on the TDS.

Environmental hazards located on the property which pose a direct health threat on occupants include:

- asbestos-containing building materials;
- formaldehyde;
- radon gas concentrations;
- hazardous waste;
- toxic mold;
- smoke from the combustion of materials;
- security bars which might interfere with an occupant's ability to exit a room to avoid another hazard; and
- lead.

Chapter 16 Key Terms

Chapter 17

Lead-based paint disclosures

Learning Objectives

After reading this chapter, you will be able to:

- use the federal lead-based paint (LBP) disclosure to timely disclose the existence of a lead-based paint hazard on residential properties built prior to 1978;
- determine when to deliver the LBP disclosure to a buyer; and
- advise owners and buyers on the conditions of the LBP disclosure.

Key Terms

lead-based paint **lead-based paint hazard**

Crystal clear transparency

An agent, prior to meeting with the owner to list an older SFR property for sale, gathers facts about the property, its ownership and its likely market value.

As the first step, the agent pulls a *property profile* on the SFR from a title company website. On receipt of the profile, the agent confirms their suspicion that the structure was built **prior to 1978**. The agent is now aware the property is the target of separate state and federal environmental protection disclosure programs designed to prevent the poisoning of children by the presence of **lead-based paint**.

lead-based paint
Any surface coating containing at least 1.0 milligram per square centimeter of lead, or 0.5% lead by weight. [See **RPI** Form 313]

The agent meets with the owner to review the requisite **listing and marketing** requirements laid down by the agent's broker. To prepare for the meeting, the agent fills out the listing agreement and attaches all the information disclosure forms needed to properly market the property and locate a buyer, called a **listing package**.

Disclosure of lead-based paint conditions

Among other informational forms for this pre-1978 SFR property, the agent includes two forms which address **lead-based paint conditions** on the property:

- the **Federal Lead-based Paint (LBP) disclosure** [See **RPI** Form 313]; and
- the California **Transfer Disclosure Statement (TDS)**. [See **RPI** Form 304]

On review of the listing agreement with the owner, the agent explains the **owner's legal obligation**, owed to prospective buyers and buyer's agents, to provide them with all the information:

- known to the owner or readily available to the owner's agent on observation or inquiry; and
- which might adversely affect the value of the property.

By making the **full-transparency** presentation about a property to prospective buyers before the owner enters into a purchase agreement, later renegotiations due to delayed disclosures are avoided, including demands for a price reduction, renovation or cancellation.[1]

Duties of the seller's agent

A full disclosure to the prospective buyer about adverse conditions on the property does not entail a review or explanation by the seller's agent about their effect on the buyer or the property once the facts are disclosed. Application of the facts disclosed and the potential consequences flowing from the facts which may affect the prospective buyer's use, possession or ownership of the property are not among the seller's agent's duties of affirmative disclosure.

However, federal LBP rules do require the seller's agent to advise the owner about the requirements for disclosures to be made to prospective buyer before they enter into a purchase agreement. It is the seller's agent who **insures compliance** by the owner before entering into a purchase agreement.

Editor's note — Regarding the LBP disclosures, the owner has no obligation to have the property inspected or a report prepared on the presence of lead-based paint or any lead-based paint hazards. Also, the owner need not perform any ***corrective work*** *to clean up or even eliminate the lead-based paint conditions, unless agreed to with the buyer.*[2]

Thus, the owner cooperates in the LBP disclosure and their agent's other marketing efforts by:

- filling out and signing the federal LBP disclosure form required on all pre-1978 residential construction [See **RPI** Form 313];
- filling out and signing the TDS containing the lead-based paint, environmental and other property conditions [See **RPI** Form 304];

1 **Jue** v. **Smiser** (1994) 23 CA4th 312

2 24 Code of Federal Regulations §35.88(a); 40 CFR §745.107(a)

- making a physical home inspection report available to prospective buyers as an attachment to the TDS form; and
- providing the seller's agent with copies of any reports or documents containing information about lead-based paint or lead-based paint hazards on the property.

Lead-based paint and hazards

*Lead-based paint***,** defined as any surface coating containing at least 1.0 milligram per square centimeter of lead, or 0.5% lead by weight, was *banned* by the Federal Consumer Product Safety Commission in 1978.[3]

A **lead-based paint hazard** is any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects.[4]

lead-based paint hazard
Any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects. [See **RPI** Form 313]

Editor's note — A list of statewide laboratories certified for analyzing lead in hazardous material, including paint, is available from the National Lead Information Center at (800) 424-LEAD. Lists are also available on the web at epa.gov/lead/national-lead-laboratory-accreditation-program-list.

LBP disclosure content

The **LBP disclosure** form includes the following:

- the *Lead Warning Statement* as written in federal regulations [See **RPI** Form 313 §1];
- the owner's statement *disclosing the presence* of known *lead-based paint hazards* or the owner's lack of any knowledge of existing lead-based paint [See **RPI** Form 313 §2];
- a *list of records or reports* available to the owner which indicates a presence or lack of lead-based paint, which have been handed to the seller's agent [See **RPI** Form 313 §2.2];
- the buyer's statement *acknowledging receipt* of the LBP disclosure, any other information available to the owner and the lead hazard information pamphlet entitled **Protect Your Family From Lead in Your Home** [See Form **RPI** 313 §3.1; see **RPI** Form 316-1];
- the buyer's statement acknowledging the buyer has received a 10-day *opportunity to inspect* the property or has agreed to reduce or waive the inspection period [See Form **RPI** 313 §3.2];
- the seller's agent's statement noting the owner has been informed of the owner's disclosure requirements and that the agent is aware of their *duty to ensure* the owner complies with the requirements [See Form **RPI** 313 §4]; and
- the *signatures* of the owner, buyer and seller's agent.[5]

The owner and the seller's broker each keep a copy of the disclosure statement for at least three years from the close of escrow on the sales transaction.[6]

3 24 CFR §35.86; 40 CFR §745.103
4 24 CFR §35.86; 40 CFR §745.103
5 24 CFR §35.92(a)(7); 40 CFR §745.113(a)(7)
6 24 CFR §35.92(c); 40 CFR §745.113(c)

Further, the disclosure form is to be written in the language of the purchase agreement. For example, if the purchase agreement is in Spanish, then the LBP disclosure will also be in Spanish.[7]

Opportunity to evaluate risk

A prospective buyer of a residence built prior to 1978 is put on notice of LBP conditions by handing them the disclosure forms before they make an offer.

The disclosures advise them they have a *10-day period* after their offer is accepted to evaluate the lead-based paint risks involved. The buyer may agree to a *lesser period of time* or simply waive all their rights to the federally permitted risk evaluation period.

However, disclosures about the SFR property cannot be waived by the use of an "as-is" sale provision or otherwise.[8] [See **RPI** Form 313]

Pre-contract disclosure avoids cancellation

Consider a prospective buyer who indicates they want to make an offer to buy pre-1978 residential property. The seller's agent hands the prospective buyer a lead-based paint disclosure signed by the owner of the property which discloses that lead-based paint is known to exist on the property.

The prospective buyer is also handed independent reports and documents related to the existence of the lead-based paint on the property.

The prospective buyer enters into a purchase agreement offer, but does not waive the 10-day lead-based paint risk evaluation period, wishing instead to *inspect and confirm* the accuracy of the owner's disclosure since the owner's disclosure of the property condition is not a warranty guaranteeing the actual condition of the property.

After the owner's acceptance of the offer, the buyer has the property inspected. The inspector's report states lead-based paint exists as stated in the owner's disclosure documents. The buyer now seeks to cancel the purchase agreement due to the presence of lead-based paint.

May the buyer refuse to complete the purchase of the property due to the existence of the lead-based paint as previously disclosed by the owner?

No! The buyer had full knowledge of the presence of lead-based paint and any lead-based paint hazards *prior to the owner's acceptance* of the purchase agreement offer. Thus, the buyer purchased the property *as disclosed.* Also, the purchase agreement did not contain conditions calling for removal or abatement of the lead-based paint. The risk evaluation period only enabled the buyer to cancel had the owner not disclosed the presence of any lead-based paint or lead-based paint hazards prior to acceptance.

7 24 CFR §35.92(a); 40 CFR §745.113(a)

8 40 CFR §745.110(a)

Thus, prior to the buyer entering into the purchase agreement, the buyer was *put on notice* – transparency – about the presence of lead-based paint on the SFR property. When timely disclosed, the buyer may not later, when under contract, use the existence of lead-based paint as justification for cancellation.

Disclosure exemption

Exempt from the Federal LBP disclosures are **foreclosure sales** of residential property.[9]

Yet, a foreclosing lender still has a **common law duty** to disclose property defects known to them at the time of the foreclosure sale. A foreclosing lender is not protected from liability for intentional misrepresentation (negative fraud by omission – deceit) when the property is sold "as-is" at a foreclosure sale and the foreclosing lender previously fails to disclose a known defect to the bidders.[10]

However, the LBP foreclosure exemption *does not apply* to the resale of housing previously acquired by the lender at a foreclosure sale, commonly called **real estate owned (REO)** property, or to the resale by a third party bidder who acquired the property at a foreclosure sale.

Thus, if a lender or other bidder who acquired property at a foreclosure sale is reselling it, the resale needs to comply with the lead-based paint disclosure requirements.[11]

9 24 CFR §35.82(a)
10 **Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767
11 61 Federal Register 9063

Chapter 17 Summary

Lead-based paint, defined as any surface coating containing at least 1.0 milligram per square centimeter of lead, or 0.5% lead by weight, was banned by the Federal Consumer Product Safety Commission in 1978. A lead-based paint hazard is any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects.

An owner of residential property built prior to 1978 cooperates in the lead-based paint (LBP) disclosure and their agent's other marketing efforts by:

- filling out and signing the federal LBP disclosure form required on all pre-1978 residential construction;
- filling out and signing the TDS containing the lead-based paint, environmental and other property conditions;
- making a physical home inspection report available to prospective buyers as an attachment to the TDS form; and

- providing the seller's agent with copies of any reports or documents containing information about lead-based paint or lead-based paint hazards on the property.

A prospective buyer of a residence built prior to 1978 is put on notice of LBP conditions by handing them the disclosure forms before they make an offer. The disclosures advise them they have a 10-day period after their offer is accepted to evaluate the lead-based paint risks involved.

Exempt from the Federal LBP disclosures are foreclosure sales of residential property. Yet, a foreclosing lender still has a common law duty to disclose property defects known to them at the time of the foreclosure sale.

Chapter 17 Key Terms

lead-based paint ..... **pg. 163**
lead-based paint hazard ..... **pg. 165**

Chapter 18

Marketing condominium units

Learning Objectives

After reading this chapter, you will be able to:

- understand the use and operating restrictions placed on conduct in homeowners' association (HOA) communities in exchange for every other owner-member doing the same;
- identify the obligations and assessments imposed on a buyer of a unit in a common interest development (CID); and
- determine when a seller's agent is to request the HOA deliver the CID documents concerning use restrictions and HOA finances for delivery to prospective buyers when a CID property is listed.

Key Terms

extraordinary expense
homeowners' association (HOA)
pro forma operating budget
regular assessments
special assessments

Managed housing

A buyer seeking to acquire a unit in a condominium project, or in any other residential *common interest development (CID),* is **bargaining for** living restrictions and ownership operating costs unlike those experienced in the ownership of a self-managed, single family residence (SFR).

Ownership of a unit in a condominium project includes compulsory membership in the **homeowners' association (HOA).** The *HOA* is charged with **managing and operating** the entire project.

homeowners' association (HOA) An organization made up of owners of units within a common interest development (CID) which manages and operates the project through enforcement of conditions, covenants and restrictions (CC&Rs).

As a common owner of the project and a HOA member, **use and operating restrictions** are placed on most types of conduct, including:

- parking;
- pets;
- guests;
- signs;
- use of the pool, recreational and other like-type common facilities;
- patio balconies;
- care and maintenance of the unit;
- structural alterations; and
- the leasing of the premises.

The implicit bargain in becoming an owner-member is the consent to conform conduct to meet extensive **use restrictions** in exchange for every other owner-member doing the same. The standards for the conduct are found in the use restriction documents created for the project, such as association bylaws, *Covenants, Conditions and Restrictions* (CC&Rs) and operating rules.

HOA governance

The HOA has a board of directors and committees, both consisting of owner-members who are appointed to oversee the conduct of all the owner-members and their guests. On a committee's recommendation concerning a member's violation of a restriction, rule or policy of the HOA, the HOA takes steps to enforce compliance, usually by a notice of violation to the offending owner-member.

A fair comparison to the member's occupancy in a **multiple-unit housing project**, such as a condominium development, is a tenant's occupancy in an apartment complex of equal quality in construction, appearance and location. The behavior of a tenant in an apartment is also controlled by use restrictions, operating rules and policies established by a landlord in a generally more responsive competitive environment.

As a competitor, a landlord is subject to market conditions when establishing guidelines for tenant conduct. Unlike a HOA, a landlord does not rule by majority vote, committees or directors.

Yet the conduct of tenants is regulated and policed in very much the same way as the conduct of a member of a condo project is policed. **Security arrangements** implemented and maintained for condo projects and apartment complexes are the same, i.e., the property is to be maintained so its use is safe and secure from dangerous defects and preventable criminal activity. Both the landlord and the board of directors of a HOA are responsible for the safety of the users of their respective multiple-housing projects. Both are managed housing.

Classification of member obligations

The bargain entered into on acquiring a unit in a CID is understood by the prospective buyer to include a highly involved **socio-economic relationship** with all other members of the project's HOA.

A commonality of interest arising out of CID ownership creates a relationship amongst the members built not only on *use restrictions* and operating rules, but also on *financial commitments* to one another.

Financially, all members collectively provide all the revenue the HOA needs to pay its expenses. These costs include present and future repairs, restorations, replacements and maintenance of all components of the structures owned through the HOA or in common.

Thus, the obligations undertaken by a prospective buyer who acquires a unit in a CID, and the HOA's documentation of those obligations, fall into two classifications:

- **use restrictions** contained in the association's articles of incorporation, by-laws, recorded CC&Rs, age restriction statements and operating rules; and
- **financial obligations** to pay assessments as documented in annual reports entitled pro forma operating budgets, a Certified Public Accountant's (CPA's) financial review, an assessment of collections and enforcement policy, an insurance policy summary, a list of construction defects, and any notice of changes made in assessments not yet due and payable.

Assessments generate revenue

Two types of assessment charges exist to fund the expenditures of HOAs:

- **regular assessments**, which fund the operating budget to pay for the cost of maintaining the common areas; and
- **special assessments**, which are levied to pay for the cost of repairs and replacements that exceed the amount anticipated and funded by the regular assessments.

regular assessments
Recurring HOA assessments which fund the operating budget to pay for the cost of maintaining the common areas.

Annual increases in the dollar amount levied as *regular assessments* are limited to a 20% increase in the regular assessment over the prior year. An increase in *special assessments* is limited to 5% of the prior year's budgeted expenses.[1]

extraordinary expense
An emergency situation lifting the limits placed on the amount an HOA may charge for regular and special assessments.

An **extraordinary expense** brought about by an emergency situation lifts the limits placed on the amount of an increase in regular and special assessments. *Extraordinary expenses* include amounts necessitated:

- by a court order;
- to repair life-threatening conditions; and
- to make unforeseen repairs.[2]

The schedule for payment of assessments by a member varies depending on the type of assessment. *Regular assessments* are set annually and are due

1 Calif. Civic Code §1366(b)

2 CC §1366(b)

and payable in monthly installments. *Special assessments* are generally due and payable in a lump sum on a date set by the HOA when making the assessment.

The buyer's expectations about assessments

special assessments
A lien against real estate by a public authority to pay the cost of public improvements, such as street lights, sidewalks and street improvements. In a common interest subdivision, an additional charge levied by the association for unanticipated repairs.

To better understand the personal financial impact of assessment obligations, a prospective buyer of a unit needs to analyze the assessments based on:

- the present and future *annual operating costs* the HOA will incur; and
- the amounts set aside annually as **reserves** for future restoration or replacement of major components of the improvements.

If the association's cash reserves are insufficient to pay for foreseeable major repairs to components of the structure, a *special assessment* is used by the association. Special assessments are an immediately call for additional funds from members to provide revenues to cover these extraordinary or inadequately reserved expenditures.

Arguably, repairs and replacements for which assessment revenues are needed to cover HOA costs are expenses any owner of a SFR might incur.

However, the difference in a CID is the individual member cannot substitute time, effort and personal judgment for how much will be paid, when the repairs will take place, how repairs might be financed or exactly what repairs or quality of repairs are appropriate. These decisions are left to HOA committees who hopefully vote based on the same concerns and ability to pay as the prospective buyer of a unit.

Getting the financial house in order

pro forma operating budget
A budget which discloses the amount of assessments collected by an HOA, its cash reserves and whether special assessments are anticipated to occur.

To determine if a HOA has its finances in order, a prospective buyer may look to the financial reports held by the owner or readily available from the HOA on the owner's request.

The HOA's current **pro forma operating budget** is the starting point for the prospective buyer's analysis of the financial impact the purchase of a unit in the CID will have on their income. Again, it is the **regular assessments** which will be increased if reserves are inadequate and a **special assessment** which is levied to cover an immediate expenditure for which insufficient cash reserves exist.

The *pro forma operating budget* makes several mandatory disclosures about the state of the HOA's finances, including:

1. An estimate of the revenues from assessments, paid or delinquent, and the **expenses** the HOA anticipates incurring during the fiscal year covered by the budget. The revenues will exceed expenses since the HOA will set aside cash reserves for the future replacement of major components of the structure.

2. A summary of the HOA's **cash reserves** itemizing:

    - the estimated repair or replacement cost of each major component of the structure owned by the HOA;

- the amount of cash reserves needed to pay for the repairs or replacements of these major components; and
- the cash reserves actually on hand and available to pay for these repairs or replacements.

3. Any determination or anticipation of the HOA's board of directors as to whether **special assessments** will be required in the future for reserves, repairs, replacements or maintenance.[3]

Considering deferred assessments to set value

On review of the HOA's pro forma operating budget, the prospective buyer can quickly determine whether cash reserve shortages exist. If they do exist, the only way for the HOA to get the funds into reserves or immediately pay for the repairs or replacements is to increase the regular assessments (which are paid monthly) or call for a special assessment (which will be a lump sum amount due and payable when set).

Thus, when setting the purchase price of a unit, the buyer considers (the present value of) the amount of **deferred assessments** to be paid in the future, assessments which were not levied and paid by the owner.

Some HOAs initially supply only a *summary* of the pro forma operating budget. In this case, the full budget may be requested and will be delivered without further charge.

Further, the prospective buyer needs to review additional HOA documents to fully **determine the value** (price) of the unit the buyer is interested in purchasing and the **financial impact** assessments will have on the buyer's disposable income.

For example, another financial disclosure issued by the HOA, unless the HOA's revenues are $75,000 or less, is a **CPA's review** of the HOA's financial statement (this is not the pro forma operating budget statement). Look for comments in the CPA's review about deficiencies in reserves, delinquent assessments, or unusual accounting procedures.[4]

HOA assessment enforcement policy

Also available from the HOA is a statement on the HOA's policies for enforcing collection of delinquent payments of assessments.[5]

At issue for a prospective buyer of a unit is the method used by the HOA to **enforce collection** of assessments, e.g.,:

- does the HOA **record a Notice of Default** and proceed with a trustee's foreclosure on the owner's unit, a default which may be cured by the payment of delinquencies and statutorily limited foreclosure costs; or
- does the HOA **hire an attorney and file a lawsuit** requiring a response, a trial and results in a personal money judgment against the owner, all of which has no limit on the dollar amount of costs

3 CC §1365(a)
4 CC §1365(a)
5 CC §1365(e)

and attorney fees to defend or prosecute and, if not paid, becomes an abstract of judgment which is a foreclosable lien on all property owned by the owner and collectible by attaching the owner's wages or salary.[6]

Also, if a "list of defects" in the structure or a disclosure of any changes already made to regular and special assessments that are not yet due and payable exists, it indicates financial inadequacies the HOA is now attempting to cure or cover.[7]

The prospective buyer of a unit in a CID needs to review all readily available HOA information with the buyer's agent **before making an offer**. With this information, the property's fundamentals become more **transparent**, allowing the buyer and the buyer's agent to better determine the price the buyer will pay for the unit and whether or not they have the ability (and desire) to carry the cost of ownership after acquisition.

Even FHA-insured financing requires the HOA to have maintained reserves and that delinquent assessments and investor ownership of multiple units are limited.

HOA documentation

An **association's participation** with a seller's agent in an effort to induce a prospective buyer to enter into a purchase agreement and close escrow on the sale of a unit located within the project is limited to:

- **providing the seller's agent**, on written request from the owner of the listed unit, with documents which include items, statements and reviews regarding the permissible use of the unit and the financial condition of the HOA [See Form 135 accompanying this chapter];[8]
- **providing escrow**, on written request from the owner of the listed unit, with documents which include notices, statements, lists and disclosures regarding the status of the owner's membership in the HOA; and
- **changing HOA administrative records** to reflect the identification of the new owner if the prospective buyer purchases the unit.

The HOA may charge a **service fee** equal to their reasonable cost to prepare and deliver the documents requested by the owner. A charge in connection with the change of ownership is permitted, but is limited to the amount necessary to reimburse the association for its actual out-of-pocket cost incurred to change its internal records to reflect the new ownership of the unit.[9]

Within 10 days after the postmark on the mailing or hand delivery to the HOA of a written request from the owner itemizing the documents sought from the HOA, the **association is obligated** to provide them to the owner. A willful failure to timely deliver up the requested documents subjects the HOA to a penalty of up to $500.[10]

---

6 CC §1367, 1367.1

7 CC §§1367, 1367.1

8 CC §§1368(a)(6), 1368(a)(8)

9 CC §§1366.1, 1368(c)

10 CC §§1368(b), 1368(d)

The association documents regarding use restrictions and financial data are to be delivered by the seller's agent to a prospective buyer prior to entering into a purchase agreement. When disclosures are received by the prospective buyer before the owner agrees to sell , the buyer does not have a valid reason to later use this information to terminate the purchase agreement.

Documents through escrow

Status documents are also available from the HOA on request (usually by escrow) prior to closing. Using these documents, the buyer confirms the owner's representations in the purchase agreement about the status of occupancy and the assessments imposed on the unit being sold.

Escrow's only concern with HOA documents is the receipt of information for the purpose of prorations made necessary by prepaid or delinquent assessments.

The closing documents needed by escrow and the buyer regarding the owner's status with the HOA include:

- the CID's *statement of condition of assessments* in order for escrow to calculate **prorates and adjustments** on closing; and
- any HOA notices to the owner of CC&R violations, a list of construction defects and any assessment charges not yet due and payable in order for the buyer to **confirm the representations** made by the owner in the purchase agreement.

CC&R cover page or stamp

When a real estate broker or their agents provide buyers (or tenants) with a copy of the HOA's use restriction documents or the covenants, conditions and restrictions (CC&Rs) they will use a **cover page or a stamp** on the first page of the CC&Rs. The cover page or stamp will state, in at least 14-point boldface type, the following:

> "If this document contains any restriction based on race, color, religion, sex, sexual orientation, familial status, marital status, disability, national origin, source of income as defined in subdivision (p) of Section 12955, or ancestry, that restriction violates state and federal fair housing laws and is void, and may be removed pursuant to Section 12956.2 of the Government Code. Lawful restrictions under state and federal law on the age of occupants in senior housing or housing for older persons shall not be construed as restrictions based on familial status."

However, the requirement to include this declaration does not apply to documents submitted to the county recorder for recordation.

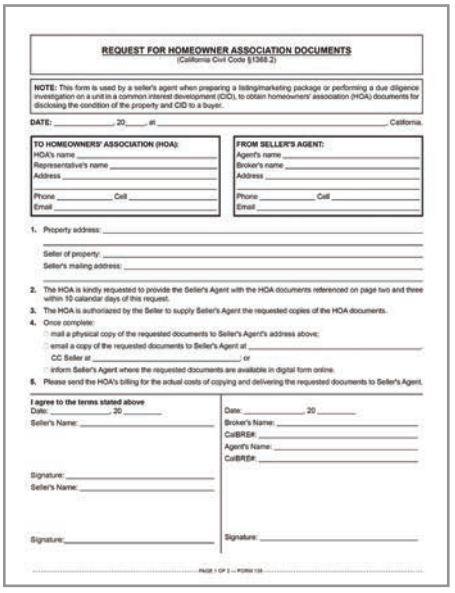
The role of the seller's agent

Unless a seller's agent is remiss, or simply ignorant of their duties owed to prospective buyers, the agent knows exactly what CID information and documents are needed to properly **market and disclose** to prospective buyers the material facts about a condominium unit the agent has listed for sale, called **transparency**.

Figure 1

Form 135

Request for Homeowner Association Documents



REQUEST FOR HOMEOWNER ASSOCIATION DOCUMENTS
(California Civil Code §1368.2)

NOTE: This form is used by a seller's agent when preparing a listing/marketing package or performing a due diligence investigation on a unit in a common interest development (CID), to obtain homeowners' association (HOA) documents for disclosing the condition of the property and CID to a buyer.

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

TO HOMEOWNERS' ASSOCIATION (HOA):
HOA's name _____
Representative's name _____
Address _____
Phone _____ Cell _____
Email _____

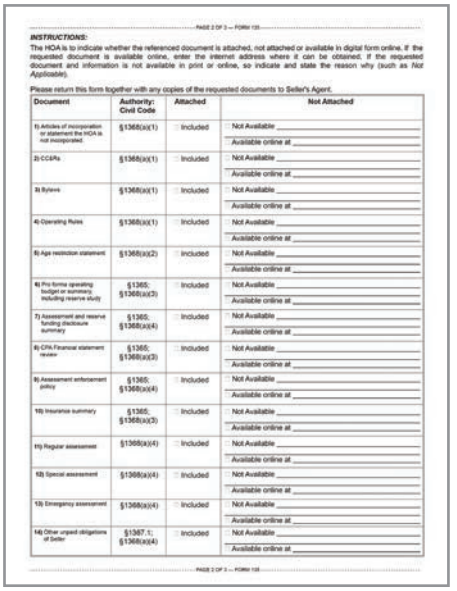
FROM SELLER'S AGENT:
Agent's name _____
Broker's name _____
Address _____
Phone _____ Cell _____
Email _____

1. Property address: _____
   Seller of property: _____
   Seller's mailing address: _____
2. The HOA is kindly requested to provide the Seller's Agent with the HOA documents referenced on page two and three within 10 calendar days of this request.
3. The HOA is authorized by the Seller to supply Seller's Agent the requested copies of the HOA documents.
4. Once complete:
   ☐ mail a physical copy of the requested documents to Seller's Agent's address above;
   ☐ email a copy of the requested documents to Seller's Agent at _____
   CC Seller at _____; or
   ☐ inform Seller's Agent where the requested documents are available in digital form online.
5. Please send the HOA's billing for the actual costs of copying and delivering the requested documents to Seller's Agent.

I agree to the terms stated above
Date: _____, 20 _____
Seller's Name: _____
Signature: _____
Seller's Name: _____
Signature: _____

Date: _____, 20 _____
Broker's Name: _____
CalBRE#: _____
Agent's Name: _____
CalBRE#: _____
Signature: _____

PAGE 1 OF 3 — FORM 135

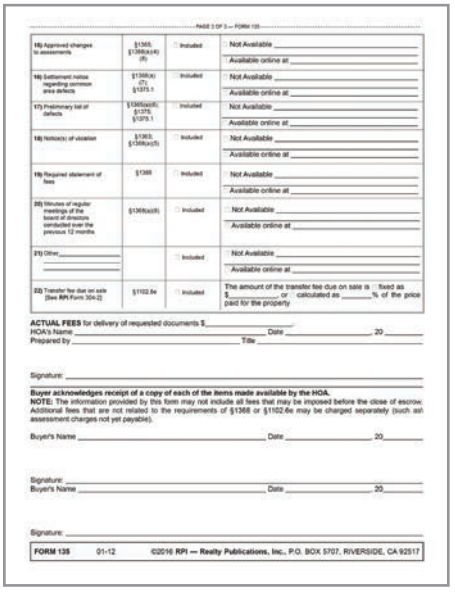


PAGE 2 OF 3 — FORM 135

INSTRUCTIONS:
The HOA is to indicate whether the referenced document is attached, not attached or available in digital form online. If the requested document is available online, enter the internet address where it can be obtained. If the requested document and information is not available in print or online, so indicate and state the reason why (such as *Not Applicable*).

Please return this form together with any copies of the requested documents to Seller's Agent.

Document	Authority: Civil Code	Attached	Not Attached
1) Articles of incorporation or statement the HOA is not incorporated.	§1368(a)(1)	☐ Included	☐ Not Available _____ Available online at _____
2) CC&Rs	§1368(a)(1)	☐ Included	☐ Not Available _____ Available online at _____
3) Bylaws	§1368(a)(1)	☐ Included	☐ Not Available _____ Available online at _____
4) Operating Rules	§1368(a)(1)	☐ Included	☐ Not Available _____ Available online at _____
5) Age restriction statement	§1368(a)(2)	☐ Included	☐ Not Available _____ Available online at _____
6) Pro forma operating budget or summary, including reserve study	§1365; §1368(a)(3)	☐ Included	☐ Not Available _____ Available online at _____
7) Assessment and reserve funding disclosure summary	§1365; §1368(a)(4)	☐ Included	☐ Not Available _____ Available online at _____
8) CPA Financial statement review	§1365; §1368(a)(3)	☐ Included	☐ Not Available _____ Available online at _____
9) Assessment enforcement policy	§1365; §1368(a)(4)	☐ Included	☐ Not Available _____ Available online at _____
10) Insurance summary	§1365; §1368(a)(3)	☐ Included	☐ Not Available _____ Available online at _____
11) Regular assessment	§1368(a)(4)	☐ Included	☐ Not Available _____ Available online at _____
12) Special assessment	§1368(a)(4)	☐ Included	☐ Not Available _____ Available online at _____
13) Emergency assessment	§1368(a)(4)	☐ Included	☐ Not Available _____ Available online at _____
14) Other unpaid obligations of Seller	§1367.1; §1368(a)(4)	☐ Included	☐ Not Available _____ Available online at _____



PAGE 2 OF 3 — FORM 135

15) Approved charges to assessments	§1365; §1368(a)(4) (6)	☐ Included	☐ Not Available _____ Available online at _____
16) Settlement notice regarding common area defects	§1368(a)(7); §1375.1	☐ Included	☐ Not Available _____ Available online at _____
17) Preliminary list of defects	§1368(a)(8); §1375; §1375.1	☐ Included	☐ Not Available _____ Available online at _____
18) Notice(s) of violation	§1363; §1368(a)(5)	☐ Included	☐ Not Available _____ Available online at _____
19) Required statement of fees	§1368	☐ Included	☐ Not Available _____ Available online at _____
20) Minutes of regular meetings of the board of directors conducted over the previous 12 months	§1368(a)(6)	☐ Included	☐ Not Available _____ Available online at _____
21) Other _____ _____		☐ Included	☐ Not Available _____ Available online at _____
22) Transfer fee due on sale [See RPI Form 304.2]	§1102.6e	☐ Included	The amount of the transfer fee due on sale is ☐ fixed as $_____ or ☐ calculated as _____% of the price paid for the property

ACTUAL FEES for delivery of requested documents $_____
HOA's Name _____ Date _____, 20 _____
Prepared by _____ Title _____

Signature: _____

Buyer acknowledges receipt of a copy of each of the items made available by the HOA.
NOTE: The information provided by this form may not include all fees that may be imposed before the close of escrow. Additional fees that are not related to the requirements of §1368 or §1102.6e may be charged separately (such as assessment charges not yet payable).

Buyer's Name _____ Date _____, 20_____

Signature: _____
Buyer's Name _____ Date _____, 20_____

Signature: _____

FORM 135 01-12 ©2016 RPI — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

For a full-size, fillable copy of this, or any other form in this book, go to realtypublications.com/forms

Accordingly, it is at the listing stage when the agent prepares the **owner's request** to the HOA to deliver up the CID documents concerning use restrictions and HOA finances. The documents are immediately available from the association and will be delivered within 10 days of the posted or hand delivered request.[11] [See Form 135]

The owner is obligated by statute to ensure the disclosures are handed to prospective buyers as soon as practicable (ASAP). It is quite easy for the owner to request and quickly receive the documents from the association.

11 CC §§1368(a), 1368(b)

Thus, the ready availability of the documents confirms the disclosures can, as a professional and practical matter, be made available to a prospective buyer before the owner accepts an offer.[12]

However, once the owner lists the property, it becomes the **seller's agent's obligation**, acting on behalf of the owner, to diligently fulfill the owner's obligation to make the association documents available for delivery to prospective buyers, ASAP.

12 CC §1368(a)

Chapter 18 Summary

Ownership of a unit in a condominium project includes compulsory membership in the homeowners' association (HOA). The HOA is charged with managing and operating the entire project.

Thus, the obligations undertaken by a prospective buyer who acquires a unit in a common interest development (CID), and the HOA's documentation of those obligations, fall into two classifications:

- use restrictions; and
- financial obligations.

Two types of assessment charges exist to fund the expenditures of HOAs:

- regular assessments, which fund the operating budget to pay for the cost of maintaining the common areas; and
- special assessments, which are levied to pay for the cost of repairs and replacements that exceed the amount anticipated and funded by the regular assessments.

To better understand the personal financial impact of assessment obligations, a prospective buyer of a unit needs to analyze the assessments based on:

- the present and future annual operating costs the HOA will incur; and
- the amounts set aside annually as reserves for future restoration or replacement of major components of the improvements.

To determine if a HOA has its finances in order, a prospective buyer may look to the financial reports held by the owner or readily available from the HOA on the owner's request. The HOA's pro forma operating budget makes several mandatory disclosures about the state of the HOA's finances, including:

- an estimate of the revenues from assessments, paid or delinquent;
- the expenses the HOA anticipates;
- a summary of the HOA's cash reserves; and

- any determination or anticipation of the HOA's board of directors as to whether special assessments will be required in the future.

Also available from the HOA is a statement on the HOA's policies for enforcing collection of delinquent payments of assessments.

It is at the listing stage when the agent prepares the owner's request to the HOA to deliver up the CID documents concerning use restrictions and HOA finances.

Chapter 18 Key Terms

Chapter 19

Bonded indebtedness for property improvements

Learning Objectives

After reading this chapter, you will be able to:

- understand what off-site improvements are and how they can be separately financed;
- advise sellers and buyers on improvement bond assessments liens; and
- provide for proper accounting of an improvement bond amount in either the price or through prorations as a monetary lien on property for sale.

Key Terms

Mello-Roos **off-site improvements**

Costs of subdividing land to create parcels

The subdivision of property carries with it the need for access roads and facilities, none of which are located on any of the parcels created for sale. The parcels created for sale as lots or condominium units are themselves either improved with structures or unimproved.

All access roads, streets, bridges, distribution systems for water, electricity, natural gas, phones and sewers, as well as parks or other community service facilities are located on portions of the subdivided lands dedicated to the public, not on the lots and units to be sold. The improvements located on the dedicated portions of the subdivided land are called **off-site improvements** since they are not located on or within the parcels sold.

off-site improvements Improvements not located on the lots being sold which add value to the development, such as access roads, street lighting and sidewalks.

Off-site improvements are constructed solely for the benefit of the parcels offered for sale. Without right-of-way access and improvements, the parcels held out for sale would have little value. It is the availability of fully

improved streets, utilities and community facilities which gives value to the parcels. These benefits ultimately set the price a buyer is willing to pay for a lot within a subdivision.

Financially, these *long-term capital improvements* require someone to provide the money necessary to develop them. When the developer or subdivider of the land does not have sufficient capital or the access to conventional mortgage financing to fund the construction of the subdivision's infrastructure, the subdivider or developer may establish an assessment district encompassing their subdivided lands.

The assessment district as an agency borrows the funds the subdivider needs to pay for the cost of the infrastructure improvements by issuing improvement bonds. Bonds are essentially a promissory note with principal, interest and a payment schedule. The bonds become a lien on each of the individual parcels in the subdivision (district) for a pro rata amount of the bonded indebtedness. They are not liens on the publicly dedicated portions of the subdivision which are actually improved by use of the funds.

The lien on each parcel securing the bonds serves the same *economic function* as a trust deed lien for mortgage financing. It is a debt enforceable by a foreclosure sale of the liened parcel if not paid.

The dollar amount of the lien on each parcel represents an allocation of the value of the benefits flowing from the off-site improvements to each parcel, called an *assessment*. Thus, a lien is placed on each parcel to secure the long-term, semi-annual repayment of the cost of the improvements on the dedicated lands. Such a lien is purchase-assist financing by any accounting standard.

Funding off-site improvements

Mello-Roos
The Mello-Roos Community Facilities Act of 1982 authorizes the formation of community facilities districts; the issuance of bonds, and the levying of special taxes thereunder to finance designated public facilities and services.

A subdivider's financing scheme to fund off-site improvements is called **Mello-Roos**, but is deceptively entitled a *special tax*. It is **not a tax**. However, the tax collection authority for each county is established as the agent for the improvement district agency to collect the installments due on the 20-year amortized payoff of the Mello-Roos bonds. The annual installment payment is called an "assessment," also a fabricated misnomer. The assessment is actually the allocation of the total costs of related off-site improvements to each property.[1]

The debt secured by each lot to repay the bonds has a principal amount which remains due and unpaid until it is prepaid or fully amortized. The interest rate on the remaining principal due is set by the rate on the bonds. At any time, the lien for the improvement bonds can be *paid off* by the owner and the "special tax" lien *released from title* to the parcel.

These infrastructure improvement bond liens are *junior* to annual property taxes. An improvement district bonding scheme for adding improvements to the right-of-way infrastructure of an *existing neighborhood*, or in several adjoining neighborhoods, is the **Improvement Bond Act of 1915**.

1 Calif. Government Code §§53311 et seq.

With the 1915 Act, the lots or units do not presently enjoy all the off-site improvements or facilities needed to give the parcels their maximum market value, such as sidewalks, street lighting, sewers, parks, etc.[2]

Thus, the 1915 Improvement Act is a financing arrangement used by parcel owners in existing subdivisions who now want to upgrade the value of their neighborhoods, and with it the value of their properties.

When voted in, a lien is created

In a democratic fashion, the owners vote to create a 1915 improvement district. Bonds are sold to pay for the off-site improvements. If voted in, a *lien* is imposed on each parcel within the improvement district in a dollar amount equal to each parcel's beneficial share of the bonded indebtedness. The bonds are payable in annual amortized installments, including interest on the remaining unpaid balance, until paid.

Of course, solvent owners with available cash can pay their pro rata share of the costs (equal to the value of the benefits received by their parcel) and avoid the lien. Once a parcel is encumbered, the owner may pay off the lien at any time.

On rare occasions, a Mello-Roos *servicing district* will be established for a different purpose by the original subdivider. Unlike the improvement district bonds which can be paid in full at any time, the *service assessment* is annual and continuous, unless scheduled to eventually "sunset." A servicing district assessment for a subdivision is for ongoing services rendered, comparable to the purposes of a homeowners' association (HOA) assessment.

Trust deed lenders and improvement bonds

A purchase-assist lender willing to fund a mortgage as a first trust deed lien on a parcel in a Mello-Roos subdivision encumbered by the improvement bond will be junior, not only to real estate taxes, but also to the "sandwich lien" held by the bondholders who funded the off-site improvements.

Thus, the lender's trust deed lien is junior and second to the monetary lien of the improvement bond with its 20-year principal amortization, and both are junior to the annual property tax lien. If the trust deed lender forecloses and acquires title, the title remains subject to the balance remaining due on the improvement bond lien. As the new owner, the lender is required to pay the installments on the bond (or pay it off completely to become the first/senior lienholder, subject only to property taxes).

Of course, the market value of property needs to equal or exceed all debts which are liens on the property — including property taxes, bonded assessments and the lender's trust deed lien — if all monetary liens are to be satisfied by the property's fair market value (FMV) as they must be or the property has a negative equity.

2 Calif. Streets and Highways Code §§8500 et seq.

Thus, the *value* of the trust deed lender's secured position on title is the difference between the FMV of the parcel with its on-site improvements (usually a home) and the amounts remaining due on the bonds (and any property taxes).

Misleading disclosures

The "special tax assessment" misnomer used to label the semi-annual installment payments due on an improvement bond lien is deceptive. The title as taxes leads prospective buyers to believe they are dealing with an annual property tax, which they are not.

As a result, sellers and their agents, when structuring the terms for payment of the price in a purchase agreement offer, often *ignore the principal* amount of the bonded indebtedness on the property, except to prorate only the current principal and interest installment on the lien, not the principal balance remaining on the lien.

The extensive use by organized brokers of their trade union purchase agreements has memorialized the financial deception into tradition. The amount of the improvement bonds is excluded from the terms with no alternative provisions for payment of the buyer's purchase price provided in their boilerplate wording. The disclosure of the bonded indebtedness assumed by the buyer is placed within the title condition provisions as a tax, which again it is not.

Escrows officers then perpetuate the concept that the improvement lien is not part of the price to be paid by the buyer by limiting prorations to only the current installment, no addressing the debt. Accounting for the *remaining principal* amount of the improvement bond, which is due but not yet payable, is ignored.

Improper accounting

The accounting employed in the trade union's purchase agreement for the buyer's assumption of the bond amount is best compared to an agreement to prorate the current installment on an assumption of a trust deed note while ignoring the elephantine principal amount remaining unpaid on the note — a monetary debenture not unlike an improvement bond. Both have principal, interest and amortized installments. Both are liens on the property.

Under this *disclosure-by-proration approach*, the buyer is given insufficient information by the seller or seller's agent to make an informed decision about assuming the lien for the bond. Alone, the purchase agreement provision does not satisfy the seller's agent's general duty to give the prospective buyer sufficient information to actually place the buyer on notice of the bonded indebtedness. This failure by silence is the deceit involved.

On the other hand, it is the *buyer's agent* who has the duty to further advise their buyer about the lack of an accounting for the bond, rather than simply "going along" with the boilerplate purchase agreement pricing and defective proration arrangements.

Presently, the disclosure of an improvement lien as a proration of taxes has become "standard operating procedure," but remains a contractually deceptive and unacceptable accounting standard.

As a result, the California legislature stepped in during the 1990s with legislation to ensure prospective buyers of real estate received sufficient information to make an informed decision. Sellers (and thus, their agents) were mandated to give to buyers of Mello-Roos encumbered properties:

- a **notice** of the lien for the bonded debt and an *opportunity* to decide whether or not to assume the debt before entering into a purchase agreement; or
- the **right to renegotiate** the terms for payment of the price if they have already agreed to buy before receipt of the notice.

If fully informed, the buyer (and thus the buyer's agent) may prudently require the bond amount to be credited toward the price paid since its entire principal amount has accrued and cannot be prorated.

Statutory Notice of Assessment

The sale of property comprised of one-to-four residential units and encumbered by a Mello-Roos or 1915 Act improvement bond *requires the seller* to disclose the existence and terms of the bonded indebtedness. To comply, sellers need to obtain and deliver to prospective buyers a notice prepared by the improvement district office entitled either *Notice of Assessment* or *Notice of Special Tax*.[3]

Anyone can request a Notice of Assessment from the office of the improvement district at any time, including both the seller's agent and the buyer's agent. No particular manner of request is required since it may be an oral or written request. The district office must deliver the notice to whoever requests it, and do so within five working days of their receipt of the oral or written request. The maximum charge for the service is $10.[4]

The seller has the *primary obligation* to request the notice and deliver it to prospective buyers. Thus, the seller's agent is to advise the seller to request the notice when entering into the listing agreement employing the broker's office to sell the property. [See Form 137 accompanying this chapter]

If the seller refuses to assist the seller's agent by complying with the seller's statutory duty for disclosure of the lien, the seller's agent can request the Notice of Assessment themselves. However requested, the agent needs to include the notice in the *listing package* prepared for disclosing to prospective buyers significant relevant information about the property. Information presented in a listing package is either *mandated*, as is the case with assessment bonds, or *known* to the seller and seller's agent to exist.

Occasionally, the seller's agent lacks knowledge of the lien's existence and thus lacks an opportunity to deliver information on the lien to the prospective

3 Calif. Civil Code §1102.6b

4 Gov C §53754(b)

Form 137

Request for Notice of Mello-Roos Assessment

REQUEST FOR NOTICE OF MELLO-ROOS ASSESSMENT
(California Civil Code §1102.6b)

NOTE: This form is used by a seller's agent when preparing a listing/marketing package or performing a due diligence investigation on a property, to request information from the Improvement District Office about Mello-Roos assessments encumbering the seller's property for disclosing the terms of the bonded indebtedness to a buyer assuming the debt.

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

TO IMPROVEMENT DISTRICT OFFICE:
District Name _____
Address _____
_____
Phone _____

FROM BROKER:
Agent's Name _____
Broker's Name _____
CalBRE#:_____
Address _____
_____
Phone _____ Cell _____
Email _____

You are kindly requested to prepare and foward to Broker identified above a Notice of Assessment regarding real estate referred to as
Property address _____
_____,
Owner's name _____,
containing the following information as the bonded indebtedness encumbering this property:

1. The present principal balance . . . . . $_____
2. The annual rate of interest _____ %,
   2.1 ☐ fixed, or ☐ variable.
3. The interest is paid through _____, 20_____.
4. Annual payments are delinquent for the years _____.
5. Total amount of delinquency to bring the Assessment current . . . . . $_____
6. The amount of each annual installment . . . . . $_____
7. The year of final payment and release of lien . . . . . $_____
8. The bond indebtedness ☐ is, or ☐ is not, a blanket lien on the property with other properties.
   8.1 If the bond is a blanked lien, a provision for release of the property from the bonded indebtedness ☐ does, or ☐ does not, exist.

Enclosed is the statutory maximum fee of $10.00 for preparing and forwarding the Notice of Assessment.
Your response is looked forward to within the statutory five-day period after your receipt of this request.

Date: _____, 20_____

Submitting Agent's Signature: _____

FORM 137 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

buyer prior to submission of an offer. Alternatively, the agent may know of the lien and deliberately delay disclosure until after a purchase agreement has been entered into.

However, when the prospective buyer enters into a purchase agreement with the seller before the Notice of Assessment is delivered to the buyer, the buyer has a *statutory contingency* allowing the buyer to cancel the purchase agreement. The buyer has three calendar days after hand delivery of the Notice of Assessment (five days after posting it by mail) to cancel the purchase agreement by handing a Notice of Cancellation to the seller or seller's agent (not escrow or the buyer's agent).[5]

Differing duties to give notice or advice

Whether a buyer receives a Notice of Assessment before agreeing to buy or after, the contents of the notice, without further explanation or information, have fulfilled the seller's and their agent's *general statutory duty* owed to the buyer to disclose the existence of the assessment.

5 Gov C §53754(c)

On the other hand, a buyer's agent needs to advise the buyer about the need for further facts regarding the assessment so an evaluation of the financial impact the assessments have on the value, price, carrying costs, etc., can be made. Worse yet, if the seller's agent does not actually know if a lien exists, the buyer's broker is obligated to review the *preliminary title report* in order to catch it.

Editor's note — If the purchase agreement does not provide for the assessment lien to remain of record, and the seller and buyer enter into a binding purchase agreement, the seller has agreed to deliver title clear of lien amounts.

Missing data in the Notice of Assessment

The Notice of Assessment (special tax) is a statutory form. However, the contents of the form do not call for the entry of enough data regarding the assessment to sufficiently inform the buyer. Without additional data on the assessment lien, the buyer cannot make an informed decision about the bonded indebtedness. The notice *only includes*:

- the amount of each annual installment (which incidentally could be a variable payment due to inflation adjusted bonds); and
- the last year in which an amortized installment will be paid (thus releasing the lien encumbering the lot as fully paid).

The Notice of Assessment does not include three additional elements about the debt which are needed to determine the *extent of the obligation*, and whether the debt is one to be assumed as a credit toward the price or to be satisfied by the seller:

- the **rate of interest** the bonds bear;
- the **current remaining principal** balance due to discharge the debt; and
- whether the bond lien is a **blanket lien** on the entire subdivision or common interest development (CID), and if so, whether a partial release of a lot is available.

Neither the interest nor the principal balance can be calculated from the information provided in the notice from the assessment district's office. Hence, the buyer's agent must step forward and request this additional information from the district, which the district is required to deliver.

On receipt of the additional information, the buyer and their agent now have sufficient information to commence an analysis of the bonds and make an intelligent decision on pricing, terms of payment, assumption of the bonds, etc. In a word, the buyer's agent needs to provide the buyer with the *transparency* needed to make decisions in a bonded indebtedness transaction.

Accounting for assessment bonds

Along with the differing biases expressed by the content and format of purchase agreements from differing sources, there are also biases for handling of the accounting for bonded assessments on the liens for subdivision improvements.

Some purchase agreements treat the unpaid principal on Mello-Roos or 1915 Act bonds as *additional consideration* paid for the property by the buyer, *over and above the price* agreed to be paid in the offer. For consistency, the current annual installment is then prorated without concern for a breakdown between the installment's principal and interest, or that the buyer assumes several thousands of dollars of principal and interest installments.

Here, the (undisclosed) remaining unpaid principal due on the bonds is not included as part of the stated purchase price the buyer is paying for the property.

Calculation of total consideration lacking

These purchase agreements do not provide for a calculation of the total consideration (price plus bond balance assumed) the buyer is actually paying for the property, called *acquisition costs*. This lack of disclosure is statutorily sanctioned conduct by the seller and seller's agent.

However, their duty of limited disclosure does not apply to the buyer's agent under their duty owed to the buyer.

Without advice from a buyer's agent about the true nature of the improvement assessment bonds, the buyer is unable to understand the nature of the contents of a Notice of Assessment or the payoff aspect. However, the advice of the buyer's agent is logically limited to their actual knowledge about the bond arrangements and any information readily available from the assessment district's office.

On the other hand, other publishers' purchase agreements place the accounting for the bonded indebtedness, if not paid off by the seller, in the price to be paid for the property. Thus, the buyer properly assumes the debt as a lien on the property owed by the seller and part of the price paid.

Accounting with the FMV

The treatment of the amount of the *monetary lien* for the bonded indebtedness is fully equivalent to the assumption of a trust deed lien by a buyer. The principal balance on the improvement bond lien is credited to the price to be paid by the buyer as part of the agreed price, which typically is the property's FMV. [See **RPI** Form 150 §7]

The argument surrounding the two diametrically opposed accounting and disclosure procedures revolves around a determination of the property's FMV.

Would two parcels in the same subdivision improved with identical same-type housing both have different sales prices simply because of the financing which encumbers them? At first glance, the answer is no.

However, for the buyer to be fully advised by their agent about the consequences of both an assumption of the improvement bonds as part of the price paid for the property, or conversely, as an additional amount to be eventually paid but not included in the price, then both of the accounting schemes are *transparent*:

- if the price offered **includes** an assumption of the bond amounts (or the seller is to clear title of the lien), the price will represent the property's FMV (which by definition is free and clear of monetary liens); or
- if the price offered **excludes** the bond amounts which are assumed, the price offered will be less than the property's FMV by the exact amount of the lien for the balance due on the bond.

Therefore, both offers would, in the final accounting, be paying the same total consideration as the *cost of the acquisition* of identical houses in the same subdivision since both houses are subject to the same amount of bonded indebtedness.

Bond assessment liens for energy improvements

Homeowners in some California counties are also able to use bond assessment liens for energy and water efficiency improvements. The **Property Assessed Clean Energy program (PACE)** allows for local governments to borrow by issuing bonds and using the funds to lend homeowners money to cover the costs of installing energy improvements.[6]

The PACE funds lent to the homeowner become a lien on the property as an improvement bond assessment, junior to property taxes but senior to any lender's mortgage on the property. The payments are annual and paid along with the homeowner's property taxes to the county tax collector over an assigned term (typically 15 to 20 years).[7]

Thus, the PACE bond assessment is attached to the property itself and may be paid off on refinancing the property or retained by the buyer assuming the debt on the sale of the property.

However, one significant drawback is the position of the assessment lien on the property. Fannie Mae and Freddie Mac have in the past refused to purchase mortgages secured by properties with outstanding PACE assessment liens. This is due to the lender's impaired security interest caused by the priority position of the lien on the property securing the mortgage.

PACE in California

To alleviate the risk, California created a loss reserve program available to lenders participating in the PACE program across the state. As long as a local PACE program meets the underwriting requirements, the reserve program will reimburse lenders for losses in a foreclosure sale attributed to PACE assessment liens on the property. Thus, it attempts to return mortgage lenders to the same position they were in prior to the PACE assessment lien being placed on the property securing their mortgage.

6 Calif. Public Resources Code §26050

7 Pub Res C §26054

Such supplements to the program have boosted its use across the state. Further, this financing scheme is of particular interest to buyer clients who purchase outdated homes, allowing them to obtain a relatively low-cost PACE loan to install energy improvement that will reduce their monthly utility bills — a reduction that can offset the cost of the PACE funding.

However, as always, agents disclose the existence of PACE assessment liens to prospective buyers of the encumbered property. If the buyer is to assume the PACE lien and the seller not pay it off, agents need to prepare the purchase agreement to include the balance of the PACE debt as a credit against the price paid for the property. It is not a property tax, but it is a 15 or 20 year amortized debt obligation which funded the cost of improvements on the property. For comparison of suitable properties for a prospective buyer, agents provide a side-by-side comparison of expenses, via an *operating cost sheet*. [See **RPI** Form 318]

Chapter 19 Summary

Improvements located on the dedicated portions of subdivided land, but not within the parcels sold, are called off-site improvements. Off-site improvements are constructed solely for the benefit of the parcels offered for sale, giving value to the parcels and ultimately setting the price a buyer is willing to pay.

To fund off-site improvements, a subdivider or developer may establish an assessment district encompassing their subdivided lands. The assessment district obtains the necessary funds by selling improvement bonds, which are added on each of the individual parcels in the subdivision (district) for a pro rata amount of the bonded indebtedness.

The subdivider's financing scheme to fund off-site improvements is called Mello-Roos and is deceptively entitled a special tax, though it is not a tax. However, the tax collection authority for each county collects the annual installments due on the 20-year amortized payoff of the Mello-Roos bonds. The annual installment payment is called an "assessment."

An improvement district bonding scheme for adding improvements to the right-of-way infrastructure of an existing neighborhood, or in several adjoining neighborhoods, is the Improvement Bond Act of 1915.

The sale of property comprised of one-to-four residential units and encumbered by a Mello-Roos or 1915 Act improvement bond requires the seller to disclose the existence and terms of the bonded indebtedness. To comply, sellers need to deliver to prospective buyers a notice prepared by the improvement district office entitled either Notice of Assessment or Notice of Special Tax.

The notice only includes:

- the amount of each annual installment (which incidentally could be a variable payment due to inflation adjusted bonds); and
- the last year in which an amortized installment will be paid (thus releasing the lien encumbering the lot as fully paid).

The Notice of Assessment does not include three additional elements about the debt which are needed to determine the extent of the obligation, and whether the debt is one to be assumed as a credit toward the price or to be satisfied by the seller:

- the rate of interest the bonds bear;
- the current remaining principal balance due to discharge the debt; and
- whether the bond lien is a blanket lien on the entire subdivision or common interest development (CID), and if so, whether a partial release of a lot is available.

Some purchase agreements treat the unpaid principal on Mello-Roos or 1915 Act bonds as additional consideration paid for the property by the buyer, over and above the price agreed to be paid in the offer. Other publishers' purchase agreements place the accounting for the bonded indebtedness, if not paid off by the seller, in the price to be paid for the property. Thus, the buyer properly assumes the debt as a lien on the property owed by the seller and part of the price paid.

Homeowners in some California counties are also able to use bond assessment liens for energy and water efficiency improvements. The Property Assessed Clean Energy program (PACE) allows for local governments to borrow by issuing bonds and using the funds to lend homeowners money to cover the costs of installing energy improvements. The PACE funds lent to the homeowner become a lien on the property as an improvement bond assessment, junior to property taxes but senior to any lender's mortgage on the property.

Chapter 19 Key Terms

Mello-Roos ..... **pg. 180**
off-site improvements ..... **pg. 179**

Chapter 20

Prior occupant's use, affliction and death

Learning Objectives

After reading this chapter, you will be able to:

- determine when to disclose a prior death on a property; and
- assess whether a history of death on a property might affect the buyer's valuation or desire to own the property.

Key Terms

material fact

Transfer Disclosure Statement (TDS)

When and when not to disclose

A seller's agent employed by a seller locates a buyer for the seller's real estate. Prior to making an offer, the seller's agent hands the buyer the seller's **Transfer Disclosure Statement (TDS)**. The *TDS* discloses the seller's and agent's knowledge about the present *physical condition* of the property. All other mandatory property and transaction disclosures are made.

The buyer does not inquire into any deaths which might have occurred on the property. Ultimately, the buyer acquires and occupies the property.

Later, the buyer is informed a prior occupant died on the property from AIDS *more than three years* before the buyer submitted their purchase offer. The buyer would not have purchased the property had they known about this event.

The buyer discovers the seller's agent knew of the prior occupant's death on the property resulting from AIDS. The buyer claims the seller's agent breached their agency duties by failing to voluntarily disclose the death to the buyer.

Did the seller's agent breach their general agency duty to the buyer by failing to disclose the death on the property occurring more than three years before the buyer submitted their offer?

Transfer Disclosure Statement (TDS) A mandatory disclosure prepared by a seller 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 **RPI** Form 304]

No! The seller's agent has no *affirmative duty to voluntarily disclose* information to a potential buyer regarding a prior occupant:

- whose death, from any cause, occurred on the real estate **more than three years prior** to the purchase offer; or
- who was afflicted with the **HIV virus** or **AIDS**.[1]

*Editor's note — Deaths on the property which occurred **within three years** of the offer are treated differently.*

Disclosure on inquiry

Regardless of whether a death occurred within three years of the buyer submitting a purchase offer, on **direct inquiry** by the buyer or their agent, the seller's agent must disclose their knowledge of any deaths on the real estate.[2]

Consider a buyer who asks the seller's agent if any deaths have ever occurred on the property.

No matter when the death occurred, on *direct inquiry*, the seller's agent must disclose their knowledge of the existence of any deaths which occurred on the real estate.[3]

An intentional misrepresentation or concealment of a known fact after a buyer makes a direct inquiry is:

- a breach of the seller's agent's *general duty* owed to the buyer to truthfully respond when the seller's agent represents the seller exclusively; or
- a breach of the buyer's agent's *agency duty* owed the buyer since the agent is the buyer's representative in the transaction.[4]

Death as a material fact

Further, an inquiry by the buyer into deaths indicates a death on the premises is a fact which might affect the buyer's *use and enjoyment* of the property. Thus, a death occurring on the property is a **material fact**.

material fact
A fact that, if known, might cause a prudent buyer or seller of real estate to make a different decision regarding what price to offer or demand for a property or whether to remain in a contract or cancel it.

On an inquiry into deaths by a buyer, an affirmative duty is imposed on the **buyer's agent** to either:

- investigate the death; or
- recommend an investigation by the buyer before an offer is made, unless the offer includes a *further-approval contingency* on the subject of death.

An agent who discloses, on inquiry, that they do not know if a death occurred on the real estate, is to hand the buyer a memorandum stating:

- the buyer has made an inquiry about deaths on the property;

1 Calif. Civil Code §1710.2(a)
2 CC §1710.2(d)
3 CC §1710.2(d)
4 CC §1710.2(d)

- the agent has disclosed all their knowledge concerning the inquiry; and
- whether the agent or others will further investigate any deaths on the property.

Deaths affecting market value

An agent's duty to disclose material facts known to them is not limited to disclosures of the property's physical condition.

Consider a buyer who enters into a purchase agreement negotiated by an agent, acting either as the buyer's agent or the seller's agent. The offer includes the seller's TDS about the condition of the property. However, the buyer is unaware multiple murders occurred on the property more than three years before the buyer's purchase offer.

The agent *conceals their knowledge* of the murders from the buyer. The agent is aware that the notoriety of the murders *adversely affects* the market value of the property, placing its value below the price the buyer is agreeing to pay.

The transaction closes and the buyer occupies the property. The buyer learns of the murders and sues the agent to collect their *price-to-value money* losses. The buyer claims the agent had a duty to disclose the deaths since the agent knew the property's market value, due to the stigma of the deaths, was measurably lower than the purchase price paid.

The agent claims they do not have a duty to disclose the deaths since they occurred over three years ago and were not required to be disclosed on the TDS.

Did the agent have an affirmative duty to disclose the deaths?

Yes! The deaths had an *adverse effect* on the property's market value and were *material facts* intentionally concealed from the buyer.

Thus, both the buyer's and seller's agent have an affirmative duty to disclose prior deaths when the death might affect the buyer's valuation or desire to own the property.[5]

Desirability based on events within three years

Consider a buyer's agent who is aware a death occurred on the real estate *within three years* of a buyer's purchase offer.

The value of the property is not adversely affected by the death. Thus, the death is not a material fact about the property which needs to be disclosed.

The buyer does not ask their agent if any deaths have occurred on the property. After closing, the buyer learns of the death and is deprived of the pleasurable use and enjoyment of the property. The buyer's attitude about death is an *idiosyncrasy* which was unknown to their agent.

The buyer claims their agent breached their agency duty by failing to disclose the death since it inflicted an intangible harm on the buyer, preventing them from enjoying the real estate.

5 **Reed** v. **King** (1983) 145 CA3d 261

Here, as a matter of prudent practice, the buyer's agent is to determine if a known death might affect the buyer's decision to purchase the property. The buyer's agent has a greater *agency duty of care* to protect the buyer than does the seller's agent. Thus, a buyer's agent discloses any death occurring on the property within three years or otherwise, especially if they believe the death might affect the buyer's decision to make a purchase agreement offer.

It is the buyer's agent's duty to *investigate and disclose* material facts about the property and the transaction. Thus, a greater burden is placed on the buyer's agent to know and understand their client, known colloquially as the **know-your-client rule**.

Conversely, buyers have a duty of care owed to themselves. Buyers themselves have a duty to *inquire and discover* facts readily available to them or their agent in an effort to protect their own personal interests.

Chapter 20 Summary

Generally, seller's agents are not required to voluntarily disclose information to a potential buyer regarding a prior occupant whose death, from any cause, occurred on the real estate more than three years prior to the purchase offer, or who was afflicted with HIV or AIDS. If a death on the property for some reason adversely affects the market price of the property, it must be disclosed.

However, on direct inquiry by the buyer or the buyer's agent about deaths on the property, the seller's agent must disclose their knowledge of any deaths on the real estate, no matter when they occurred. An intentional concealment of a death after a buyer makes a direct inquiry is a breach of the seller's agent's general duty and the buyer's agent's agency duty.

An inquiry by the buyer into deaths on a property indicates a death on the premises is material fact which might affect the buyer's use and enjoyment of the property. This imposes an affirmative duty on the buyer's agent to investigate or recommend an investigation into any deaths before an offer is made.

Chapter 20 Key Terms

material fact ..... **pg. 192**
Transfer Disclosure Statement (TDS) ..... **pg. 191**

Chapter
21

Seller's net sales proceeds estimate

Learning Objectives

After reading this chapter, you will be able to:

- advise a seller of the anticipated costs, credits and net proceeds they will likely incur on the sale of their property; and
- prepare a Good Faith Estimate of Seller's Net Sales Proceeds and deliver it to a seller when listing a property or reviewing a purchase agreement offer.

Key Terms

equity
material fact
net sales proceeds
seller's net sheet

Financial consequences of a sale, before taxes

The most pressing concern sellers of real estate generally have about selling is the amount of money they will receive on closing a sale of their property. Sellers know the **net sales proceeds** they receive on closing will not be the price paid by the buyer for the property.

net sales proceeds
The seller's receipts on closing a sale of their property after all costs of the sale have been deducted from the gross proceeds.

Often, sellers do not ask their agent how much money they will receive on closing a sale on the property. However, the serious nature of this unspoken concern the seller has about the amount of money they will take away from the closing is implicit. Sellers want to know, and they need to know, the amount of money they will actually receive as *net sales proceeds* for transferring ownership. The amount is the net worth of their property.

The sole reason an owner employs agent is to convert the **equity** in their property into cash (or an exchange) by locating a buyer ready, willing and able to pay the highest possible price.

equity
The interest or value an owner has in real estate over and above the liens against it.

Significantly, a seller on listing their property for sale has a *motive* which drives their decision to acquire cash, if only for the opportunities cash makes available. The motives range from the disposal of real estate no longer of use

or in foreclosure to the need for cash to accomplish a personal, business or investment objective. The seller may want to acquire a replacement home or premises for their trade or business, invest in equities, bonds or commodities markets, or simply put the cash into savings.

A reasonable estimate of costs for the seller

However, the ordinary seller has little idea how to figure the dollar amount of net proceeds a sale of their property will bring. A seller's initial thinking is that the net sales proceeds will be roughly equal to their equity in the property, less a broker fee. Most sellers are not familiar with the cost of retrofitting property and complying with governmental safety regulations, as well as lender payoff penalties and a buyer's demands for repairs — until these costs are brought to their attention.

Further, the asking price is unadjusted for the need to fix up the property and clear it of structural pests and deferred maintenance to prepare it for marketing.

seller's net sheet
A document prepared by a seller's agent to disclose the financial consequences of a sale when setting the listing price and on acceptance of a buyer's price in a purchase offer. [See **RPI** Form 310]

On the other hand, agents have a working understanding and knowledge of all the expenses a seller is most likely to be confronted with to market, sell and close escrow on a property. This is their business.

A reasonable estimate of the likely net sales proceeds on any sale is first prepared on a **seller's net sheet** at the listing stage. It is again prepared when reviewing offers or updating the net sheet figures to reflect any change in pricing. [See Form 310 accompanying this chapter]

material fact
A fact that, if known, might cause a prudent buyer or seller of real estate to make a different decision regarding what price to offer or demand for a property or whether to remain in a contract or cancel it.

For a seller's agent, some risk accompanies disclosures regarding net sales figures. The information may cause a prospective client to decide not to sell, or cause a seller of listed property to reject an offer and counter at a price needed by the seller but unacceptable to a buyer. It is for these seller pricing decisions that the net sheet information is a **material fact** requiring an *affirmative disclosure* by the seller's agent of the figures which comprise the seller's net sheet and the seller's bottom line. Thus, a net sheet review with an owner is part of every listing presentation for the sale of property.

Costs of sale as a material fact

A *material fact* is information which, if known to a client, might affect their decisions, such as a seller's decision to enter into a listing or accept an offer to buy.

If the information — such as sales expenses, closing costs or the net proceeds of a sale — is known to the seller, the seller's agent has no obligation to disclose it. However, if the information can affect a decision to be made by the seller and the information *is not fully known* to the seller but is known or *more readily available* to the seller's agent, the costs need to be disclosed to the seller to meet the agent's obligations under their *special agency duties* owed the client.

It is best practice to prepare and review a net sheet with a seller, regardless of whether the seller requests or even declines to review a net sheet. The

time and effort expended to prepare a net sheet is a small premium to pay to assure the agreed fee is not attacked at the time of closing, such as a seller's claim they thought they were to receive a greater amount of net proceeds.

Analyzing the net sheet estimates

A seller's agent prepares a Good Faith Estimate (GFE) of Seller's Net Sales Proceeds, **RPI** Form 310, to inform their client about the expenses the seller will likely incur on the disposition of their real estate by sale.

The estimates entered on the form by the seller's broker or agent are to be based on information *known* or *readily available* to them on the inquiry of others or on minimal investigation about each item of expense they anticipate the seller will incur. Thus, the figures entered as estimates reflect the seller's agent's *honestly held belief* that the amounts estimated will likely be experienced by the seller.

Brokerage events triggering an agent's preparation of the net sheet and a review of its contents with the seller include:

- soliciting or entering into a seller's listing agreement;
- submitting a buyer's purchase agreement offer;
- entering into a counteroffer; and
- entering into an exchange agreement offer or acceptance.

Use of the net sheet

The net sheet is used by a seller's agent for the purpose of disclosing to the seller the crucial financial information surrounding expenditures required to:

- put the property in a condition attractive to the greatest number of prospective buyers, typically clearing out deferred maintenance called fix-up costs;
- comply with local retrofit ordinances and current safety standards;
- eliminate defects and infestation, often exposed in home inspection and pest control reports; and
- provide the seller's agent with reports for delivery to prospective buyers which contain information on the physical condition of the property, the natural hazards of the property's location, the expenses of ownership and any other aspects regarding the integrity of the property that have a measurable impact on the property's value.

The GFE of Seller's Net Sales Proceeds form consists of four sections, each serving an entirely separate purpose in the setting of the amount of net proceeds to be received by a seller on a sale.

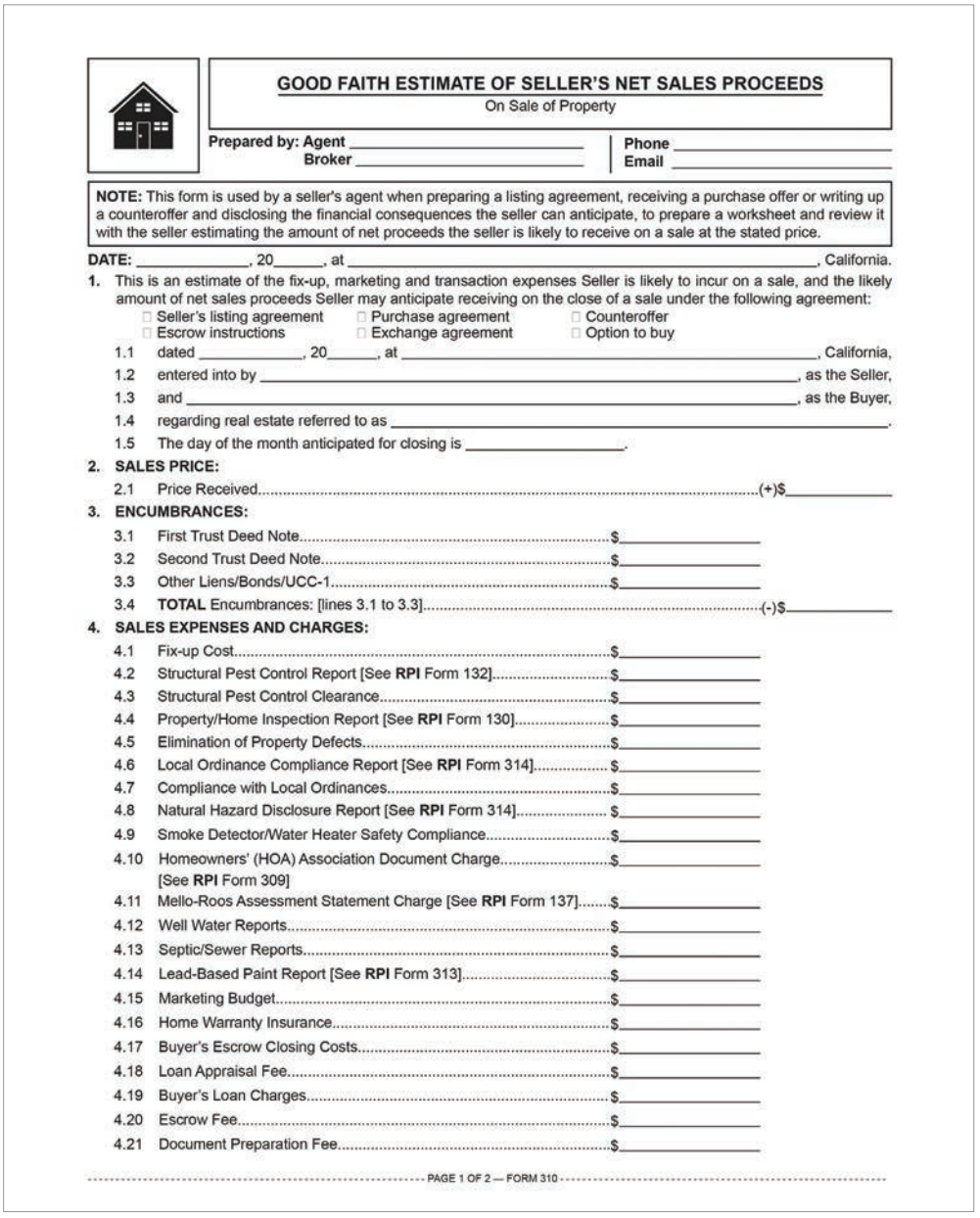
The sections list:

- the **encumbrances** of record, including any improvement district bonds, mortgages and possible abstracts of judgment or tax liens to be assumed, reconveyed or released;

Form 310

Good Faith Estimate of Seller's Net Sales Proceeds

Page 1 of 2



GOOD FAITH ESTIMATE OF SELLER'S NET SALES PROCEEDS
On Sale of Property

Prepared by: Agent _____ Phone _____
Broker _____ Email _____

NOTE: This form is used by a seller's agent when preparing a listing agreement, receiving a purchase offer or writing up a counteroffer and disclosing the financial consequences the seller can anticipate, to prepare a worksheet and review it with the seller estimating the amount of net proceeds the seller is likely to receive on a sale at the stated price.

DATE: _____, 20_____, at _____, California.

1. This is an estimate of the fix-up, marketing and transaction expenses Seller is likely to incur on a sale, and the likely amount of net sales proceeds Seller may anticipate receiving on the close of a sale under the following agreement:
   ☐ Seller's listing agreement ☐ Purchase agreement ☐ Counteroffer
   ☐ Escrow instructions ☐ Exchange agreement ☐ Option to buy
   1.1 dated _____, 20_____, at _____, California,
   1.2 entered into by _____, as the Seller,
   1.3 and _____, as the Buyer,
   1.4 regarding real estate referred to as _____.
   1.5 The day of the month anticipated for closing is _____.
2. **SALES PRICE:**
   2.1 Price Received.....(+)$_____
3. **ENCUMBRANCES:**
   3.1 First Trust Deed Note.....$_____
   3.2 Second Trust Deed Note.....$_____
   3.3 Other Liens/Bonds/UCC-1.....$_____
   3.4 **TOTAL** Encumbrances: [lines 3.1 to 3.3].....(-)$_____
4. **SALES EXPENSES AND CHARGES:**
   4.1 Fix-up Cost.....$_____
   4.2 Structural Pest Control Report [See **RPI** Form 132].....$_____
   4.3 Structural Pest Control Clearance.....$_____
   4.4 Property/Home Inspection Report [See **RPI** Form 130].....$_____
   4.5 Elimination of Property Defects.....$_____
   4.6 Local Ordinance Compliance Report [See **RPI** Form 314].....$_____
   4.7 Compliance with Local Ordinances.....$_____
   4.8 Natural Hazard Disclosure Report [See **RPI** Form 314].....$_____
   4.9 Smoke Detector/Water Heater Safety Compliance.....$_____
   4.10 Homeowners' (HOA) Association Document Charge.....$_____ [See **RPI** Form 309]
   4.11 Mello-Roos Assessment Statement Charge [See **RPI** Form 137].....$_____
   4.12 Well Water Reports.....$_____
   4.13 Septic/Sewer Reports.....$_____
   4.14 Lead-Based Paint Report [See **RPI** Form 313].....$_____
   4.15 Marketing Budget.....$_____
   4.16 Home Warranty Insurance.....$_____
   4.17 Buyer's Escrow Closing Costs.....$_____
   4.18 Loan Appraisal Fee.....$_____
   4.19 Buyer's Loan Charges.....$_____
   4.20 Escrow Fee.....$_____
   4.21 Document Preparation Fee.....$_____

PAGE 1 OF 2 — FORM 310

- the **expenses** of a sale, including repair and renovation expenditures, fees for investigative reports and closing charges paid by the seller;
- **adjustments and prorates** for unpaid or prepaid items and any tenant deposits to be taken over by the buyer; and
- the **net proceeds** remaining after deducting all sales-related expenses, fees and charges, as well as the form the net proceeds will take.

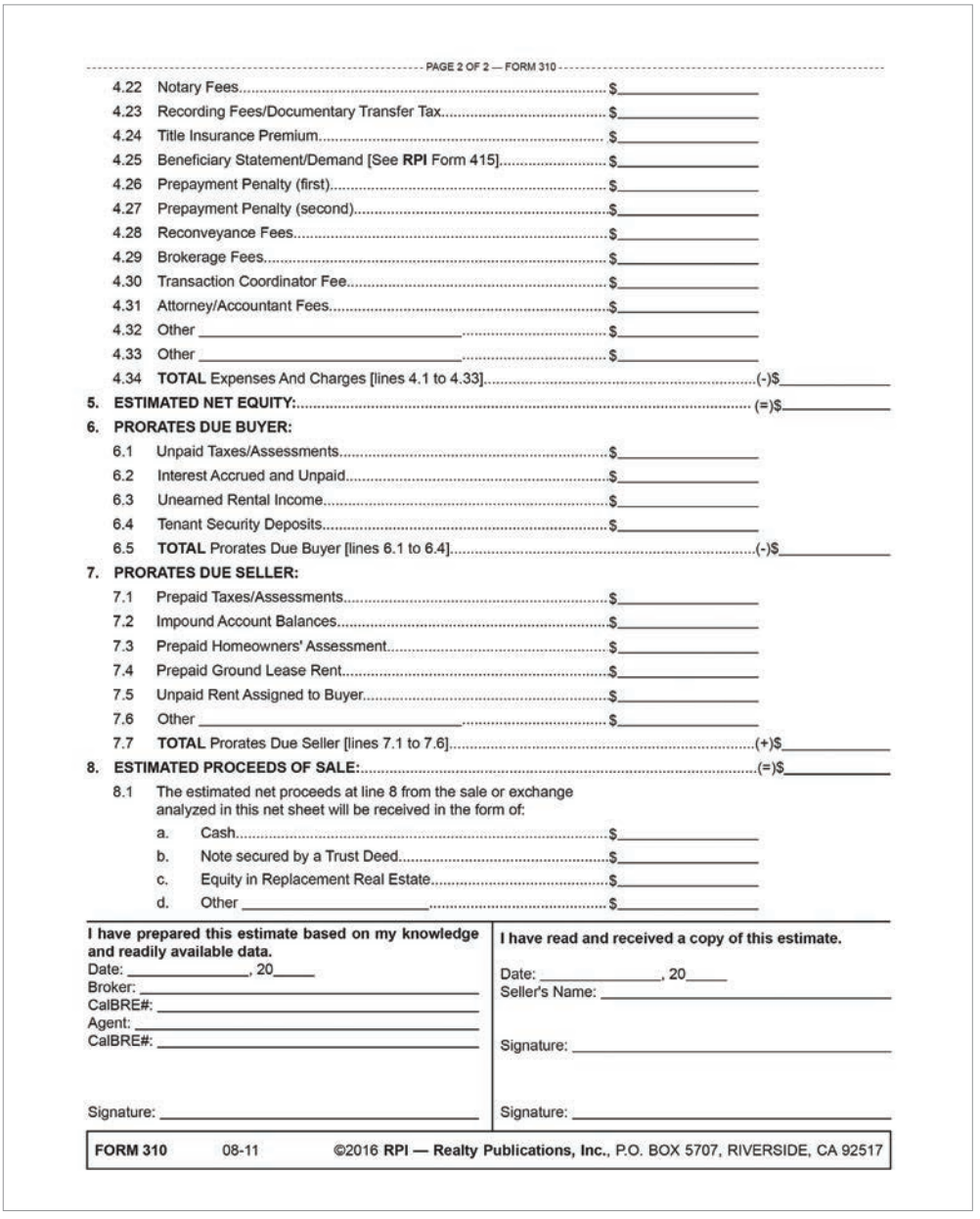
Preparing the seller's net sheet

The following instructions are for the preparation and use of the Good Faith Estimate of Seller's Net Sales Proceeds – On Sale of Property, **RPI** Form 310, with which a seller's agent may prepare an estimate for an analysis of the costs the seller will likely incur in the preparation, marketing and sale of the

Form 310

Good Faith Estimate of Seller's Net Sales Proceeds

Page 2 of 2



PAGE 2 OF 2 — FORM 310

4.22	Notary Fees	$_____
4.23	Recording Fees/Documentary Transfer Tax	$_____
4.24	Title Insurance Premium	$_____
4.25	Beneficiary Statement/Demand [See **RPI** Form 415]	$_____
4.26	Prepayment Penalty (first)	$_____
4.27	Prepayment Penalty (second)	$_____
4.28	Reconveyance Fees	$_____
4.29	Brokerage Fees	$_____
4.30	Transaction Coordinator Fee	$_____
4.31	Attorney/Accountant Fees	$_____
4.32	Other _____	$_____
4.33	Other _____	$_____
4.34	**TOTAL** Expenses And Charges [lines 4.1 to 4.33]	(-)$_____
5.	**ESTIMATED NET EQUITY:**	(=)$_____
6.	**PRORATES DUE BUYER:**	
6.1	Unpaid Taxes/Assessments	$_____
6.2	Interest Accrued and Unpaid	$_____
6.3	Unearned Rental Income	$_____
6.4	Tenant Security Deposits	$_____
6.5	**TOTAL** Prorates Due Buyer [lines 6.1 to 6.4]	(-)$_____
7.	**PRORATES DUE SELLER:**	
7.1	Prepaid Taxes/Assessments	$_____
7.2	Impound Account Balances	$_____
7.3	Prepaid Homeowners' Assessment	$_____
7.4	Prepaid Ground Lease Rent	$_____
7.5	Unpaid Rent Assigned to Buyer	$_____
7.6	Other _____	$_____
7.7	**TOTAL** Prorates Due Seller [lines 7.1 to 7.6]	(+)$_____
8.	**ESTIMATED PROCEEDS OF SALE:**	(=)$_____
8.1	The estimated net proceeds at line 8 from the sale or exchange analyzed in this net sheet will be received in the form of:	
a.	Cash	$_____
b.	Note secured by a Trust Deed	$_____
c.	Equity in Replacement Real Estate	$_____
d.	Other _____	$_____

I have prepared this estimate based on my knowledge and readily available data.
Date: _____, 20____
Broker: _____
CalBRE#: _____
Agent: _____
CalBRE#: _____

Signature: _____

I have read and received a copy of this estimate.
Date: _____, 20____
Seller's Name: _____

Signature: _____

Signature: _____

FORM 310 08-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

property. The disclosure of this data to the seller is necessary for the seller to make an informed decision regarding whether to sell, and if so, on what terms and conditions.

Each instruction corresponds to the number given each item in the form.

*Editor's note — **Enter** figures throughout the net sheet in the blanks provided, unless the item is not intended to be included in the final estimate, in which case it is left blank.*

Document identification

Enter the date and name of the city where the net sheet is prepared. The date is used when referring to this form.

1. **Check** the appropriate box to indicate the underlying agreement which is the subject of this disclosure.

   1.1 1.1-1.5 **Enter** the identification date, the name(s) of the parties to the underlying agreement, the address or parcel number identifying the property for sale, and the day of the month on which escrow is to close for pro rations and adjustments.

2. **Sales price:**

   2.1 *Price received:* **Enter** the amount of the sales price to be paid by the buyer.

Sales price and encumbrances

3. **Encumbrances:**

   3.1 *First mortgage note:* **Enter** the dollar amount of the principal balance remaining due on any first mortgage of record as noted on mortgage payment records held by the seller, whether the mortgage is to be assumed or paid off on closing.

   3.2 *Second mortgage note:* **Enter** the dollar amount of the principal balance remaining due on any second mortgage of record as noted on mortgage payment records held by the seller, whether the mortgage is to be assumed or paid off on closing.

   3.3 *Other liens/bonds/UCC-1:* **Enter** the total dollar amount of the principal balance and any accrued unpaid interest on any judgment liens, tax liens and improvement district bond liens encumbering the property, and any UCC-1 liens on any personal property which are part of the sale, whether the liens will be assumed or paid off on closing.

Editor's note — Some purchase agreements, in their provisions for handling improvement district bond liens, omit any accounting on the transfer of title subject to a lien for the balance of an improvement district bond with annual installments. Annual installments on the improvement bond lien are treated in these purchase agreements as pro rates of the next principal and interest installment, without concern for an accounting of the principal balance which remains to be paid in future years.

   3.4 ***TOTAL** encumbrances:* **Add** the figures entered in sections 3.1 through 3.3. **Enter** the total as the dollar amount of debts encumbering the property, whether assumed by the buyer or paid off on closing.

Expenses and charges

4. **Sales expenses and charges:**

   4.1 *Fix-up cost:* **Enter** the dollar amount estimated to cover the costs it is anticipated the seller will incur to ready the property for previews by other agents, caravans, walk-throughs by prospective buyers and open house viewings, such as the cost to

Expenses and charges, cont'd

add color to the landscaping, paint outside trim and any interior walls showing wear and tear, and replace any plumbing or electrical fixtures which are beyond repair or of unacceptable appearance.

4.2 *Structural pest control report:* **Enter** the dollar amount of the fee a pest control operator will charge to conduct a physical inspection and submit a report on their findings and provide an estimate of the costs of repairs necessary to eliminate any infestation and repair any existing damage or condition allowing for infestation. These are property conditions most buyers do not want to acquire.

4.3 *Structural pest control clearance:* **Enter** the dollar amount estimated to cover the cost it is anticipated the seller will incur for fumigation or to correct damage from an infestation or conditions supporting an infestation. The amount estimated will need to be reviewed and updated on receipt of the structural pest control report. This amount needs to be considered when setting any ceiling in a counteroffer on the costs the seller might be willing to incur to correct the adverse condition of their property.

4.4 *Property/home inspection report:* **Enter** the dollar amount of the fee a home inspection company will charge to conduct a physical inspection of the property and submit a report (HIR) on their observations of defects existing on the property. The HIR is to be relied on when preparing the TDS, then both delivered to prospective buyers.

4.5 *Elimination of property defects:* **Enter** the dollar amount estimated to cover the costs the seller will incur to eliminate, by repair or replacement, any conditions not up to building or safety codes, such as malfunctioning or defective components, e.g., the roof, electrical wiring, plumbing, heating, the foundation, walls, fences, doors, and appliances. The amount estimated needs to be reviewed and updated on receipt of a property/home inspection report. This amount is considered when setting any ceiling in an offer or counteroffer of the amount of costs the seller might be willing to incur to correct the condition of their property for transfer.

4.6 *Local ordinance compliance report:* **Enter** the dollar amount of the fee a local government agency charges to inspect the property and submit a report on its findings and the corrections required to be completed before transfer of ownership and occupancy may occur.

4.7 *Compliance with local ordinances:* **Enter** the dollar amount estimated to cover the cost it is anticipated the seller will incur for retrofitting, curative permits and any repairs necessary to

Expenses and charges, cont'd

meet local ordinance standards as a requisite to a change in ownership or occupancy. The amount estimated will need to be reviewed and updated on receipt of the local agency's compliance report.

4.8 *Natural Hazard Disclosure report:* **Enter** the dollar amount of the fee charged by a third party for a review of the county records and the preparation and submission of a report (NHD) on the natural hazards affecting the property due to its location.

4.9 *Smoke detector/water heater safety compliance:* **Enter** the dollar amount of the cost it is anticipated the seller will incur to install smoke detectors, the water heater anchors or bracing and window or garage door safety mechanisms necessary to comply with safety standards.

4.10 *Homeowners' association (HOA) document charge:* **Enter** the dollar amount of the fees charged by any owners' association connected to the property for their delivery of a complete marketing packet of documents comprised of restrictions, operations, budgets, insurance and other documents mandated to be handed to the prospective buyer, and their delivery to escrow of their statement of condition of assessments.

4.11 *Mello-Roos assessment statement charge:* **Enter** the dollar amount of the fee charged for a statement of assessments to be provided by any improvement district which holds a lien on the property to secure the repayment of bonds issued by the improvement district.

4.12 *Well water reports:* **Enter** the dollar amount of the combined fees which will be charged by a licensed well-drilling contractor to test and certify the capacity of any well on the property, and by a licensed water testing lab to test and report on the quality of the water produced by the well.

4.13 *Septic/sewer reports:* **Enter** the dollar amount of the fee charged by a licensed plumbing contractor to test and certify the function of the sewage disposal system, and if it contains a septic tank, whether it is in need of pumping.

4.14 *Lead-based paint report:* **Enter** the dollar amount of the fee charged by an environmental testing company to investigate and report on the lead content of paint on the premises.

4.15 *Marketing budget:* **Enter** the dollar amount of any contribution (to be) made by the seller toward the expenses of marketing the property and locating prospective buyers.

4.16 *Home warranty insurance:* **Enter** the dollar amount of the premium the seller agrees to pay as charged by a home warranty insurance company to issue a policy to the buyer.

Expenses and charges, cont'd

4.17 *Buyer's escrow closing costs:* **Enter** the dollar amount of the combined escrow closing costs incurred by the buyer which the seller agrees to pay.

4.18 *Mortgage appraisal fee:* **Enter** the dollar amount of any mortgage appraisal fee the seller will agree to pay which will be charged to determine the property's qualification for the purchase-assist mortgage which will be applied for by the buyer.

4.19 *Buyer's mortgage charges:* **Enter** the dollar amount of any mortgage charges the seller will agree to pay which the buyer will incur for the purchase-assist mortgage needed to fund the price to be paid for the property. These mortgage charges are also referred to as non-recurring mortgage charges.

4.20 *Escrow fee:* **Enter** the dollar amount of the charge the seller will incur for escrow services to process the closing of the sale.

4.21 *Document preparation fee:* **Enter** the dollar amount of the charge the seller will incur, usually with escrow, for a third party to prepare the documents necessary for the seller to convey the property, such as grant deeds and bills of sale.

4.22 *Notary fees:* **Enter** the dollar amount of the charge the seller will incur for services provided by a notary to acknowledge the seller's signature on documents which are to be recorded to accomplish the transfer of the property (grant deed, spousal quit claim deed, release of recorded instruments, power-of-attorney, etc.).

4.23 *Recording fees/documentary transfer tax:* **Enter** the dollar amount of the combined recording charges and transfer taxes collected by the county recorder and paid by the seller to convey title.

4.24 *Title insurance premium:* **Enter** the dollar amount of the premium the title insurance company will charge for issuance of a policy of title insurance conveying the seller's conveyance of the property.

4.25 *Beneficiary statement/demand:* **Enter** the dollar amount of the combined fees the mortgage lender of record will charge for delivering a beneficiary statement or payoff demand to escrow which is needed to either confirm the mortgage balance on an assumption or subject-to transaction, or the amount of a payoff of the mortgage on closing a sale.

4.26 *Prepayment penalty (first):* **Enter** the dollar amount of any penalty the first mortgage lender will charge on a payoff of the mortgage on close of a sale.

Expenses and charges, cont'd

4.27 *Prepayment penalty (second):* **Enter** the dollar amount of any penalty the second mortgage lender will charge on a payoff of the mortgage on close of a sale.

4.28 *Reconveyance fees:* **Enter** the dollar amount of reconveyance fees and recording fees the trustees on the mortgages of record will charge to release the mortgage liens from the record title to the property sold.

4.29 *Broker fees:* **Enter** the dollar amount of the fees earned by the brokers which will be paid by the seller on the close of escrow for the sale of the property.

4.30 *Transaction coordinator fee:* **Enter** the dollar amount of the fee charged the brokers which the seller will pay for a third party to assist the seller's agent in the preparation of the listing package and the sales package to provide all the documentation necessary to close the transaction.

4.31 *Attorney/accountant fees:* **Enter** the dollar amount estimated as the attorney fees and accounting fees the seller will incur as a result of their advice and assistance in the sale.

4.32 *Miscellaneous expense:* **Enter** the name of the further expense. **Enter** the dollar amount of the expense.

4.33 *Miscellaneous expense:* **Enter** the name of the further expense. **Enter** the dollar amount of the expense.

4.34 ***TOTAL*** *expenses and charges:* **Add** the figures entered in sections 4.1 through 4.33. **Enter** the total as the dollar amount of the expenses and charges on the sale.

Seller's net equity

5. **Estimated net equity: Subtract** the figures entered in sections 4.4 and 4.34 from the figure entered at section 2.1.

Enter the difference as the dollar amount of the estimated net equity, an amount against which prorations and adjustments are next made to calculate the estimated net sales proceeds generated by the sale.

Buyer prorations

6. **Pro rates due buyer:**

6.1 *Unpaid taxes/assessments:* **Enter** the dollar amount of those real estate taxes and improvement district bond installments which have accrued and have not been paid by the seller if they are to be prorated without a credit to the price for the remaining principal due on bonds under section 3.3. Taxes have not been paid for one of two reasons: they are not yet due to be paid to the tax collector or they are past due and delinquent. If they are not yet due, the taxes which accrued during the

seller's ownership will be paid by the buyer at a later date.

Thus, taxes are prorated as a credit to the buyer through the **last day prior** to the date of closing. The proration is calculated as a daily amount of the annual tax based on a 30-day month. The current tax bill or, if it is not yet available, the past year's amounts are used (and adjusted for up to 2% inflation, etc.) to arrive at the daily amount of the proration.

Editor's note — For example, if escrow is scheduled to close September 16, the tax billing has not yet been received and (if it has been) it has not been paid. Thus, 75 days of accrued taxes/assessments at the daily rate are credited to the buyer (and charged to the seller).

Buyer prorations, cont'd

6.2 *Interest accrued and unpaid:* **Enter** the dollar amount of interest accrued and unpaid on mortgages assumed under sections 2.1 through 3.3 for the number of days during the month the seller will remain the owner prior to closing. The proration will be calculated as a daily amount of interest paid in monthly installments based on a 30-day month.

The daily amount of interest accruing is credited to the assuming buyer for each day of the month prior to the day scheduled for closing since interest on mortgages is paid after the running of the monthly accrual period. Thus, the current installment will become the obligation of the buyer, unless the installment is disbursed by escrow and charged pro rata to each the seller and the buyer.

6.3 *Unearned rental income:* **Enter** the portion of the dollar amount of rent from the rent rolls, both prepaid and unpaid, which will remain unearned on the day scheduled for closing. The buyer is entitled to a credit of the unearned portion as a proration.

The day of closing is the first day of ownership by the buyer and entitles the buyer to unearned rents for the entire day. The proration is calculated as a daily amount of the rent roll earned (accrued) based on a 30-day month.

Editor's note — For example, if the rents are $30,000 monthly, the daily proration for earned rents will be $1,000. This daily figure is then multiplied by the number of days remaining in the month, beginning with and including the day of closing. If closing is on the 16th, the dollar amount of prorated rents credited to the buyer from funds accruing to the seller's account on closing will be $15,000, the 16th being day one of the remainder of the 30-day month.

For unpaid delinquent rents shown on the rent roll, see section 7.5 for an offset charge to the buyer by an adjustment.

6.4 *Tenant security deposits:* **Enter** the dollar amount of all the security deposits held by the seller (as landlord) which belong to the tenants as disclosed on the seller's rent roll information sheet. This credit is an **adjustment in funds**, not a proration, which is due the seller on closing since the buyer on transfer of ownership will be the landlord (by assignment of the leases and rent agreements) and responsible for the eventual accounting to the tenants for any deposit held by the seller.

Editor's note — Include any interest accrued and unpaid on the security deposits from the date of the seller's receipt of the deposits if mandated by rent control or landlord-tenant law.

6.5 ***TOTAL*** *pro rates due buyer:* **Add** the figures estimated in sections 6.1 through 6.4. **Enter** the total as the dollar amount of all the "credits" the buyer can anticipate due to pro rations and adjustments.

Seller prorations

7. **Pro rates due seller:**

7.1 *Prepaid taxes/assessments:* **Enter** the dollar amount of real estate taxes and improvement assessments prepaid by the seller which have not yet accrued. The calculations are made in the same manner as explained in section 6.1.

Editor's note — For example, the seller has paid all installments of taxes/assessments for the entire fiscal year (July through June). A closing of the buyer's transaction on January 2 requires a proration charge to be paid by the buyer for one-half year's taxes and assessments since they have been prepaid, but will not accrue until after the buyer closes escrow.

7.2 *Impound account balances:* **Enter** the dollar amount of any impounds held by the lender on mortgages assumed under sections 3.1, 3.2 or 3.3. The information is readily available as an "escrow account" item on the lender's monthly statement of the mortgage's condition received by the seller from the lender servicing the mortgage.

7.3 *Prepaid association assessment:* **Enter** the dollar amount of the prepaid and unaccrued portion of the seller's current installment for any owners' association assessment. The proration charge is based on a 30-day month for those days remaining in the month beginning with the day of closing as day one of the days remaining in the month.

7.4 *Prepaid ground lease:* **Enter** the dollar amount of the prepaid and unaccrued portion of rent the seller has paid on the ground lease if the property interest being purchased is a leasehold interest transferred by assignment, not a fee interest transferred by grant deed.

7.5 *Unpaid rent assigned to buyer:* **Enter** the portion of the dollar amount of delinquent unpaid rents to be charged to the buyer if the seller will not collect the rent before the close of escrow. These unpaid rents belong to the buyer on closing due to the seller's assignment of the leases to the buyer, unless other arrangements are made for an accounting of the uncollected rents. Typically, a closing after the tenth of the month will not experience the need for a delinquent rent adjustment. (Rents have been prorated in section 6.3.)

7.6 *Miscellaneous pro rates and adjustments:* **Enter** the name of other items to be adjusted in the transaction. **Enter** the dollar amount charged to the buyer.

7.7 ***TOTAL*** *pro rates due seller:* **Add** the figures estimated in sections 7.1 through 7.6. **Enter** the total as the dollar amount of all the "charges" the buyer is likely to experience due to pro rations and adjustments.

Seller sale proceeds

8. **Estimated proceeds of sale: Add** the figures in sections 5 and 7.7, and then **subtract** the figure in section 6.5 from the sum. **Enter** the difference as the total dollar amount of the estimated net proceeds generated by the sale.

   8.1 *Form of net sales proceeds:* **Enter** the dollar amount of the net sales proceeds estimated in section 6 allocated to cash, carryback note, equity received in exchange or other form of consideration the seller will be receiving on the sale.

Signatures

Broker's/Agent's signature: **Enter** the date the seller's net sheet is signed, the broker's name and CalBRE license number and the agent's name. **Enter** the broker's (or agent's) signature.

Seller's signature: **Enter** the date the seller signs and the seller's name. **Obtain** the seller's signature.

Chapter 21 Key Terms

A seller's agent prepares a Good Faith Estimate (GFE) of Seller's Net Sales Proceeds to inform the seller about they will likely incur on the sale of their property. A reasonable estimate of the likely net sales proceeds on any sale is first prepared on a seller's net sheet at the listing stage. It is again prepared when reviewing offers or updating the net sheet figures to reflect any changes in pricing.

If the information — such as sales expenses, closing costs or the net proceeds of a sale — is known to the seller, the seller's agent has no obligation to disclose it. However, if the information can affect a decision to be made by the seller and the information is not fully known to the seller but is known or more readily available to the seller's agent, the costs needs to be disclosed to the seller to meet the agent's obligations under their special agency duties owed the client.

Brokerage events triggering an agent's preparation of the net sheet and a review of its contents with the seller include:

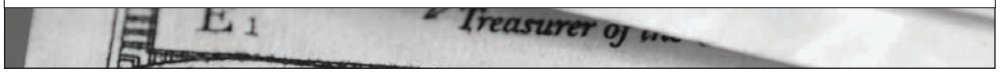
- soliciting or entering a seller's listing agreement;
- submitting a buyer's purchase agreement offer;
- entering into a counteroffer; and
- entering into an exchange agreement offer or acceptance.

It is best practice to prepare and review a net sheet with a seller, regardless of whether the seller requests or even declines to review a net sheet.

Chapter 21 Key Terms

Chapter
22

Buyer's estimated acquisition costs



Learning Objectives

After reading this chapter, you will be able to:

- prepare a good-faith estimate of the expenditures a buyer is likely to experience on acquiring a property with purchase-assist mortgage funding;
- demonstrate for a buyer the qualifications needed to become a homeowner;
- determine a buyer's real estate purchasing power by evaluating their income, assets and mortgage qualifications; and
- understand the supply and demand aspects of working with sellers and buyers under differing economic conditions in a business cycle.

Key Terms

buyer's cost sheet
carryback financing
listing agreement
loan-to-value ratio (LTV)
operating expenses
purchase-assist funding

The capital to buy real estate

During every real estate business cycle, a time comes when buyers collectively refuse or become unable to pay higher prices. Gone are the backup buyers and forgotten are the previously ever-present multi-offer auctions surrounding nearly every fresh listing of a property.

Thus begins a multi-year decline of real estate prices. The drop in prices is usually brought about by the end of a cyclical real estate bubble, evidenced by excessive asset inflation, low mortgage rates and momentum speculators.

It is during this evolving buyer's market of descending prices and ever more anxious sellers that real estate agents have difficulty attracting buyers, whether as clients they will represent or as prospective buyers of properties

they have listed. For agents, a *clientele* of buyers becomes financially more rewarding during the transition into a buyer's market than a pile of property listings.

However, buyers are reticent about buying during this corrective phase of the real estate business cycle. With its soft prices and plentiful supply of inventory for cautious buyers to consider, this *period of price correction* will eventually reflect sales-to-listing ratios indicating less than 25% of the existing listings are selling each month (with a bottom of less than 10% sold during the period of 2008 to mid-2009).

Agents generally face a decline in overall sales activity until prices stabilize and begin to rise. In the interim, the less ingenious and most disconnected agents will fail to maintain a livelihood in real estate sales.

Disclosures as confidence builders

To reverse the trend in buyer apathy toward acquiring real estate during these corrective transitions, the "sales" approach used by sales agents needs to be altered. Buyers can no longer be rushed to purchase since they have no sense of urgency when prices are dropping and buyers are fleeing.

Under these market conditions, buyers will not first jump into a purchase agreement contract and sort out the facts later — conduct which is typical during the run up to the peak of a real estate sales bubble. They now want the *facts first*, and for the most part will not act until they have them.

To combat an undersold real estate market, sellers and their agents need to be more forthcoming with property information when placing a property on the market, rather than deceptively stalling until they have a buyer in escrow at an agreed price.

Buyer's agents adjust more quickly than seller's agents to the cyclical shift from a seller's market long on buyers to a buyer's market long on sellers and inventory (and short on demand). They simply marshal information on a property and analyze it before making an offer since the property is not going anywhere, rather than doing so later as is too often the case when competition between demanding buyers is keen.

Show tenants they qualify for financing

To accommodate individuals who are hesitant about buying now, or to encourage others such as tenants who are not presently considering the purchase of a home, the initial step taken by an agent striving to become a buyer's representative is to *financially qualify* the individual as both a mortgage borrower and prospective buyer.

purchase-assist funding
The use of proceeds from a mortgage to fund the price paid by the borrower to acquire real estate.

An individual buyer needs to accumulated wealth and income to buy real estate. That is, they need access to cash to pay the price and costs of acquiring property, called capital. Beyond the cash available in savings and readily liquidated investments (stocks/bonds), arranging **purchase-assist funding**

is nearly always a requisite to establishing what price and costs of acquisition an individual is able to pay — and this aspect is based on their income, not their accumulated wealth.

With financing come charges by the lender, mortgage banker and mortgage broker who originates the mortgage. Charges related to mortgage origination greatly exceed the costs of all other services required to buy or carry property, except for broker transactional fees (which the seller usually pays out of funds received from the buyer).

Amount and source of funds

To document the cash a prospective buyer can gather from all their available sources to *fund the purchase* of a property, the buyer's agent uses a worksheet, called a **buyer's cost sheet**. The worksheet helps the agent identify and itemize the estimated-in-good-faith costs of acquisition and financing, as well as the buyer's sources of funding. The buyer's agent then reviews the completed form with the prospective buyer. [See Form 311 accompanying this chapter]

buyer's cost sheet
A worksheet used when estimating the total expenditures for acquiring a property and the amount of funds needed to close, including the source of the funds. [See **RPI** Form 311]

The *maximum price* a prospective buyer is able to offer for a property is determined by the amount of available funds from all sources which remains after deducting the acquisition costs. It is this residual amount of funds available for payment of a property's price which determines the value of a property to the buyer, never the seller's listing price. Sellers and their agents tend to ignore this pricing reality as interest rates rise, but take full advantage of the pricing rule when rates fall.

The primary source of cash for nearly all buyers of any type of real estate is a purchase-assist mortgage from a lender. Before a cost sheet review with the buyer can go beyond identifying the various sources of cash available to the buyer, the agent needs to arrange a conference for the prospective buyer with a representative of a lender.

Meeting with a lender

The objective of the conference with a lender is to determine:

- the maximum gross dollar amount of purchase-assist, fixed-rate mortgage funds the buyer will be *pre-approved* to borrow (if the property qualifies); and
- the lender's (good-faith) cost estimate of the dollar amount of all costs the buyer will incur to originate the maximum fixed-rate mortgage they are qualified to borrow. [See **RPI** Form 204-5]

These two dollar amounts (the mortgage and its costs) are treated as mutually exclusive amounts, separately analyzed on the buyer's cost sheet. The lender's estimated costs of borrowing will be entered on the agent's cost worksheet to document the amount of funds the buyer will need to pay for all transactional and financing costs. Separately, the total amount of the mortgage the buyer qualifies to borrow will be entered on the buyer's cost worksheet as cash available from a purchase-assist mortgage source.

During the conference with the lender, the buyer's agent needs to inquire about any restrictions the lender may place on the mortgage commitment. For example, a **loan-to-value ratio (LTV)** may require a minimum down payment by the buyer of up to 20% of the price paid for a property.

loan-to-value ratio (LTV)
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value.

Also, limitations may be placed on the seller's payment of the buyer's *nonrecurring transactional* and *financing costs*, such as permitting the seller's payment of all, a ceiling amount or none at all.

With knowledge of any lender restrictions, the buyer's agent is able to structure purchase agreement offers to shift large amounts of transactional and financing charges to the seller. Thus, the charges are paid by the seller out of funds the seller receives from the buyer, not paid by the buyer separately, which would reduce the funds they have available to buy property. Here, the buyer can acquire a more valuable property with more amenities since they will have more funds for payment of the purchase price.

An agent's *rule of thumb* for estimating borrowings: the amount of mortgage money a qualified buyer can borrow is equal to the principal (present value) at the current mortgage interest rate that 31% of the buyer's income will fully amortize over 30 years of monthly payments.

Certainty of costs builds confidence to buy

Having determined the prospective buyer's costs of mortgage funding and the transactional charges they will incur to acquire a property, the buyer becomes certain about the price they can pay and the amount of upfront nonrecurring acquisition and financing costs they will incur. What remains for the buyer's agent to do is locate qualifying properties and write up a purchase agreement offer agreeable to the buyer on the most suitable one.

Buyers combat declining prices and alleviate their tendency to wait before buying by making an offer at a price they feel comfortable paying for a property. Thus, pricing is based on:

- their knowledge the real estate market is in a decline;
- the property's condition; and
- their capacity to arrange for payment of the negotiated price and bear the costs of financing and closing escrow.

The task of complying with the agent's duty to care for and protect the buyer begins with the gathering of data to complete the preparation of the cost sheet. The process ends by making offers to come up with the match the buyer wants.

Cost of carrying property

While a review of the costs of acquisition is under way, other related disclosure information will come to the attention of the buyer's agent.

For example, a separate cost analysis involves the ongoing **operating expenses** a buyer will likely incur as the owner of property. Operating expenses are obtained from the seller's agent or compiled by the buyer's agent

from data readily available to the seller, and reviewed with the prospective buyer. [See **RPI** Form 306]

operating expenses The total annual cost incurred to maintain and operate a property for one year. [See **RPI** Form 352 §3.21]

Also, a drop in prices is usually a loss in the present value of a property brought on by an increase in long-term interest rates. Prices and mortgage rates move in opposite directions, usually within 12 months of a rate movement. Important to buyers during times of rising long-term interest rates is the understanding that the *price paid* and *costs* incurred to acquire property are *unalterable* in the future once escrow closes on the purchase.

However, this rigidity is not true for *interest rates*. A high interest rate on a mortgage required to finance payment of the purchase price of a property can be reduced by refinancing during later periods of cyclically lower interest rates. Conversely, the original purchase price paid, if too high, is unalterable.

Reducing and shifting the costs

Taxwise, a source of an additional minimal amount of cash to cover the costs of acquiring property is available to buyers who itemize deductions on their federal tax returns. Mortgage origination fees or points incurred to finance the purchase can be deducted (even when paid by the seller) to reduce the buyer's taxable income (and thus the amount of taxes paid) for the year of purchase. As a result, more funds are freed by a tax refund (or reduced payment).

For example, payment to the lender of 2% of the mortgage amount for *origination fees* will produce a rebate (a subsidy) to the buyer by way of a reduction in federal income taxes equal to 1/3 to 2/3 of a percent of the purchase price paid for the property. The amount of the refund depends on the buyer's low-income (10%-15%) or high-income (28%-35%) tax bracket status and the amount of the buyer's adjusted gross income.

carryback financing A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing, also known as an installment sale, credit sale or seller financing.

Also, buyers who finance their purchase under government-insured finance programs can attend *homeownership classes* and earn credits which cut their costs of acquiring financing. In a buyer's market, potential first-time buyers, such as tenants, may be encouraged to consider homeownership by attending one of these lender-provided classes. The purpose is to learn about the benefits and obligations of owning real estate. The financing costs charged by the lender will be reduced when the prospective buyers decide to purchase after completing such a course.

Carryback financing from the seller

Sellers, in an effort to maintain price, often are willing to extend credit in some form of **carryback financing**, a method used by the buyer to finance the purchase price. For a buyer, seller carryback financing avoids all the costs of new financing.

If the *interest rate* charged by the seller on the carryback is low enough (below market), the price paid for the property may logically be above market. The buyer's reduced long-term carrying costs arguably justify payment of the above-market price, one offsetting the other based on the dollar amount

saved in interest. However, the buyer is advised to seek an option, granted by the seller, to pay off the carryback early and at a discount. This arrangement keeps the purchase price realistic should the buyer later decide to sell or refinance the property.

During the early stages of a buyer's market, and continuing until prices bottom out and become stable, buyers who make offers need to be prepared to see their offers rejected. Historically, sellers and seller's agents are slow to acknowledge that prices have in fact stopped rising on comparable properties. Thus, they induce sellers to counter or otherwise reject realistic offers.

When sellers and their agents finally recognize market values are declining, they often panic by accepting large price reductions — at exactly the same time buyers are entering the market in increasing numbers and the bottom of the price cycle is about to or has arrived.

Once buyers become familiar with the possibilities of price and cost reductions, buyer's agents will need to be more creative to keep costs down as sales volume increases. One maneuver for shaving a sizeable dollar amount off the price of property is for buyer's agents to track suitable properties by the **date the listing expires**. On expiration of the listing, an inquiry of the seller by the buyer's agent for the sole purpose of submitting an offer, not for soliciting a dual agency listing, is likely to open up a price advantage for the buyer.

The advantage for the buyer amounts to a price paid for the property of around 3% less than the previously listed price. Here, the buyer's agent still receives the same amount for a fee as they would have received if a higher price was paid under a listing and the broker fee shared with the seller's agent (who did not locate a buyer).

Motivating individuals to own

The objective of agents in a buyer's market of declining prices, increasing inventory and fewer sales is to create buyers, not sellers. The supply of property is not the problem; it's the *lack of demand* as buyers fear to tread.

Agents can no longer concentrate primarily on listing property and remain successful. Primary attention needs to be given to potential and prospective buyers to educate them and demonstrate why they benefit most from being represented by a buyer's agent.

Thus, locating buyers is no longer best accomplished by listing and marketing property for sale. Individuals who are qualified to be buyers of real estate need to be attracted to the market by inducements other than publishing property listings and holding auctions or open houses.

Most potential buyers are tenants occupying apartments, condominium units or single family residences (SFRs). They have a job and, thus, can qualify for a purchase-assist mortgage to enter into ownership. These tenants are sought out by agents through business, social, civic, collegiate, athletic and religious networks.

New arrivals to the community may be contacted by advertisements located in airports, train stations and bus terminals to convert the new arrivals to homeownership. A kiosk in a shopping mall (or airport) managed by an agent may solicit tenants to fill out a homeownership application for the agent to review and advise on the homeownership options available to the tenant.

Finally, the issue of the agent's need to enter into a **listing agreement** before the agent undertakes the representation of an individual needs to be addressed.

listing agreement An employment agreement used by brokers and agents when a client retains a broker to render real estate transactional services as the agent of the client. [See **RPI** Form 102 and 103]

The need for a written employment may be broached with the potential buyer either *before* or *after* making a thorough mortgage qualification analysis and a review of acquisitions costs. However, once the buyer's financial capability and price range have been established, the buyer's listing agreement needs to be asked for and entered into before commencing a search for qualified properties suitable to the buyer.

Analyzing the cost sheet estimates

The **Good Faith Estimate of Buyer's Acquisition Costs, RPI** Form 311, is used by buyer's brokers and their agents to inform a prospective buyer about the cost of acquiring a particular parcel of real estate they have located and have determined is suitable for acquisition by the buyer. The form contains a checklist of bookkeeping items typical of most purchases, including acquisition costs, financing charges, prorations, funds required for acquisition and the buyer's probable sources for these funds.

The *estimates* entered on the form by the buyer's agent needs to be based on information about transactional costs and financing charges both known to them or readily available on an inquiry of others or on minimal investigation. Thus, the figures entered reflect the agent's *honestly held belief* that the estimated amount will likely be experienced by the buyer if the buyer acquires the property under consideration.

The *cost sheet* is used to disclose the crucial *financial information* the buyer needs to know about the acquisition of a property. With it, the buyer's agent provides the buyer with a high level of *transparency* about the costs of acquisition. Thus, the prospective buyer is able to make an informed decision about the financial commitment needed to purchase the property.

Use of the cost sheet

The events triggering the buyer's agent's preparation of a cost sheet and a review of the costs with the prospective buyer include:

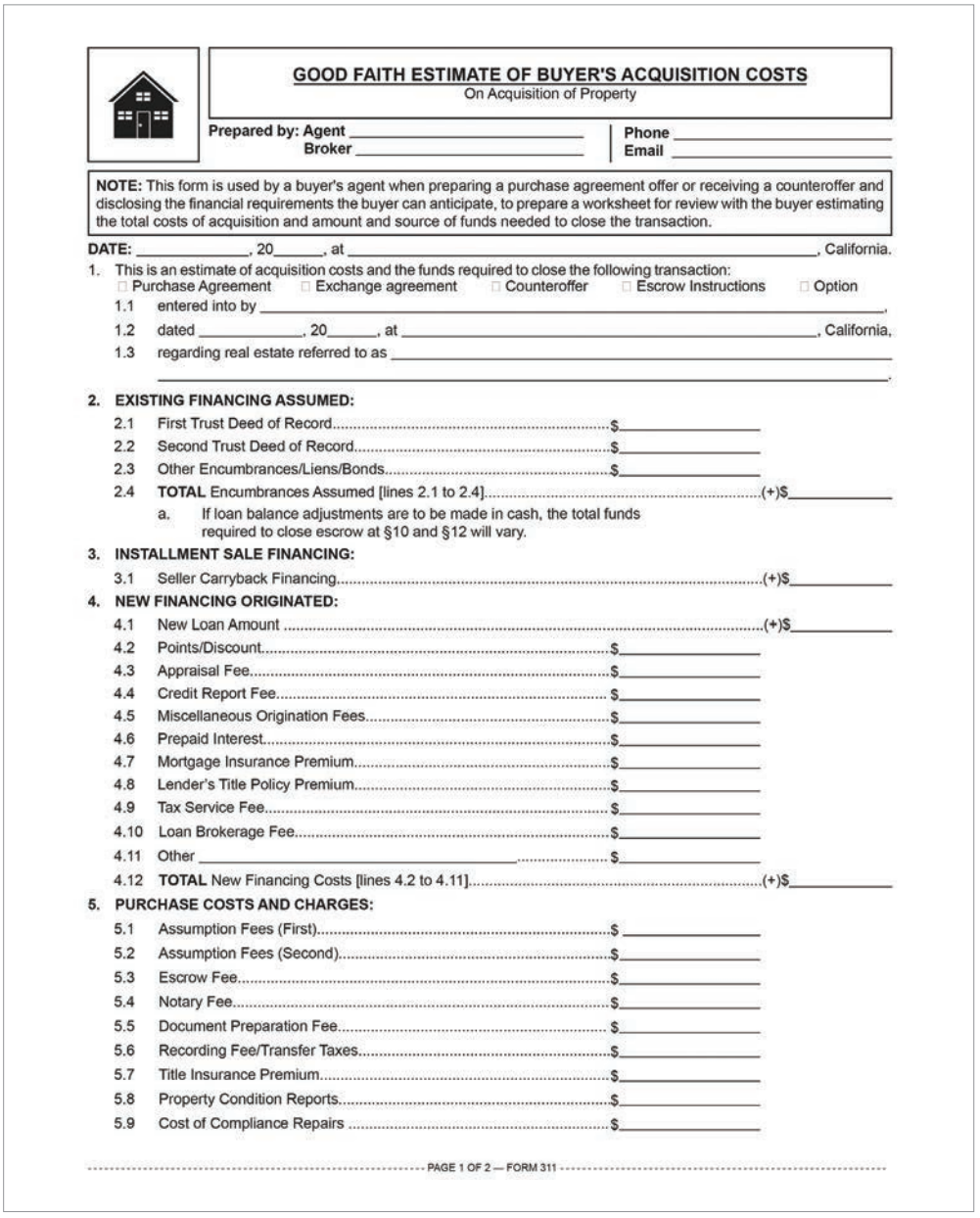
- entering into a buyer's listing agreement;
- pre-qualifying for a maximum mortgage amount; and
- entering into a purchase agreement offer or accepting a counteroffer.

The cost sheet is also used to *solicit tenants* — residential or nonresidential — to consider the purchase of property. With it, the agent demonstrates whether the tenant has the financial capability to occupy a comparable property as an owner instead of as a tenant, be it a home or business premises.

Form 311

Good Faith Estimate of Buyer's Acquisition Costs

Page 1 of 2



GOOD FAITH ESTIMATE OF BUYER'S ACQUISITION COSTS
On Acquisition of Property

Prepared by: Agent _____ Phone _____
Broker _____ Email _____

NOTE: This form is used by a buyer's agent when preparing a purchase agreement offer or receiving a counteroffer and disclosing the financial requirements the buyer can anticipate, to prepare a worksheet for review with the buyer estimating the total costs of acquisition and amount and source of funds needed to close the transaction.

DATE: _____, 20_____, at _____, California.

1. This is an estimate of acquisition costs and the funds required to close the following transaction:
☐ Purchase Agreement ☐ Exchange agreement ☐ Counteroffer ☐ Escrow Instructions ☐ Option
1.1 entered into by _____,
1.2 dated _____, 20_____, at _____, California,
1.3 regarding real estate referred to as _____.

2. **EXISTING FINANCING ASSUMED:**
2.1 First Trust Deed of Record.....$_____
2.2 Second Trust Deed of Record.....$_____
2.3 Other Encumbrances/Liens/Bonds.....$_____
2.4 **TOTAL** Encumbrances Assumed [lines 2.1 to 2.4].....(+)$_____
a. If loan balance adjustments are to be made in cash, the total funds required to close escrow at §10 and §12 will vary.

3. **INSTALLMENT SALE FINANCING:**
3.1 Seller Carryback Financing.....(+)$_____

4. **NEW FINANCING ORIGINATED:**
4.1 New Loan Amount .....(+)$_____
4.2 Points/Discount.....$_____
4.3 Appraisal Fee.....$_____
4.4 Credit Report Fee.....$_____
4.5 Miscellaneous Origination Fees.....$_____
4.6 Prepaid Interest.....$_____
4.7 Mortgage Insurance Premium.....$_____
4.8 Lender's Title Policy Premium.....$_____
4.9 Tax Service Fee.....$_____
4.10 Loan Brokerage Fee.....$_____
4.11 Other _____.....$_____
4.12 **TOTAL** New Financing Costs [lines 4.2 to 4.11].....(+)$_____

5. **PURCHASE COSTS AND CHARGES:**
5.1 Assumption Fees (First).....$_____
5.2 Assumption Fees (Second).....$_____
5.3 Escrow Fee.....$_____
5.4 Notary Fee.....$_____
5.5 Document Preparation Fee.....$_____
5.6 Recording Fee/Transfer Taxes.....$_____
5.7 Title Insurance Premium.....$_____
5.8 Property Condition Reports.....$_____
5.9 Cost of Compliance Repairs .....$_____

PAGE 1 OF 2 — FORM 311

Each section in Form 311 has a separate purpose, which cover:

- the *acquisition costs* of the property (cost basis);
- the *closing charges* (including prorations and adjustments); and
- the buyer's *source of funds* (savings, gifts, mortgages, etc.).

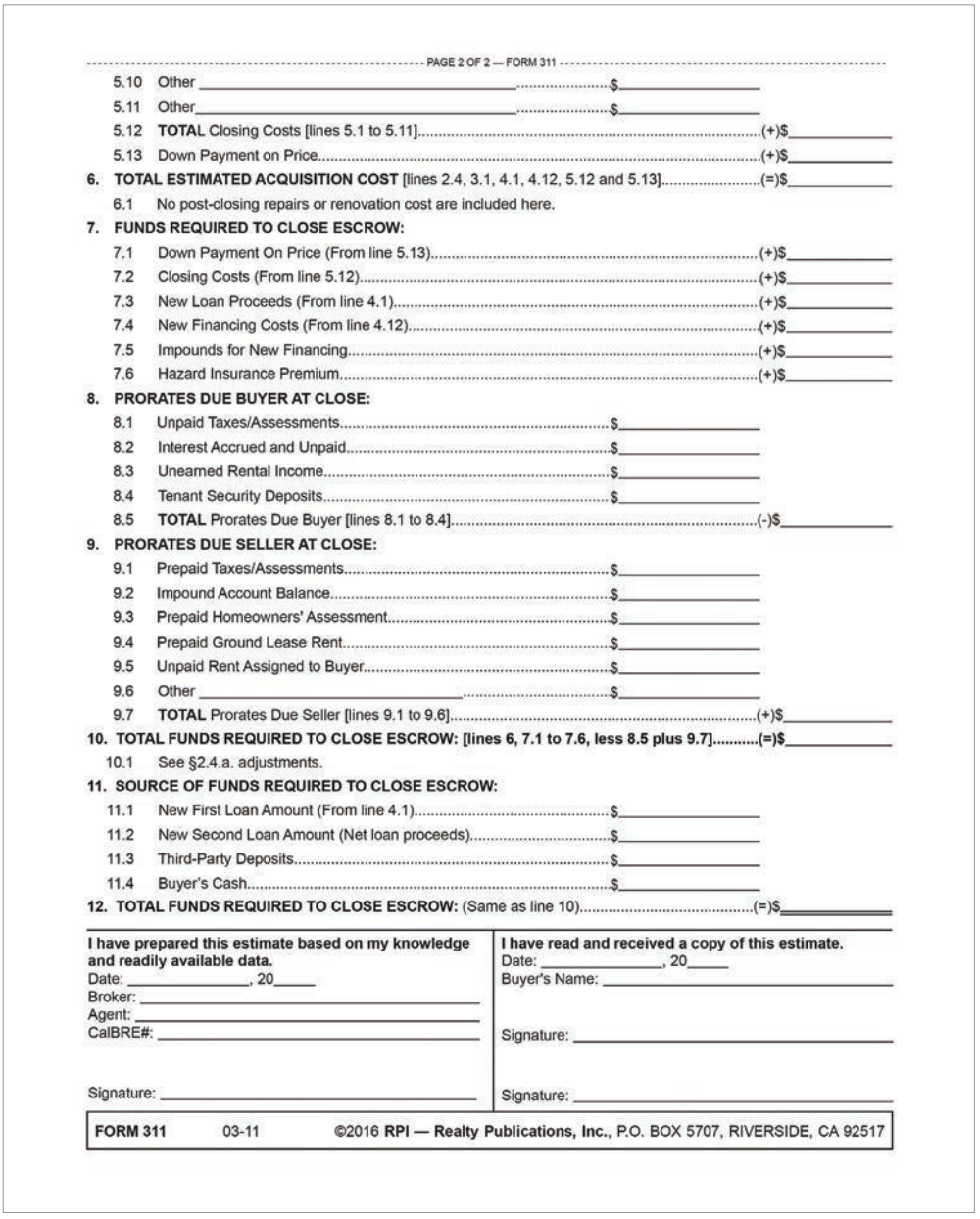
Preparing the buyer's cost sheet

The following instructions are for the preparation and use of the Good Faith Estimate of Buyer's Acquisition Costs – On Acquisition of Property, **RPI** Form 311, with which the buyer's broker and their agent may prepare an estimate for an analysis of the buyer's ability to pay the price and all the costs and charges related to the purchase.

Form 311

Good Faith Estimate of Buyer's Acquisition Costs

Page 2 of 2



PAGE 2 OF 2 — FORM 311

5.10 Other _____ $_____
5.11 Other _____ $_____
5.12 **TOTAL** Closing Costs [lines 5.1 to 5.11] (+)$_____
5.13 Down Payment on Price (+)$_____
6. TOTAL ESTIMATED ACQUISITION COST [lines 2.4, 3.1, 4.1, 4.12, 5.12 and 5.13] (=)$_____
6.1 No post-closing repairs or renovation cost are included here.
7. FUNDS REQUIRED TO CLOSE ESCROW:
7.1 Down Payment On Price (From line 5.13) (+)$_____
7.2 Closing Costs (From line 5.12) (+)$_____
7.3 New Loan Proceeds (From line 4.1) (+)$_____
7.4 New Financing Costs (From line 4.12) (+)$_____
7.5 Impounds for New Financing (+)$_____
7.6 Hazard Insurance Premium (+)$_____
8. PRORATES DUE BUYER AT CLOSE:
8.1 Unpaid Taxes/Assessments $_____
8.2 Interest Accrued and Unpaid $_____
8.3 Unearned Rental Income $_____
8.4 Tenant Security Deposits $_____
8.5 **TOTAL** Prorates Due Buyer [lines 8.1 to 8.4] (-)$_____
9. PRORATES DUE SELLER AT CLOSE:
9.1 Prepaid Taxes/Assessments $_____
9.2 Impound Account Balance $_____
9.3 Prepaid Homeowners' Assessment $_____
9.4 Prepaid Ground Lease Rent $_____
9.5 Unpaid Rent Assigned to Buyer $_____
9.6 Other _____ $_____
9.7 **TOTAL** Prorates Due Seller [lines 9.1 to 9.6] (+)$_____
10. TOTAL FUNDS REQUIRED TO CLOSE ESCROW: [lines 6, 7.1 to 7.6, less 8.5 plus 9.7] (=)$_____
10.1 See §2.4.a. adjustments.
11. SOURCE OF FUNDS REQUIRED TO CLOSE ESCROW:
11.1 New First Loan Amount (From line 4.1) $_____
11.2 New Second Loan Amount (Net loan proceeds) $_____
11.3 Third-Party Deposits $_____
11.4 Buyer's Cash $_____
12. TOTAL FUNDS REQUIRED TO CLOSE ESCROW: (Same as line 10) (=)$_____

I have prepared this estimate based on my knowledge and readily available data.
Date: _____, 20____
Broker: _____
Agent: _____
CalBRE#: _____
Signature: _____

I have read and received a copy of this estimate.
Date: _____, 20____
Buyer's Name: _____
Signature: _____
Signature: _____

FORM 311 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

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

*Editor's note — **Enter** figures throughout the cost sheet in the blanks provided, unless the items left blank are not intended to be included in the final estimate.*

Document identification

Enter the date and name of the city where the cost sheet is prepared. This date is used when referring to this form.

1. **Check** the appropriate box indicating the underlying agreement which is the subject of this disclosure of costs.

   1.1 **Enter** the name(s) of the parties to the agreement.

1.2 **Enter** the date of the agreement and place of preparation.

1.3 **Enter** the address or parcel number identifying the property involved.

Financing

2. **Existing financing assumed:**

2.1 *First mortgage of record*: **Enter** the dollar amount of the first mortgage balance if the buyer is to take over the mortgage.

2.2 *Second mortgage of record*: **Enter** the dollar amount of the second mortgage balance if the buyer is to take over the mortgage.

2.3 *Other encumbrances/liens/bonds*: **Enter** the dollar amount of the principal balance remaining on any other money obligations which the buyer is to take over, such as liens for improvement district bond assessments (Mello Roos, 1915 Act, etc.), abstracts of judgment, UCC-1 security agreements (on personal property/improvements included in the purchase) or other debts to be assumed by the buyer.

2.4 **TOTAL** *encumbrances assumed*: **Add** the figures estimated in sections 2.1, 2.2 and 2.3. Enter the total as the dollar amount of the principal balance on debts to be assumed or otherwise taken over by the buyer as part of the price.

a. *Funds to close escrow will vary*: Each estimated figure may vary by the time of closing, depending on the accuracy of the estimates, principal reduction on existing mortgages and changing service charges, fees and premiums. Also, if the difference in amounts is to be adjusted into the cash down payment, the amount of funds required to close escrow at sections 10 and 12 will vary.

Adjustments into price, such as in an equity purchase transaction, merely adjust the total consideration paid to the seller, not the amount of the down payment or any carryback note and trust deed. Likewise, adjustments for the differences into any seller carryback leaves the price and down payment unaffected, but will alter the amount of the carryback note at section 3.1 by the time escrow closes.

3. **Installment sale financing:**

3.1 *Seller carryback financing*: **Enter** the dollar amount of the note the buyer is to execute in favor of the seller. This amount will vary if adjustments at closing are to be made into the carryback note, and not into the down payment or the price.

4. **New financing originated:**

Financing, cont'd

4.1 *New mortgage amount*: **Enter** the dollar amount of the new mortgage the buyer is to originate with a lender to provide purchase-assist funds to close escrow. The total amount of the mortgage is entered without reduction for any lender discounts, costs, fees or charges.

4.2 *Points/discount*: **Enter** the dollar amount of the points to be paid or the discount charged to originate the new mortgage, a figure usually calculated as a percentage of the new mortgage amount.

4.3 *Appraisal fee*: **Enter** the dollar amount the new lender will charge for an appraisal of the property to be purchased. Upon request, the buyer is entitled to a copy of the appraisal from the lender. [See **RPI** Form 200-3]

4.4 *Credit report fee*: **Enter** the dollar amount of the credit report fee charged by the lender for ordering the report and analyzing the buyer's creditworthiness.

4.5 *Miscellaneous origination fees*: **Enter** the total dollar amount of all other fees charged by the lender to process the mortgage, including fees labeled as escrow set-up fees, administrative fees, processing fees, origination fees, wire fees, document preparation fees, etc., which are not itemized in sections 4.2 through 4.11.

4.6 *Prepaid interest*: **Enter** the dollar amount of prepaid interest the new lender will demand for closing before the last day of the calendar month. The interest charge will be a daily amount due for each day following closing through the last day of the month in which the sale closes. This prepayment of interest allows for the first installment on the mortgage to be due on the first day of the first month falling more than 30 days after closing.

4.7 *Mortgage insurance premium*: **Enter** the dollar amount of any private mortgage insurance (PMI), mortgage insurance premium (MIP) or other insurance premium to be paid by the buyer to guarantee payment for losses the lender may suffer on a default.

The amount is a quote by a corporate or government insurer based on the LTV ratio and the amount of the mortgage. A further creditworthiness risk review of the buyer is conducted by the insurer, which could alter the premium or the availability of the insurance.

4.8 *Lender's title policy premium*: **Enter** the dollar amount of the premium charged by the title company to issue a separate lender's policy of title insurance (in addition to the owner's policy at section 24) to cover the existence of the security interest in the property as evidenced by the lender's trust deed lien.

Financing, cont'd

4.9 *Tax service fee*: **Enter** the dollar amount charged by a separate service company which informs the lender when the buyer has not paid the property taxes.

4.10 *Mortgage broker fee*: **Enter** the dollar amount of any fees due a mortgage broker for arranging the new mortgage for the buyer. Do not include any financial benefit (kickback/referral fee) paid the brokers or sales agents by the lender since they are paid from increased fees or above-market interest rates the lender charges the buyer.

4.11 *Miscellaneous mortgage charges*: **Enter** the name of any other mortgage charge to be incurred by the buyer due to the new mortgage origination. Enter the dollar amount of the charge.

4.12 *TOTAL new financing costs*: **Add** the figures estimated in sections 4.1 through 4.11. Enter the total as the dollar amount of all the expenditures anticipated to be incurred by the buyer to originate a new mortgage.

Additional costs and fees

5. **Purchase costs and charges:**

5.1 *Assumption fees (first)*: **Enter** the dollar amount of the anticipated assumption fees the existing first mortgage lender will likely demand if the lender's consent is required for the buyer to take over the mortgage.

5.2 *Assumption fees (second)*: **Enter** the dollar amount of the anticipated assumption fees the existing second mortgage lender will likely demand if the lender's consent is required for the buyer to take over the mortgage.

5.3 *Escrow fee*: **Enter** the dollar amount of the service charge the buyer will incur for an escrow to handle the closing of the purchase agreement.

5.4 *Notary fee*: **Enter** the dollar amount of the charges the buyer will incur for notary services to acknowledge the buyer's signature on documents which are to be recorded to purchase the property (trust deeds, power of attorney, spousal quit claim deeds, declaration of homestead, release of recorded instruments, request for NOD/NODq, UCC-1 filing, etc.).

5.5 *Document preparation fee*: **Enter** the dollar amount of any additional miscellaneous fees charged by escrow for providing escrow-related services.

5.6 *Recording fee/transfer taxes*: **Enter** the dollar amount of charges imposed or collected by the county recorder and paid by the buyer for recordings which are necessitated by the transfer.

Additional costs and fees, cont'd

5.7 *Title insurance premium*: **Enter** the dollar amount of the title insurance premium the title company will charge for issuing a policy to the buyer if the buyer is to pay the premium. Typically, the seller pays the premium to acquire the insurance which covers the seller's conveyance to the buyer.

5.8 *Property condition reports*: **Enter** the total dollar amount of fees and charges it is anticipated the buyer will incur to investigate and confirm the condition of the property (its land, improvements and components) as known to the buyer by both the buyer's observations and disclosures made by the seller or the seller's agent prior to entering into the purchase agreement.

*Editor's note — The seller's broker or agent has a statutory duty, owed to prospective buyers on the sale of one-to-four residential units, to personally conduct a **visual inspection** of the property and enter on the mandated seller's Transfer Disclosure Statement (TDS) any **observations** they may have contrary to the seller's disclosures. The TDS is to be made available to prospective buyers at the earliest opportunity during the negotiating stage The first opportunity to disclose rarely occurs later than at the time a purchase agreement offer is accepted. [See **RPI** Form 304]*

However, the seller's agent too often deliberately delays an investigation or certification of a property's condition until after the buyer has committed themselves to purchase the property (in its undisclosed condition). Thus, the buyer, in an effort to confirm the property is all they have been lead to believe it is, needs to obtain the reports and certifications to discover the conditions which were known (or should have been known) and not disclosed by the seller or their agent prior to entering into the purchase agreement, a form of fraud called negative deceit.

Such reports, clearances and certificates include pest control reports, local occupancy certificates, sewer/septic certificates, home inspection reports, well water condition certificates, hazard reports, safety compliances, etc. It is the buyer's agent, not the seller's agent, who is duty bound to see to it their buyer has been informed about inspections and investigations readily available to the buyer, and explain which they believe the buyer should use to check out the property.

5.9 *Cost of compliance repairs:* **Enter** the dollar amount of the costs it is anticipated the buyer will incur to correct, retrofit or eliminate defects in the property prior to or immediately after closing, which will not be eliminated by the seller.

5.10 *Miscellaneous closing costs:* **Enter** the name of any additional costs it is anticipated or believed the buyer will incur to acquire the property prior to or immediately after closing. **Enter** the dollar amount estimated as likely to be incurred.

5.11 *Miscellaneous closing costs:* See instructions for section 5.10.

Additional costs and fees, cont'd

5.12 **TOTAL** *closing costs*: **Add** the figures estimated for sections 5.1 through 5.11. **Enter** the total as the dollar amount of all costs it is anticipated the buyer will incur to close escrow.

5.13 *Down payment on price*: **Enter** the dollar amount of the down payment the buyer has agreed to pay the seller through or outside of escrow, whether the funds are from the buyer's cash reserves, gifts and bonuses from third parties, or a broker fee credited to the buyer's account due to the buyer's participation as a licensee in the transaction.

Editor's note — This sum of money for the down payment does not include any mortgage funds to be paid over to the seller from the new mortgage under section 4.1, or charges, prorations and adjustments reflected in section 10.

Acquisition costs and funds required to close

6. **Total estimated acquisition cost**: **Add** the figures from sections 2.4, 3.1, 4.1, 4.12, 5.12 and 5.13. **Enter** the total as the approximate dollar amount of monetary commitments in cash or mortgage amounts which the buyer will be committing themselves to pay.

6.1 *Post-closing repairs*: This cost figure does not include any capital contribution to be made by the buyer to pay for the cost of any renovation, rehabilitation or reconstruction of any part of the property to be incurred immediately after closing, which will become part of the buyer's cost of acquisition for tax reporting purposes.

7. **Funds required to close escrow**:

7.1 *Down payment on price*: **Enter** the dollar amount from section 5.13.

7.2 *Closing costs*: **Enter** the dollar amount from section 5.12.

7.3 *New mortgage proceeds*: **Enter** the dollar amount from section 4.1.

7.4 *New financing costs*: **Enter** the dollar amount from section 4.12.

7.5 *Impounds for new financing*: **Enter** the dollar amount of the deposit of buyer's funds into the lender's mortgage escrow account the lender will demand if the new mortgage under section 4.1 is to be impounded for the future payment of property taxes, assessments and hazard insurance premiums.

Editor's note — When disbursed by the lender, these expenditures from the impound account become the operating expenses of the buyer. They are not, now or then, a cost of acquiring the property (but are nonetheless an out-of-pocket advance made prior to closing).

7.6 *Hazard insurance premium:* **Enter** the dollar amount of the premium the buyer will be advancing for hazard insurance coverage on the property.

Editor's note — This is not a cost of acquisition. It is an operating expense.

Calculating buyer prorations

8. **Prorates due buyer at close**:

8.1 Unpaid taxes/assessments: Enter the dollar amount of those real estate taxes and improvement district bond assessments which have accrued and have not been paid by the seller if they are to be prorated and are not credited to the price under section 2.3.

They have not been paid for one of two reasons: they are not yet due to be paid to the tax collector or they are past due and delinquent. If they are not yet due, the buyer will at a later date be paying those property taxes which accrued during the seller's ownership. Thus, they are prorated as a credit to the buyer through the last day prior to the date of closing.

The proration is calculated as a daily amount of the annual tax and assessment amounts based on a 30-day month. The current tax bill or, if it is not yet available, the past year's amounts are used (and adjusted for inflation, etc.) to arrive at the daily amount of the proration.

Editor's note — If escrow is scheduled to close September 16, the tax billing has not yet been received and the current taxes have not been paid. Thus, 75 days of accrued taxes/assessments at the daily rate are credited to the buyer (and charged to the seller).

8.2 *Interest accrued and unpaid:* **Enter** the dollar amount of interest accrued and unpaid on mortgages assumed under sections 2 through 2.3 for the number of days during the month the seller will remain the owner prior to closing. The proration will be calculated as a daily amount of interest paid in monthly installments based on a 30-day month.

The daily amount of interest accrued is credited to the buyer for each day of the month prior to the day scheduled for closing since interest on mortgages is paid following the month of accrual. Thus, the next installment will become the obligation of the buyer, unless the installment is disbursed by escrow and charged pro rata to the seller and the buyer.

8.3 *Unearned rental income:* **Enter** the portion of the dollar amount of rent from the rent rolls, both prepaid and unpaid, which remains unearned on the day scheduled for closing. The buyer is entitled to a credit of the unearned portion of rent as a proration. The day of closing is the first day of ownership

by thebuyer and entitles the buyer to unearned rents for the entire day on which escrow closes. The proration is calculated as a daily amount of the rent roll unearned based on a 30-day month.

Editor's note — If the rents are $30,000 monthly, the daily proration for earned rents would be $1,000, which is multiplied by the number of days remaining in the month, beginning with and including the day of closing. If closing is on the 16th, the dollar amount of prorated rents credited to the buyer from funds accruing to the seller's account on closing would be $15,000, the 16th being day one of the remainder of the 30-day month.

For unpaid delinquent rents shown on the rent roll, see section 9.5 for an offset charge to the buyer by an adjustment.

Calculating buyer prorations, cont'd

8.4 *Tenant security deposits*: **Enter** the dollar amount of all the security deposits held by the seller (as landlord) which belong to the tenants as disclosed on the seller's rent roll information sheet. This credit is an adjustment, not a proration, in funds due the seller since the buyer on transfer of ownership will be the landlord (by assignment of the leases and rent agreements) and responsible for accounting to the tenants for any deposit held by the seller.

Editor's note — Include any interest accrued and unpaid on the security deposits from the date of the seller's receipt of the deposits if mandated by rent control or landlord-tenant law.

8.5 **TOTAL** *prorates due buyer at close*: **Add** the figures estimated in sections 8.1 through 8.4. **Enter** the total as the dollar amount of all the "credits" the buyer can anticipate due to prorations and adjustments.

Editor's note — The debits charged to the buyer by proration are calculated in the following sections.

Calculating seller prorations

9. **Prorates due seller at close:**

9.1 *Prepaid taxes/assessments*: **Enter** the dollar amount of real estate taxes and improvement assessments prepaid by the seller which have not yet accrued. The calculations are made in the same manner as explained in section 8.1.

Editor's note — For example, the seller has paid all installments of taxes/assessments for the entire fiscal year (July through June). A closing of the buyer's transaction on December 31 requires a proration charge to be paid by the buyer for one-half year's (180 days') taxes/assessments since they have been prepaid, but will not accrue until after the buyer closes escrow.

9.2 *Impound account balance*: **Enter** the dollar amount of the impounds held by the lender on each mortgage assumed under

Calculating seller prorations, cont'd

sections 2.1, 2.2 or 2.3. The information is readily available from the monthly accounting of the mortgage's condition received by the seller from the lender servicing the mortgage.

9.3 *Prepaid homeowners' assessment*: **Enter** the dollar amount of the prepaid and unaccrued portion of the seller's current installment for any homeowners' association (HOA) assessment. The proration charge is based on a 30-day month for those days remaining in the month, beginning with the day of closing as day one of the days remaining in the month.

9.4 *Prepaid ground lease rent*: **Enter** the dollar amount of the prepaid and unaccrued portion of rent the seller has paid on the ground lease if the property interest being purchased is a leasehold interest transferred by assignment and not a fee interest transferred by grant deed.

9.5 *Unpaid rents assigned to buyer*: **Enter** the dollar amount of delinquent unpaid rents to be charged to the buyer if the seller will not collect the rent before the close of escrow. These unpaid rents belong to the buyer on closing due to the seller's assignment of the leases to the buyer, unless other arrangements are made for an accounting of the uncollected rents. Typically, a closing after the tenth of the month will not experience the need for a delinquent rent adjustment. (All rents have been prorated in section 8.3.)

9.6 *Miscellaneous prorates and adjustments*: **Enter** the name of other prorates or adjustments which may be required. **Enter** the dollar amount charged to the buyer.

9.7 **TOTAL** *prorates due seller*: **Add** the figures estimated in sections 9.1 through 9.6. Enter the total as the dollar amount of all the "charges" the buyer is likely to experience due to prorations and adjustments.

Funds required to close and their source

10. **Total funds required to close escrow: Add** the figures from sections 6, 7.1 through 7.6, 9.7, and then subtract the figure from section 8.5 from the total. **Enter** the difference as the dollar amount of funds the buyer will need to close escrow.

10.1 See section 2.4a adjustments.

11. **Source of funds required to close escrow:**

11.1 *New first mortgage amount*: **Enter** the dollar amount of the new mortgage estimated in section 4.1.

11.2 *New second mortgage amount*: **Enter** the dollar amount of any second mortgage to be originated. If the costs of originating the

second have not been entered in section 4.2 through 4.12, then **enter** only the estimated amount of the net proceeds generated by the second mortgage here.

11.3 *Third-party adjustments*: **Enter** the dollar amount of any funds received from third parties which the buyer expects to use to fund the purchase of the property. For example, families make gifts, employers give bonuses and equity sharing and other coownership arrangements contribute cash.

11.4 *Buyer's cash*: **Subtract** the figures in sections 11.1 through 11.3 from the figure in section 10. Enter the result as the dollar amount of funds the buyer needs to presently hold or have in reserves (savings/readily convertible securities and certificates) to meet the expenditures anticipated by the estimates in this opinion given by the buyer's broker or their agent.

12. **Total funds required to close escrow: Add** the figures estimated in sections 11.1 through 11.4. Enter the total as the amount of funds needed by the buyer to acquire the property.

Editor's note — The amount here in section 12 will be the same as the amount arrived at in section 10.

Signatures

Broker's/Agent's signature: **Enter** the date the cost sheet is signed, the broker's name and CalBRE license number and the agent's name. Obtain the broker's (or agent's) signature.

Buyer's signature: **Enter** the date the buyer signs and the buyer's name. **Obtain** the buyer's signature.

Chapter 22 Summary

To document the cash a prospective buyer can bring together from all their available sources to fund the purchase of a property, the buyer's agent uses a worksheet, called a buyer's cost sheet. The worksheet helps the agent identify and itemize the estimated-in-good-faith costs of acquisition and financing, as well as the buyer's sources of funding. The events triggering the buyer's agent's preparation of a cost sheet and a review of the costs with the prospective buyer include:

- entering into a buyer's listing agreement;
- pre-qualifying for a maximum mortgage amount; and
- entering into a purchase agreement offer or accepting a counteroffer.

Arranging purchase-assist funding is nearly always a requisite to establishing what price and costs of acquisition an individual is able to pay. Charges related to mortgage origination greatly exceed the costs of all other services required to buy or carry property, except for broker transactional fees (which the seller usually pays out of funds received from the buyer).

The maximum price a prospective buyer is able to offer for a property is determined by the amount of available funds from all sources which remains after deducting the acquisition costs. This determines the value of a property to the buyer, never the seller's listing price.

Before a cost sheet review with the buyer can go beyond identifying the various sources of cash available to the buyer, the agent needs to arrange a conference for the prospective buyer with a representative of a lender. The objective of the conference with a lender is to determine the maximum gross dollar amount of purchase-assist funding the buyer will be pre-approved to borrow and the lender's (good-faith) cost estimate of the dollar amount of all costs the buyer will incur to originate the mortgage.

Agents can also strategically help buyers get more value for their money by reducing or transferring some of the purchase and acquisition costs with such measures as:

- itemized deductions for financing charges and interest;
- homeowner classes for lender discounts;
- carryback financing arrangements; and
- waiting until a listing expires to submit an offer in the hope that the seller will accept a reduced price.

Chapter 22 Key Terms

Need to renew your
sales agent or broker license?

Sign up for a 45-hour renewal package from **firsttuesday** for just $84.50! It's quick and easy — you'll be done in as little as 6 days.

Enroll now

Chapter 23

The purchase agreement

Learning Objectives

After reading this chapter, you'll be able to:

- describe the multiple functions of a purchase agreement form;
- identify various types of purchase agreements; and
- understand the sections and provisions that make up a purchase agreement.

Key Terms

equity purchase (EP) agreement

purchase agreement

Types and variations

A newcomer's entry as a real estate agent into the vocation of soliciting and negotiating real estate transactions typically begins with the marketing and locating of single family residences (SFRs) as a seller's agent or a buyer's agent (also known as listing agents or selling agents, respectively).

Other properties an agent might work with include:

- one-to-four unit residential properties;
- apartments;
- nonresidential income properties (office buildings, commercial units and industrial space);
- agricultural property; or
- unimproved parcels of land.

For real estate sales conveying ownership of a property, the **primary document** used to negotiate the transaction between a buyer and seller is a **purchase agreement** form. Different types of properties each require a different variety of *purchase agreements.* Various purchase agreements comprise provisions necessary to negotiate the sale of a particular type of property.

purchase agreement The primary marketing device used to negotiate a real estate sales transaction between a buyer and seller. [See **RPI** Forms 150-159]

Three basic categories of purchase agreements exist for the documentation of real estate sales. The categories are influenced primarily by legislation and court decisions addressing the handling of the disclosures and due diligence investigations in the marketing of properties.

The three *categories of purchase agreements* are for:

- one-to-four unit residential property sales transactions;
- other than one-to-four unit residential property sales transactions, such as for residential and nonresidential income properties and owner-occupied business/farming properties; and
- land acquisition transactions.

Within each category of purchase agreement, several variations exist. The variations cater to the specialized use of some properties, the diverse arrangements for payment of the price and to the specific conditions which affect a property, particularly within the one-to-four unit residential property category.

Purchase agreement variations

Purchase agreement variations for **one-to-four unit residential sales** transactions include purchase agreements for:

- negotiating the conventional financing of the purchase price [See Figure 1];
- negotiating a short sale [See **RPI** Form 150-1];
- negotiating a cash to new or existing mortgage, or a seller carryback note [See **RPI** Form 150-2];
- negotiating for separate broker fees paid each broker by their client [See **RPI** Form 151];
- negotiating the government insured financing (FHA/VA) of the purchase price [See **RPI** Forms 152 and 153];
- negotiating the sale of an owner-occupied residence-in-foreclosure to an investor, called an **equity purchase (EP) agreement** [See **RPI** Form 156];
- negotiating an *equity purchase* short sale [See **RPI** Form 156-1];
- direct negotiations between principals (buyers and sellers) without either party being represented by a real estate agent [See **RPI** Form 157]; and
- negotiating highly specialized transactions using a "short-form" purchase agreement which does not contain boilerplate provisions setting forth the terms for payment of the price, which allows the agent to attach specialty addenda to set the terms for payment (a carryback ARM, equity sharing addenda, etc.). [See **RPI** Forms 155-1 and 155-2]

equity purchase (EP) agreement
The document used to negotiate the sale of an owner-occupied residence-in-foreclosure to an investor. [See **RPI** Form 156]

Variations among purchase agreements used in **income property** and **owner-occupied business property** sales transactions include purchase agreements for:

- the conventional financing of the purchase price [See **RPI** Form 159]; and
- the downpayment note financing of the purchase price. [See **RPI** Form 154]

Finally, a variation exists for land sales of a parcel of real estate which has no improvements in the form of buildings and for **farm and ranch** sales. [See **RPI** Forms 158 and 158-1 through 158-6]

Editor's note — For a full-size, fillable copy of any form referenced in this book, go to realtypublications.com/forms

Escrow instructions provide yet another variation on the purchase agreement. For example, a buyer and seller having orally agreed on the terms of a sale, with or without the assistance of an agent, contact an escrow company to handle their deal. Escrow instructions are prepared and signed, without first entering into a real estate purchase agreement. Here, the escrow instructions bind the buyer and seller as though they had entered into a purchase agreement. [See **RPI** Form 401]

Purchase agreement addenda

Attached to all these various purchase agreements are one or more **addenda**, regarding:

- disclosures about the property;
- the financing of the price paid for the property;
- agency relationship law; and
- special provisions called for by the needs of the buyer or seller.

In this Chapter, the focus is on the needs of the newly licensed agent and thus limited to documenting and managing the negotiations in an SFR real estate transaction. The document reviewed here is the purchase agreement used in SFR sales transactions structured for the conventional financing of the purchase price.

Analyzing the purchase agreement

A buyer's agent uses the **Purchase Agreement (One-to-Four Residential Units – Conventional and Carryback Financing)** to prepare and submit the buyer's *written offer* to purchase a one-to-four unit residential property.

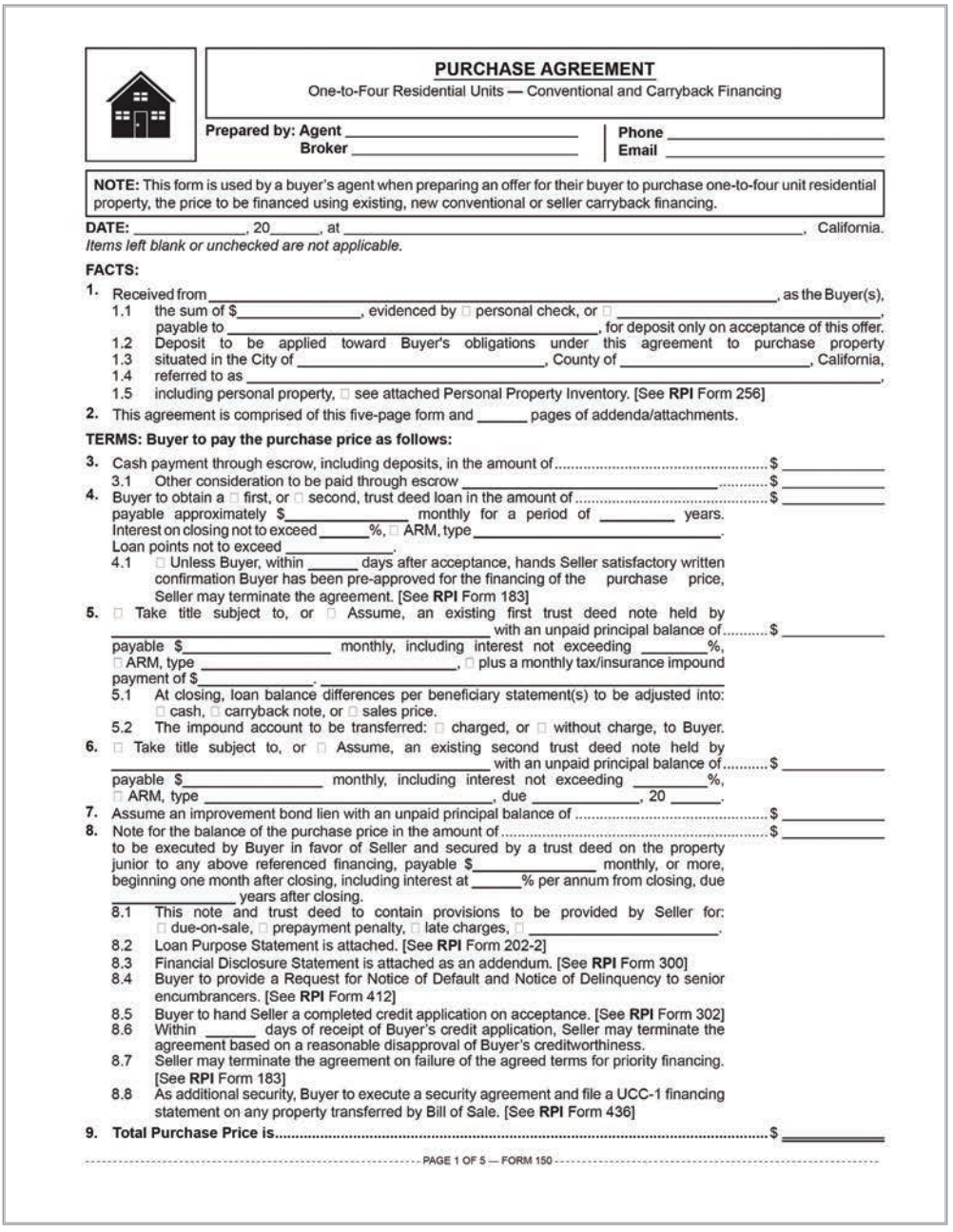
The pricing and terms for performance are limited to conventional financing, a takeover of existing mortgages, a carryback note or a combination of some of these arrangements. This *purchase agreement* is also properly used by sellers when confronted with a counteroffer situation. The seller's agent prepares an entirely new purchase agreement, then submits it as their fresh offer to sell on terms different from those of an unacceptable purchase offer received from the buyer.

Figure 1

Form 150

Purchase Agreement

Page 1 of 5



PURCHASE AGREEMENT
One-to-Four Residential Units — Conventional and Carryback Financing

Prepared by: Agent _____ Phone _____
Broker _____ Email _____

NOTE: This form is used by a buyer's agent when preparing an offer for their buyer to purchase one-to-four unit residential property, the price to be financed using existing, new conventional or seller carryback financing.

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. Received from _____, as the Buyer(s),
 1.1 the sum of $_____, evidenced by ☐ personal check, or ☐ _____, payable to _____, for deposit only on acceptance of this offer.
 1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
 1.3 situated in the City of _____, County of _____, California,
 1.4 referred to as _____,
 1.5 including personal property, ☐ see attached Personal Property Inventory. [See **RPI** Form 256]
2. This agreement is comprised of this five-page form and _____ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of ..... $ _____
 3.1 Other consideration to be paid through escrow _____ ..... $ _____
4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of ..... $ _____
 payable approximately $_____ monthly for a period of _____ years.
 Interest on closing not to exceed _____%, ☐ ARM, type _____.
 Loan points not to exceed _____.
 4.1 ☐ Unless Buyer, within _____ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **RPI** Form 183]
5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____ with an unpaid principal balance of ..... $ _____
 payable $_____ monthly, including interest not exceeding _____%,
 ☐ ARM, type _____, ☐ plus a monthly tax/insurance impound payment of $_____.
 5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.
 5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.
6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____ with an unpaid principal balance of ..... $ _____
 payable $_____ monthly, including interest not exceeding _____%,
 ☐ ARM, type _____, due _____, 20 _____.
7. Assume an improvement bond lien with an unpaid principal balance of ..... $ _____
8. Note for the balance of the purchase price in the amount of ..... $ _____
 to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____ years after closing.
 8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ _____.
 8.2 Loan Purpose Statement is attached. [See **RPI** Form 202-2]
 8.3 Financial Disclosure Statement is attached as an addendum. [See **RPI** Form 300]
 8.4 Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **RPI** Form 412]
 8.5 Buyer to hand Seller a completed credit application on acceptance. [See **RPI** Form 302]
 8.6 Within _____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.
 8.7 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **RPI** Form 183]
 8.8 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **RPI** Form 436]
9. **Total Purchase Price is** ..... $ _____

PAGE 1 OF 5 — FORM 150

On acceptance, the purchase agreement becomes a *binding written contract* between the buyer and seller. To be enforceable, the price and terms for performance need to be clear, concise and complete to prevent misunderstandings.

To this end, a comprehensive purchase agreement includes as "boilerplate" all provisions that might be needed in a likely transaction. They are designed to serve as a **checklist** of provisions an **agent** is to consider when preparing an offer. The various conventional financing arrangements and conditions a prudent buyer considers when making an offer to purchase a home are tightly worded for easy selection. [See Figure 1]

Components of the purchase agreement

Each section of Form 150 has a separate purpose and need for enforcement. The parts include:

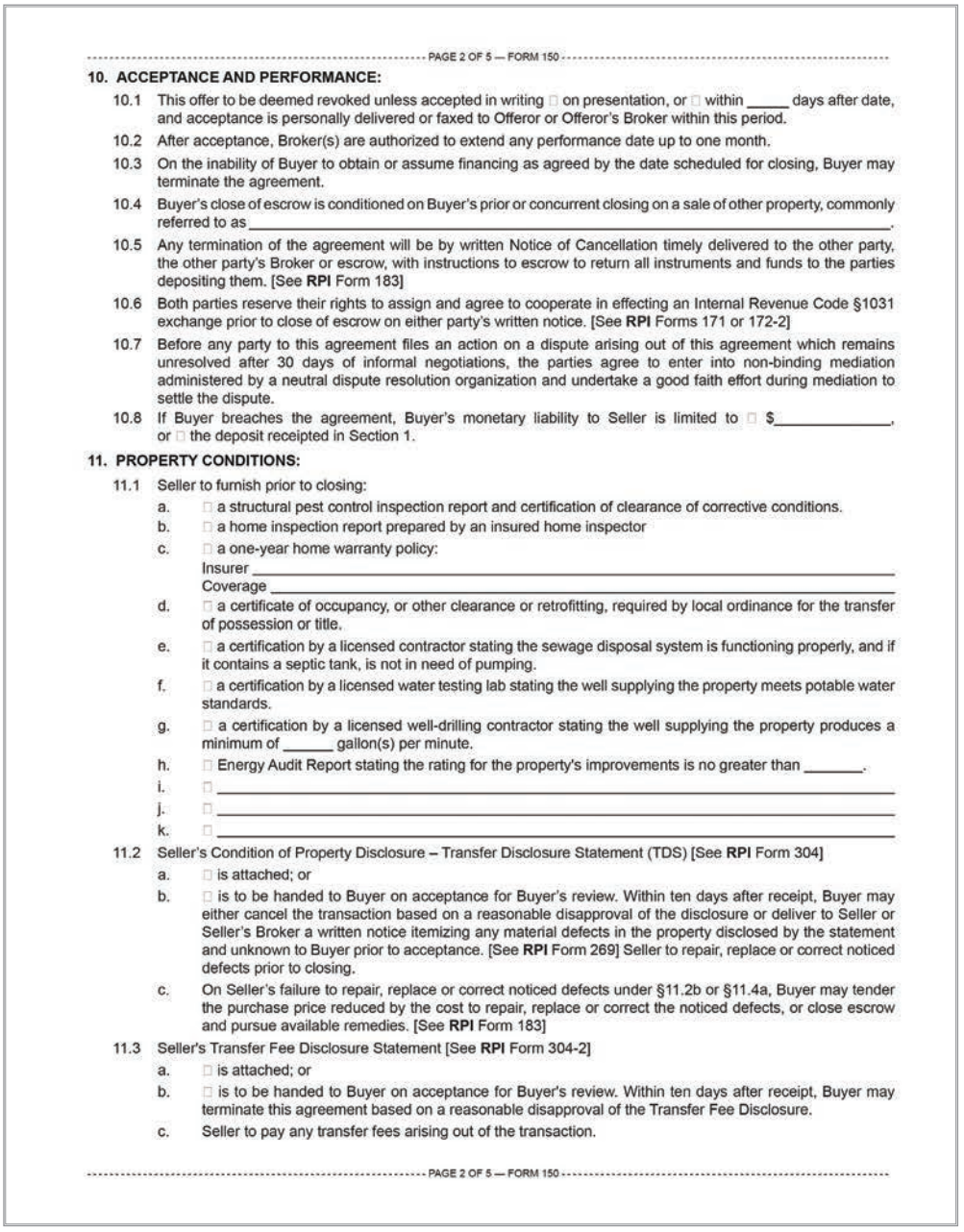
1. *Identification:* the date and place of preparation, the buyer's name, the amount of the good-faith deposit, the description of the real estate, an inventory of personal property included in the transfer and the number of pages contained in the agreement and its addenda (Sections 1 and 2).
2. *Price and terms*: variations for payment of the price by conventional purchase-assist financing or a takeover of existing financing (Sections 3 through 9).
3. *Acceptance and performance:* aspects of the formation of a contract, excuses for nonperformance and termination of the agreement, such as the time period for acceptance, the broker's authorization to extend performance deadlines, financing of the price as a closing contingency, procedures for cancellation, a sale of other property as a closing contingency, cooperation to effect a §1031 transaction and limitations on monetary liability for breach of contract (Section 10).
4. *Property Conditions:* the buyer's confirmation of the physical condition of the property as disclosed prior to acceptance by the seller's delivery of reports, warranty policies, certifications, disclosure statements, an environmental, lead-based paint and earthquake safety booklet, operating cost and income statements, and homeowners' association (HOA) documents not handed to the buyer prior to entry into the purchase agreement, as well as by the buyer's initial inspection, personally or by a home inspector, and final inspection at closing (Section 11).
5. *Closing conditions:* the escrow holder, escrow instruction arrangements, closing date, title conditions, title insurance, hazard insurance, prorates and mortgage adjustments (Section 12).
6. *Notice of supplemental property tax:* notifies the buyer they will receive supplemental property tax bills they are to pay when the county assessor revalues the property after a change in ownership (Section 13).
7. *Notice regarding gas and hazardous liquid pipelines:* notifies the buyer of the public availability of information regarding gas and hazardous liquid transmission pipelines via the National Pipeline Mapping System (NPMS) web site.
8. *Brokerage and agency:* authorizes the release of sales data on the transaction to trade associations, sets the broker fee, confirms delivery of the agency law disclosure to both buyer and seller and confirms the confirmation of the agency undertaken by the brokers and their agents (Section 15).
9. *Signatures:* the seller and buyer bind each other to perform as agreed in the purchase agreement by signing and dating their signatures.

Figure 1

Form 150

Purchase Agreement

Page 2 of 5



PAGE 2 OF 5 — FORM 150

10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

10.3 On the inability of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

10.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as _____.

10.5 Any termination of the agreement will be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See **RPI** Form 183]

10.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See **RPI** Forms 171 or 172-2]

10.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

10.8 If Buyer breaches the agreement, Buyer's monetary liability to Seller is limited to ☐ $_____, or ☐ the deposit receipted in Section 1.

11. PROPERTY CONDITIONS:

11.1 Seller to furnish prior to closing:

a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.

b. ☐ a home inspection report prepared by an insured home inspector

c. ☐ a one-year home warranty policy:
Insurer _____
Coverage _____

d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

e. ☐ a certification by a licensed contractor stating the sewage disposal system is functioning properly, and if it contains a septic tank, is not in need of pumping.

f. ☐ a certification by a licensed water testing lab stating the well supplying the property meets potable water standards.

g. ☐ a certification by a licensed well-drilling contractor stating the well supplying the property produces a minimum of _____ gallon(s) per minute.

h. ☐ Energy Audit Report stating the rating for the property's improvements is no greater than _____.

i. ☐ _____

j. ☐ _____

k. ☐ _____

11.2 Seller's Condition of Property Disclosure – Transfer Disclosure Statement (TDS) [See **RPI** Form 304]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may either cancel the transaction based on a reasonable disapproval of the disclosure or deliver to Seller or Seller's Broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance. [See **RPI** Form 269] Seller to repair, replace or correct noticed defects prior to closing.

c. On Seller's failure to repair, replace or correct noticed defects under §11.2b or §11.4a, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [See **RPI** Form 183]

11.3 Seller's Transfer Fee Disclosure Statement [See **RPI** Form 304-2]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Transfer Fee Disclosure.

c. Seller to pay any transfer fees arising out of the transaction.

PAGE 2 OF 5 — FORM 150

Preparing the purchase agreement

The following instructions are for the preparation and use of the Purchase Agreement – One-to-Four Residential Units, **RPI** Form 150. Form 150 is designed as a checklist of practical provisions so a broker or their agent can prepare an offer for a prospective buyer who seeks to purchase conventionally financed, one-to-four unit residential property located in California.

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 who will sign the offer. Do **not** enter the word nominee or assignee.
   - 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).
   - 1.2 **Confirms** the deposit is to be applied towards the buyer's obligation to purchase the property.
   - 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 need to be listed as inventory if they are to be acquired by the buyer. [See **RPI** 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

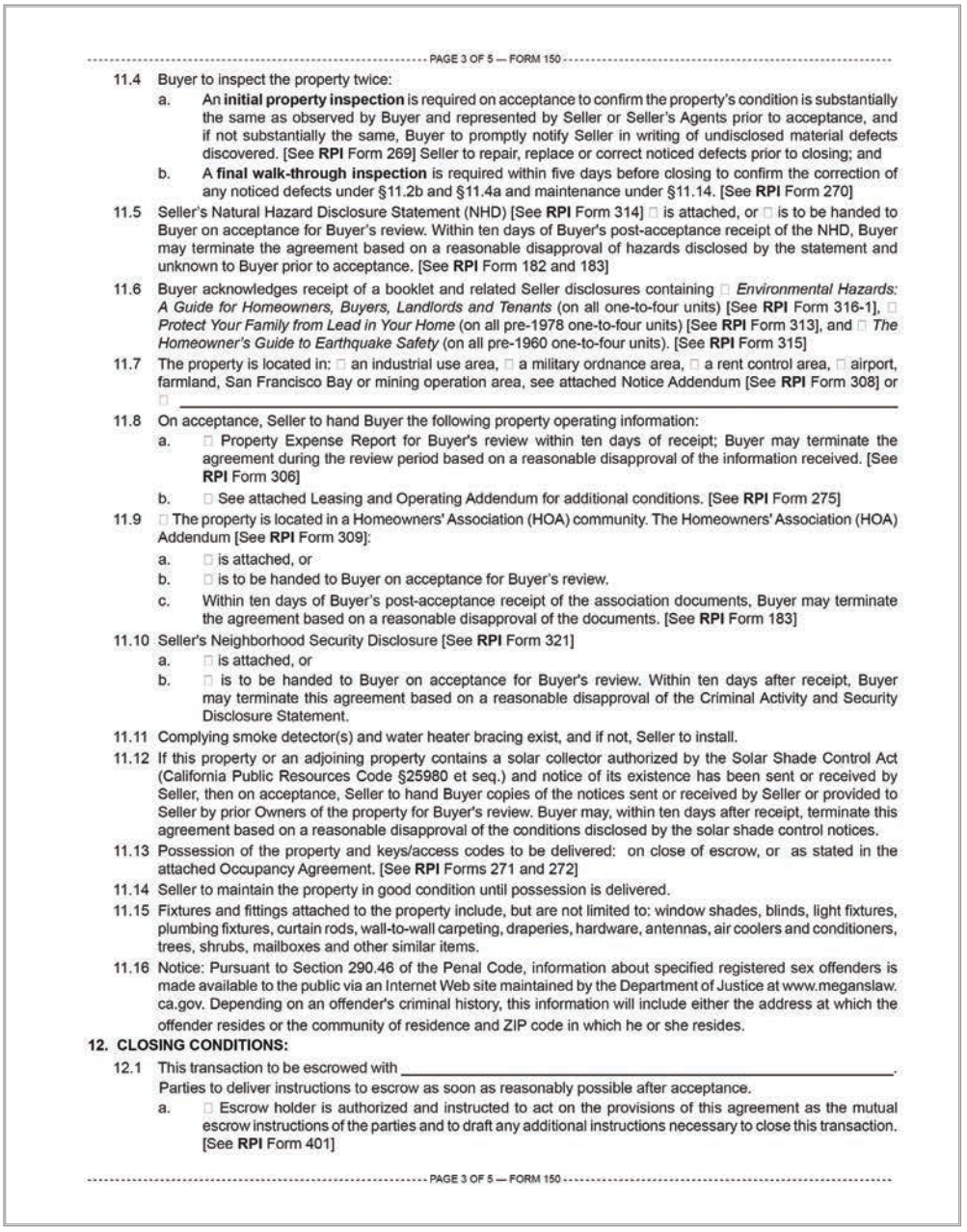
3. *Cash down payment*: **Enter** the dollar amount of the buyer's cash downpayment toward the purchase price.
   - 3.1 *Additional down payment*: **Enter** the description of any other consideration to be paid as part of the price, such as trust deed notes, personal property or real estate equities (an exchange). **Enter** the dollar amount of its net value.
4. *New trust deed mortgage*: **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed mortgage. **Enter** the amount of the mortgage, the monthly principal and interest (PI) payment, the term of the mortgage 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 mortgage points.
   - 4.1 *Buyer's mortgage qualification*: **Check** the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new mortgage and fails to deliver documentation from a lender indicating they have been pre-approved for a mortgage. **Enter** the number of days the buyer has after acceptance to deliver written confirmation of their qualification for the mortgage. [See **RPI** Form 183]

Figure 1

Form 150

Purchase Agreement

Page 3 of 5



PAGE 3 OF 5 — FORM 150

11.4 Buyer to inspect the property twice:
- a. An **initial property inspection** is required on acceptance to confirm the property's condition is substantially the same as observed by Buyer and represented by Seller or Seller's Agents prior to acceptance, and if not substantially the same, Buyer to promptly notify Seller in writing of undisclosed material defects discovered. [See **RPI** Form 269] Seller to repair, replace or correct noticed defects prior to closing; and
- b. A **final walk-through inspection** is required within five days before closing to confirm the correction of any noticed defects under §11.2b and §11.4a and maintenance under §11.14. [See **RPI** Form 270]

11.5 Seller's Natural Hazard Disclosure Statement (NHD) [See **RPI** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of Buyer's post-acceptance receipt of the NHD, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the statement and unknown to Buyer prior to acceptance. [See **RPI** Form 182 and 183]

11.6 Buyer acknowledges receipt of a booklet and related Seller disclosures containing ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units) [See **RPI** Form 316-1], ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978 one-to-four units) [See **RPI** Form 313], and ☐ *The Homeowner's Guide to Earthquake Safety* (on all pre-1960 one-to-four units). [See **RPI** Form 315]

11.7 The property is located in: ☐ an industrial use area, ☐ a military ordnance area, ☐ a rent control area, ☐ airport, farmland, San Francisco Bay or mining operation area, see attached Notice Addendum [See **RPI** Form 308] or ☐ _____

11.8 On acceptance, Seller to hand Buyer the following property operating information:
- a. ☐ Property Expense Report for Buyer's review within ten days of receipt; Buyer may terminate the agreement during the review period based on a reasonable disapproval of the information received. [See **RPI** Form 306]
- b. ☐ See attached Leasing and Operating Addendum for additional conditions. [See **RPI** Form 275]

11.9 ☐ The property is located in a Homeowners' Association (HOA) community. The Homeowners' Association (HOA) Addendum [See **RPI** Form 309]:
- a. ☐ is attached, or
- b. ☐ is to be handed to Buyer on acceptance for Buyer's review.
- c. Within ten days of Buyer's post-acceptance receipt of the association documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [See **RPI** Form 183]

11.10 Seller's Neighborhood Security Disclosure [See **RPI** Form 321]
- a. ☐ is attached, or
- b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Criminal Activity and Security Disclosure Statement.

11.11 Complying smoke detector(s) and water heater bracing exist, and if not, Seller to install.

11.12 If this property or an adjoining property contains a solar collector authorized by the Solar Shade Control Act (California Public Resources Code §25980 et seq.) and notice of its existence has been sent or received by Seller, then on acceptance, Seller to hand Buyer copies of the notices sent or received by Seller or provided to Seller by prior Owners of the property for Buyer's review. Buyer may, within ten days after receipt, terminate this agreement based on a reasonable disapproval of the conditions disclosed by the solar shade control notices.

11.13 Possession of the property and keys/access codes to be delivered: on close of escrow, or as stated in the attached Occupancy Agreement. [See **RPI** Forms 271 and 272]

11.14 Seller to maintain the property in good condition until possession is delivered.

11.15 Fixtures and fittings attached to the property include, but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

11.16 Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP code in which he or she resides.

12. CLOSING CONDITIONS:

12.1 This transaction to be escrowed with _____.
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.
- a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See **RPI** Form 401]

PAGE 3 OF 5 — FORM 150

First and second trust deeds

5. *First trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing mortgage or by an "assumption" of the mortgage if the buyer is to take over an existing first trust deed mortgage. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the mortgage. **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.

   5.1 *Mortgage balance adjustments*: **Check** the appropriate box to indicate the financial adjustment desired for mortgage balance differences at the close of escrow.

5.2 *Impound balances*: **Check** the appropriate box to indicate whether the impound account transferred to the buyer will be with or without a charge to the buyer.

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

Bonds and liens

7. *Bond or assessment assumed*: **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos or 1915 improvement bonds) 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 buyer 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.*

Financing provisions

8. *Seller carryback note*: **Enter** the amount of the carryback note to be executed by the buyer 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.

8.1 *Special carryback provisions:* **Check** the appropriate box to indicate any special provisions to be included in the carryback note or trust deed. **Enter** the name of any other special provision to be included in the carryback note or trust deed, such as impounds, discount options, extension provisions, guarantee arrangements or right of first refusal on the sale or hypothecation of the note.

8.2 *Loan Purpose Statement:* **Fill out** and **attach** the Loan Purpose Statement. [See **RPI** Form 202-2]

8.3 *Financial disclosure:* **Fill out** and **attach** a Financial Disclosure Statement as an addendum. [See **RPI** 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.

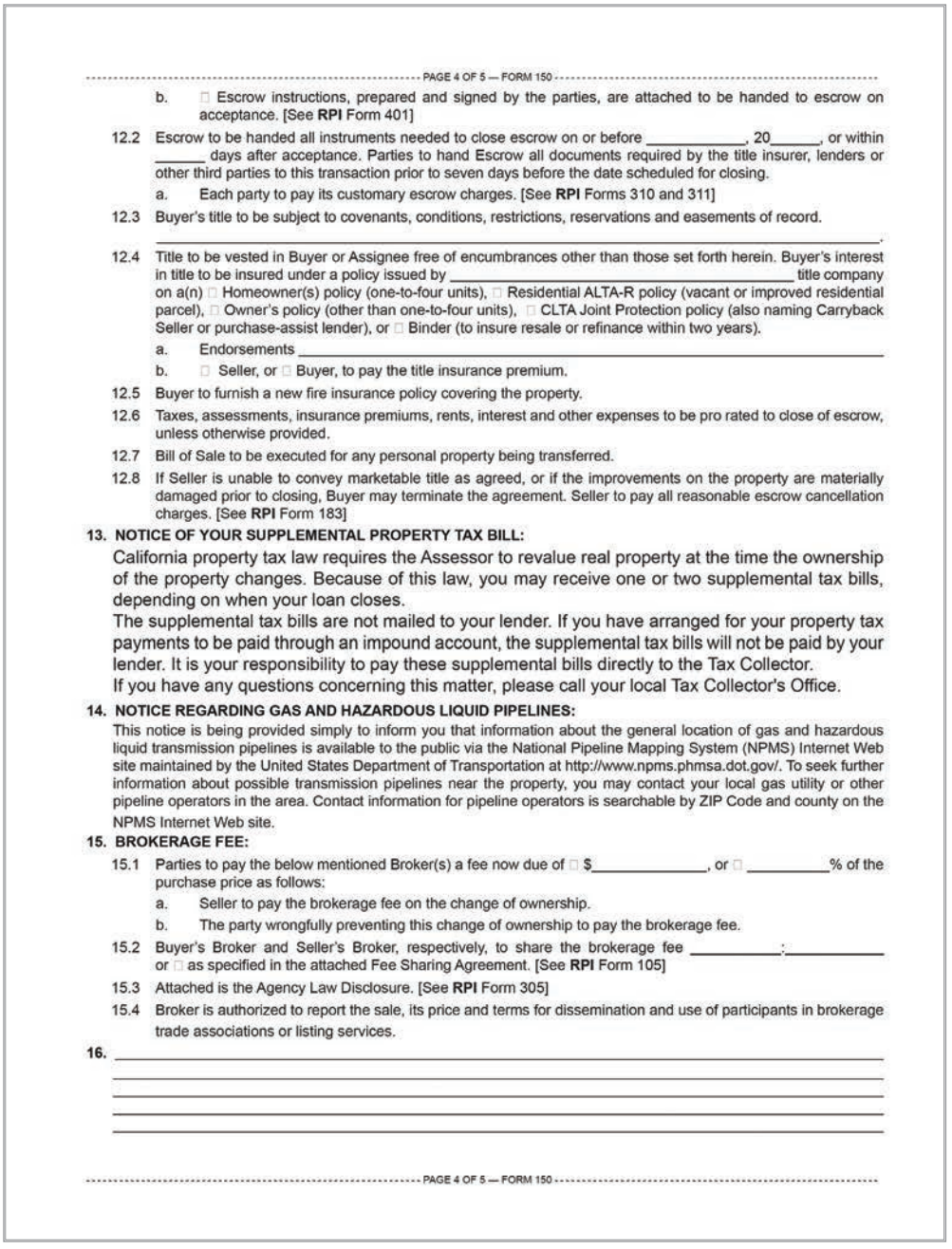
8.4 *Notice of Delinquency:* **Requires** the buyer to execute a Request for Notice of Default and Notice of Delinquency and

Figure 1

Form 150

Purchase Agreement

Page 4 of 5



PAGE 4 OF 5 — FORM 150

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See **RPI** Form 401]

12.2 Escrow to be handed all instruments needed to close escrow on or before _____, 20_____, or within _____ days after acceptance. Parties to hand Escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary escrow charges. [See **RPI** Forms 310 and 311]

12.3 Buyer's title to be subject to covenants, conditions, restrictions, reservations and easements of record.

_____.

12.4 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.

12.5 Buyer to furnish a new fire insurance policy covering the property.

12.6 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

12.7 Bill of Sale to be executed for any personal property being transferred.

12.8 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See **RPI** Form 183]

13. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.

The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.

If you have any questions concerning this matter, please call your local Tax Collector's Office.

14. NOTICE REGARDING GAS AND HAZARDOUS LIQUID PIPELINES:

This notice is being provided simply to inform you that information about the general location of gas and hazardous liquid transmission pipelines is available to the public via the National Pipeline Mapping System (NPMS) Internet Web site maintained by the United States Department of Transportation at http://www.npms.phmsa.dot.gov/. To seek further information about possible transmission pipelines near the property, you may contact your local gas utility or other pipeline operators in the area. Contact information for pipeline operators is searchable by ZIP Code and county on the NPMS Internet Web site.

15. BROKERAGE FEE:

15.1 Parties to pay the below mentioned Broker(s) a fee now due of ☐ $_____, or ☐ _____% of the purchase price as follows:

a. Seller to pay the brokerage fee on the change of ownership.

b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

15.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee _____:_____ or ☐ as specified in the attached Fee Sharing Agreement. [See **RPI** Form 105]

15.3 Attached is the Agency Law Disclosure. [See **RPI** Form 305]

15.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

16. _____

_____

_____

_____

_____

_____

PAGE 4 OF 5 — FORM 150

pay the costs of recording and serving it on senior lenders since they will have priority on title to the trust deed securing the carryback note. [See **RPI** Form 412]

8.5 *Buyer creditworthiness*: **Requires** the buyer to provide the seller with a completed credit application. [See **RPI** Form 302]

8.6 *Approval of creditworthiness*: **Enter** the number of days within which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

8.7 *Subordination*: **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a trust deed mortgage with priority on title to the carryback note are exceeded. [See **RPI** Form 183]

8.8 *Personal property as security*: **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 financing statement to provide additional security for any carryback note. [See **RPI** Form 436]

9. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

Acceptance and performance contingencies

10. **Acceptance and performance:**

10.1 *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 — Acceptance occurs on the return delivery to the person making the offer (or counteroffer) or to their broker of a copy of the unaltered purchase agreement offer containing the signed acceptance.

10.2 *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.

10.3 *Mortgage contingency*: **Authorizes** the buyer to cancel the transaction at the time scheduled for closing if the financing for payment of the price is not obtainable or assumable.

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

10.5 *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. [See **RPI** Form 183]

10.6 *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. [See **RPI** Forms 171 and 172]

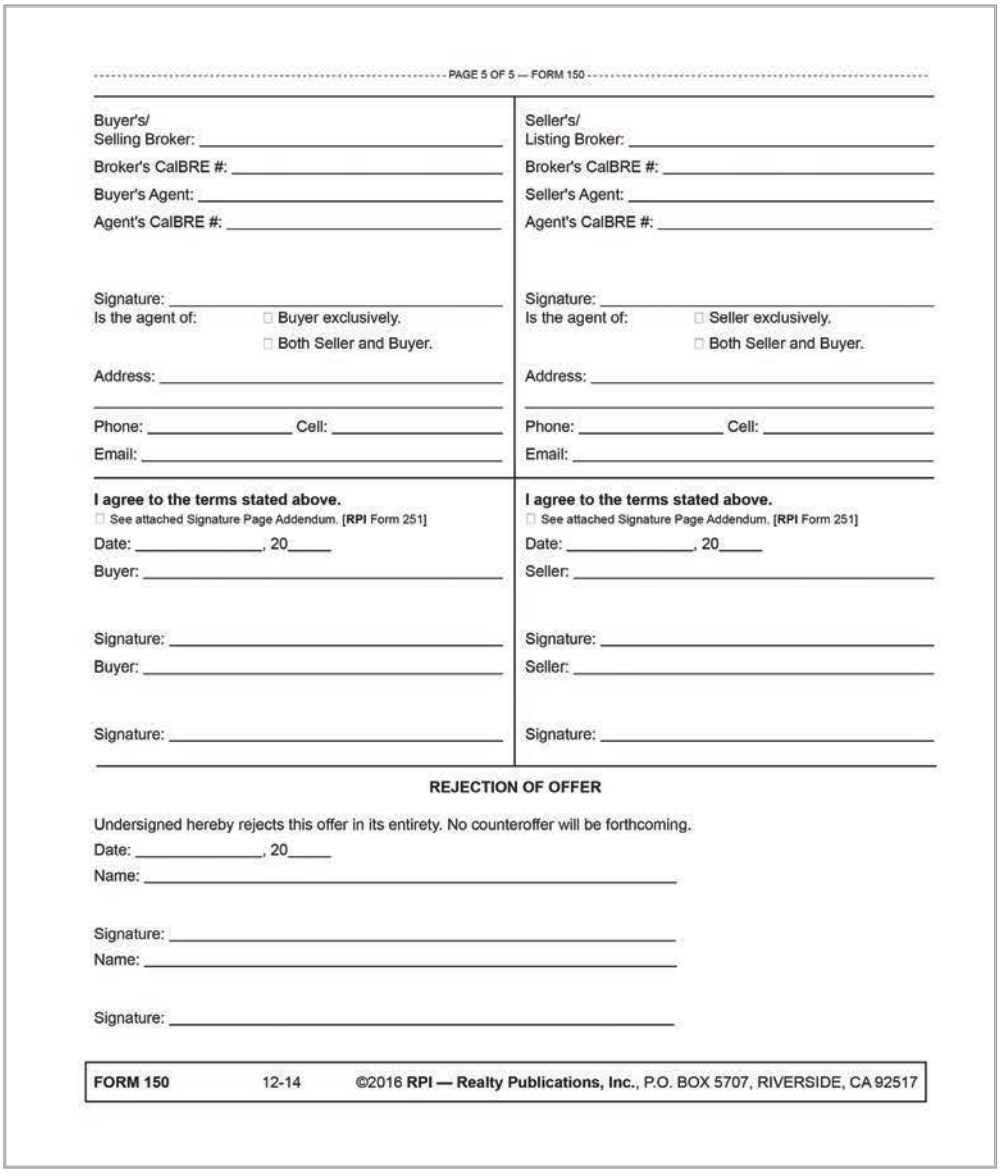
10.7 *Mediation provision*: **Provides** for the parties to enter into non-binding mediations to resolve a dispute remaining unsolved after 30 days of informal settlement negotiations. [See Chapter 34]

Figure 1

Form 150

Purchase Agreement

Page 5 of 5



PAGE 5 OF 5 — FORM 150

Buyer's/ Selling Broker: _____	Seller's/ Listing Broker: _____
Broker's CalBRE #: _____	Broker's CalBRE #: _____
Buyer's Agent: _____	Seller's Agent: _____
Agent's CalBRE #: _____	Agent's CalBRE #: _____
Signature: _____	Signature: _____
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: _____	Address: _____
Phone: _____ Cell: _____	Phone: _____ Cell: _____
Email: _____	Email: _____
I agree to the terms stated above. ☐ See attached Signature Page Addendum. [RPI Form 251]	**I agree to the terms stated above.** ☐ See attached Signature Page Addendum. [RPI Form 251]
Date: _____, 20____	Date: _____, 20____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____

REJECTION OF OFFER

Undersigned hereby rejects this offer in its entirety. No counteroffer will be forthcoming.

Date: _____, 20____

Name: _____

Signature: _____

Name: _____

Signature: _____

FORM 150 12-14 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

10.8 *Liability limitations:* **Provides** for a dollar limit on the buyer's liability for the buyer's breach of the agreement. **Check** the first box and **enter** the maximum dollar amount of money losses the seller may recover from the buyer or **check** the second box to indicate the buyer's monetary liability is limited to the good-faith deposit tendered with the offer to buy.

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.

Condition reports and certificates

11. **Property Conditions:**

11.1 *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*: **Check** the box and **enter** the rating of the property's improvements.

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

Property condition disclosure

11.2 *Property condition(s)*: **Check** the appropriate box within the following subsections to indicate the status of the seller's Condition of Property Disclosure – **Transfer Disclosure Statement (TDS)**. [See **RPI** Form 304]

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 "as disclosed" is accepted by the buyer upon entering into the purchase agreement offer as mandated.

Editor's note — Use of the TDS form is mandated on one-to-four unit residential property.

b. *Later delivered TDS*: **Check** the box to indicate the TDS is to be **delivered later** to the buyer to confirm the condition of

the property is "as disclosed" prior to entry into the purchase agreement. On receipt of the TDS, the buyer 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 buyer to either cancel the transaction or adjust the price if the seller fails to correct the defects noticed under sections 11.2b or 11.4a. [See **RPI** Form 183]

Transfer fee disclosure

11.3 *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 **RPI** 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.

The buyers property inspection

11.4 *Buyer's inspection*: **Authorizes** the buyer 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 buyer 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 **RPI** Form 269]

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

11.5 *Seller's Natural Hazard Disclosure Statement (NHD)*: **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 buyer. If it has been received by the buyer, **attach** a copy to the purchase

agreement. If the NHD will be handed to the buyer after acceptance, the buyer has ten days after the buyer'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.[1]

Hazard and other disclosures

11.6 *Hazard disclosure booklets*: **Check** the appropriate box(es) to indicate which hazard booklets have been received by the buyer, together with the seller's prepared and signed disclosures accompanying each booklet. [See **RPI** Forms 316-1, 313 and 315]

11.7 *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 **RPI** Forms 307 and 308]

Operating costs

11.8 *Operating costs and rents*: **Check** the appropriate box(es) to indicate the information the seller is to disclose regarding the operating expenses of ownership and tenancies affecting title.

a. *Operating cost sheet*: **Check** the box to indicate the seller will prepare and hand the buyer an Operating Cost Sheet on acceptance of this offer. The buyer may cancel the purchase agreement and escrow if the operating expenses disclosed are unacceptable. [See **RPI** Form 306]

b. *Leasing and Operating Addendum:* **Check** the box to indicate the Leasing and Operating Addendum is attached to confirm the buyer is taking title subject to the tenancies disclosed. [See **RPI** Form 275]

HOA information and documents

11.9 *Homeowners' association (HOA)*: **Check** the box to indicate the property is located in a Homeowners' Association (HOA) community.

a. *Attached addendum*: **Check** the box to indicate the seller's Homeowners' Association (HOA) Addendum has been prepared and handed to the buyer, and if so, **attach** it to this agreement. [See **RPI** Form 309]

b. *Later delivered addendum:* **Check** the box to indicate the HOA addendum is to be delivered to buyer on acceptance for buyer's review.

c. *Disapproval of HOA documents:* **Authorizes** the buyer to terminate this purchase agreement within ten days after their receipt of HOA documents when the disclosures are made after entering into the purchase agreement. Disclosure

1 Calif. Civil Code *§1103*

of HOA conditions in escrow triggers a statutory contingency allowing the buyer to cancel the purchase agreement. [See **RPI** Form 183]

Security disclosure

11.10 *Criminal Activity and 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 **RPI** Form 321]

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.

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

11.12 *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.

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

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

Editor's note — See section 11.4b for the buyer's final inspection to confirm maintenance at closing.

11.15 *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 the Personal Property Inventory at section 3. [See **RPI** Form 256]*

Sex offender disclosures

11.16 *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 voluntarily make further disclosures regarding registered sex offenders.

Escrow and closing

12. **Closing conditions:**

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

a. *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. [See **RPI** Form 401]

b. *Escrow instructions*: **Check** the box to indicate escrow instructions have been prepared and are attached to this purchase agreement. **Prepare** and **attach** the prepared escrow instructions to the purchase agreement and **obtain** the signatures of the parties. [See **RPI** Form 401]

12.2 *Closing date:* **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. [See **RPI** From 310 and 311]

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

12.4 *Title insurance:* **Provides** for title to be vested in the name of the buyer 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 buyer or seller is to pay the title insurance premium.

12.5 *Fire insurance:* **Requires** the buyer to provide a new policy of hazard insurance.

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

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

12.8 *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 buyer may terminate the agreement if the seller is unable to provide a marketable title or should the property improvements suffer major damage. [See **RPI** Form 183]

13. *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.

14. *Gas and hazardous liquid pipelines:* **Notifies** the buyer of the public availability of information regarding general location of gas and hazardous liquid transmission pipelines via the National Pipeline Mapping System (NPMS) web site.

Broker fee provisions

15. **Broker fee:**

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

a. *Seller paid:* **Provides** that the seller will pay the broker fee on the change of ownership.

b. *Wrongful prevention:* **Provides** that the party wrongfully preventing the change of ownership will pay the broker fee.

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

15.2 *Fee sharing:* **Enter** the percentage share of the fee each broker is to receive. [See **RPI** Form 105]

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.

15.3 *Agency law disclosures:* **Attach** a copy of the Agency Law Disclosure addendum for all parties to sign. [See **RPI** Form 305]

Editor's note — The disclosure is mandated to be acknowledged by the buyer with the offer and acknowledged by the seller on acceptance as a prerequisite to the buyer's broker enforcing collection of their fee when the property involved contains one-to-four residential units.

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

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

Agency confirmation

Buyer's broker identification: **Enter** the name of the buyer's broker and their California Bureau of Real Estate (CalBRE) license number. **Enter** the name of any buyer's agent and their CalBRE license number. **Obtain** the signature of the buyer's broker or the buyer's 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 buyer's broker's address, telephone and cell numbers, and email address.

Seller's broker identification: **Enter** the name of the seller's broker and their CalBRE license number. **Enter** the name of any seller's agent and their CalBRE license. **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 seller's broker's address, telephone and cell numbers, and email address.

Signatures

Buyer's signature: If *additional* buyers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all buyers are individually named and have signed. **Enter** the date the buyer signs the purchase agreement and the buyer's name. **Obtain** the buyer's signature. [See **RPI** Form 251]

Seller's signature: If *additional* sellers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all sellers are individually named and have signed. **Enter** the date the seller signs the purchase agreement and the seller's name. **Obtain** the seller's signature. [See **RPI** Form 251]

Rejection of offer

If the offer contained in the purchase agreement is rejected instead of accepted and the rejection won't result in a counteroffer, **enter** the date of the rejection and the names of the party rejecting the offer. **Obtain** the signatures of the party rejecting the offer.

Observations

As a policy of the publisher to provide users of **RPI** forms with maximum loss reduction protection, the **RPI** purchase agreement does not contain clauses which tend to increase the risk of litigation or are generally felt to work against the best interests of the buyer, seller and broker.

Excluded provisions include:

- an **attorney fee provision**, which tends to **promote litigation** and inhibit normal contracting;
- a ***time-essence clause***, since future performance (closing) 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;

- an **arbitration provision**, since arbitration decisions are **final and unappealable**, without any assurance the arbitrator's award will be fair or correct; [See Chapter 34] and
- a **liquidated damages provision**, since they **create wrongful** expectations of windfall profits for sellers and are nearly always forfeitures and unenforceable. [See Chapter 33]

Chapter 23 Summary

For sales, the primary document used to negotiate the transaction between a buyer and seller is a purchase agreement form. The three categories of purchase agreements are for:

- one-to-four unit residential property sales transactions;
- other than one-to-four unit residential property sales transactions, such as for residential and nonresidential income properties and owner-occupied business/farming properties; and
- land acquisition transactions.

A buyer and seller who enter into escrow instructions without entering into a real estate purchase agreement are bound by the escrow instructions as though it was a purchase agreement. Attached to all these various purchase agreements are one or more addenda, regarding:

- disclosures about the property;
- the financing of the price paid for the property;
- agency relationship law; and
- special provisions called for by the needs of the buyer or seller.

A buyer's agent uses the conventional purchase agreement, **RPI** Form 150, to prepare and submit the buyer's written offer to purchase a one-to-four unit residential property.

Chapter 23 Key Terms

Chapter 24

Vesting the ownership

Learning Objectives

After reading this chapter, you will be able to:

- trace the heritage of the laws governing the possession and conveyance of property interests in California;
- identify the various title vestings for the ownership of real estate including sole ownership and multiple types of co-ownership;
- advise a buyer on the most suitable vesting under which they may take title to property in a real estate transaction;
- establish, maintain and sever a co-owner's right of survivorship of their interest in title to real estate; and
- distinguish joint tenancy from community property and identify the ways in which they are used by married co-owners.

Key Terms

chain of title
community property
conveyance
ownership
severalty ownership
stepped-up basis
vesting

Possession and transfer of rights

All parcels of real estate have a recorded history. When the United States became the owner of all California land, titles were "proven up" by individuals in federal courts or with government agencies who issued *certificates of title* based on comparable rights held by the individuals under prior Spanish, Mexican or California sovereign law.

Thus began the *recorded history of title* to each parcel in California. Assessors of each county now identify each parcel by a different parcel number.

A **conveyance** by the vested owner of a parcel transfers title to the next owner if the person conveying ownership rights holds title under a prior conveyance transferring into their name the rights conveyed. Thus, for each

conveyance
A transfer of an interest in title to property from one person to another, such as is effected by a deed or a trust deed.

chain of title
A history of conveyances and encumbrances affecting the title from the time the original patent was granted, or as far back as records are available, used to determine how title came to be vested in the current owner.

parcel a linkage exists in title from the beginning of the state of California to the present, called a **chain of title**. The *chain of title* for a parcel reflects a conveyance by each person who previously took title to the property, from one vested owner of title to the next, ending with the present holder of title.

The initial focus for an analysis of a transfer of title in a sales transaction is on the person who is conveying title, not the new owner who is taking title. If the person conveying does not hold a good and *marketable (insurable) title* to the property and have the authority to convey it, the transfer to the new owner is defective, if not ineffective.

Today, the ability of the current owner to transfer title is the concern of title companies. Title insurers issue policies covering the risk regarding whether the transfer of the ownership interest bargained for by the new owner has occurred. Title company analysis of this *conveyancing risk* is based on the nature and validity of the present owner's **vesting**, typically established when that owner took title.

vesting
A method of holding title to real estate, including tenancy in common, joint tenancy, community property and community property with the right of survivorship.

The *vesting* used to take title when a person acquires ownership establishes the rules controlling their later conveyance of an interest in the property to another.

Thus, the text of this chapter focuses on the *vesting used to acquire* an interest in real estate under a deed, lease or trust deed.

The time for setting the vesting

Consider a buyer who has entered into a purchase agreement and escrow instructions. The purchase agreement states the buyer will take title in the condition agreed and as insured by a title insurer under a policy of title insurance issued to the buyer.

The *precise vesting* the buyer will use does not need to be stated in the purchase agreement as it is not a condition of the purchase agreement or escrow. However, escrow instructions include the wording for the vesting desired by the buyer in the mutual instructions signed by the seller and buyer.

The vesting on conveyance is chosen by the buyer at any time prior to closing — but in sufficient time for preparation of the deed, signature by the sellers and acknowledgement by a notary *prior to* the date scheduled for closing.

Escrows prefer to draft the deed to be signed by the seller when escrow instructions are prepared. Thus, an early decision by the buyer about their vesting is necessary to accommodate the escrow process.

Consequently, the buyer's agent needs to possess a working *knowledge of vestings* to be able to advise the buyer on the vestings available. In turn, the buyer decides on their vesting, a decision needed by the agent so they can dictate instructions to escrow, including the vesting to be used when preparing the grant deed.

A person or persons take title

Real estate is owned by a person (or persons), who by definition is either an *individual* (or individuals) or an *entity*, such as a corporation, limited liability company (LLC) or partnership. Trusts are not entities in California unless they have been qualified as a corporation by the Department of Business Oversight (DBO). Thus, the *beneficiary* of the trust relationship, whether an individual or entity, is the *owner* of the real estate despite the vesting being in the name of a third person as trustee.

ownership
The right of one or more persons to possess and use property to the exclusion of all others. A collection of rights to the use and enjoyment of property.

Further, **ownership** by an individual or entity is classified as either:

- a *sole ownership*, legally called a **severalty ownership**;[1] or
- a *co-ownership* of two or more persons.

severalty ownership
Ownership by one person.

Sole ownership is reflected by use of a vesting naming an individual or entity as the one person entitled to ownership of the entire property described in the conveyance transferring title to that person. The *one person named* in this vesting context may be a married individual who owns property as the separate property of the married individual.

Co-ownership vestings

Co-ownerships exist for *individuals* in two ways:

- as *vested co-owners* on title; or
- as *co-owners* of an entity, which is itself the vested owner holding title to the property.

Co-owners vest title in their individual names under one of four types of ownership available for property located in California:

- as *joint tenants*;
- as *tenants in partnership*;
- as *tenants in common*; and
- as *community property*, with or without the right of survivorship.[2]

No other co-ownership vesting exists for individuals. Thus, the *trust vestings* provide for one person as *trustee* to hold title for the true owner(s) who are named as *beneficiary(ies)* under a title holding agreement the owner entered into with the trustee.

The trust agreement spells out ownership arrangements which are either the same as one of the four co-ownership interests listed above or distinguishable from them, such as a subordinated ownership interest, priority distributions, allocation of tax benefits, etc. — typical of co-ownership arrangements for an entity.

community property
All property acquired by husband or wife during a marriage when not acquired as the separate property of either spouse.

Finally, **community property** ownership has two available vestings:

- two spouses or domestic partners as community property; and
- two spouses or domestic partners as community property with the right of survivorship.

1 Calif. Civil Code §681
2 CC §§682, 683

The community property vestings are only available to married couples and registered domestic partners.[3]

Possessory rights of co-owners

Each co-owner of property has the right to:

- *possess* the entire property themselves, to the extent it is not already possessed or leased to others by another co-owner;
- *lease* their possessory right to occupy and use the entire property to a tenant, except for community property as the lease may be set aside by a nonconsenting spouse or domestic partner within one year after its commencement;
- *sell* their ownership interest in the property without the need for prior notice to or the consent of the other co-owners, except for community property or a co-owner who has agreed to the contrary; and
- *encumber* their ownership interest in the property without the consent of their co-owners, except for community property or when prohibited by a co-ownership agreement.

On the other hand, a co-owner has obligations to other co-owners not to:

- *exclude other* co-owners from their right to possession of any part of the property;[4] or
- *create an easement* on the property against a co-owner.

Tenancy in common

When two or more persons take title to real estate and the type of vesting is not stated, the co-owners are presumed to be **tenants in common**, a *default vesting* attributed to their ownership. Likewise, when the co-owners are spouses or domestic partners and title is not vested as a tenancy in common, the property is presumed to be *community property*. Also, when the conduct of co-owners is in fact that of partners, the property ownership is subject to the rights of a tenancy in partnership.[5]

Thus, a tenancy-in-common vesting is the form of ownership used by two or more persons when:

- they have an *equal or disproportionate share* of ownership in the property as the separate property of each;
- they do not intend their relationship to be that of joint tenants on death or of partners for profit; and
- they have not acquired the property as a community property asset.[6]

When the fractional co-ownership interest held by each co-owner was transferred to them at the same time, by the same deed and in equal shares, e.g., 1/3, 1/3 and 1/3, on the recording of one deed, the only distinction between vesting the co-ownership as a tenancy in common or a joint tenancy is the **right of survivorship** attached to the joint tenancy vesting.

3 Calif. Family Code §297.5(k)(1)
4 **Oberwise** v. **Poulos** (1932) 124 CA 247
5 CC §686
6 CC §685

Accordingly, the person vested as a tenant in common *retains control* over the destiny of their ownership interest on death. The control is exercisable by will or by vesting the co-owner's interest in the name of their inter vivos trust. The surviving co-owners in a co-ownership arrangement vested as tenants in common do not take a deceased co-owner's interest as occurs under a joint tenancy vesting on the co-owner's death.

As tenants in common, co-owners retain the ability on death to transfer their interests in real estate to individuals other than the remaining co-owners of the property. Children who jointly take property on the death of a parent or relative are often designated as tenants in common by the will or trust agreement. If the transfer documents do not state the nature of the co-ownership created they are automatically classified as tenants in common.

Tenancy in partnership

Groups of investors numbering just a few individuals often acquire property as co-owners, to hold and operate as income-producing property. Typically, they take title to the real estate as *tenants in common*. As a critical fact, their common venture necessitates a joint effort for the *collective benefit* of all the individual co-owners. Here, a **tenancy in partnership** is the result for ownership purposes. Thus, a California partnership has been formed for operating purposes.[7]

The group, as co-owners of property which requires day-to-day management, jointly operates a business venture. The management is conducted either directly by one or more of the co-owners in a coordinated effort or indirectly through property management. However, to be common-law tenants in common, the co-owners need to intend *not* to act as a group, an issue use solely to avoid income tax partnership treatment.

Property vested in the names of *profit-sharing, co-venturing co-owners* as tenants in common is property owned by their "partnership." The property is not fractionally owned and separately managed and operated by each co-owner individually.[8]

Thus, even though title is vested in all the individual co-owners as tenants in common, each co-owner actually holds title as a *trustee* on behalf of their *informal partnership* when the property's operation requires a coordinated or *centralized-management* effort.[9]

Nature of a joint tenancy

Although most **joint tenancies are created** between spouses or domestic partners, a joint tenancy can be created between persons other than a married couple, such as between other family members. In contrast, the community property vestings — of which there are two — are only available to a married couple or domestic partners.

7 CC §682(2); Calif. Corporations Code §§16202(a), 16204(c)

8 Corp C §16203

9 Corp C §16404(b)(1)

Also, the number of joint tenants holding title is not limited to two, as is the case for a married couple's or domestic partners' ownership of community property. Any number of co-owners may take title to real estate, under one deed, as joint tenants if they take equal shares in ownership.

The joint tenancy vesting is an estate planning tool used for the orderly transfer of ownership between family members on death. The vesting is rarely used in a business environment, except for community-owned enterprises or investments.

The four unities

Historically, the creation of a joint tenancy required the conveyance of what is referred to as the **four unities**:

- *unity of title*, meaning the joint tenants take title to the real estate through the same instrument, such as a *grant deed*;
- *unity of time*, meaning the joint tenants receive their interest in title at the *same time*;
- *unity of interest*, meaning the joint tenants own *equal shares* in the ownership of the property; and
- *unity of possession*, meaning each joint tenant has the *right to possess* the entire property.

Today, a joint tenancy is loosely based on these four unities. For example, a joint tenancy is defined as ownership by two or more persons in *equal shares*. Thus, the joint tenancy co-ownership incorporates the unity of interest into the statutory definition.[10]

Joint tenancy transfers

A joint tenancy needs to be created by a *single transfer* to all those who are to become joint tenants. Thus, the historic unity of title (same deed) and unity of time (simultaneous transfers) required under common law have been retained in one event — typically the recording of the conveyance transferring title to the joint tenants.

A joint tenancy ownership in real estate may be created by any of the following transfers, each being *a single conveyance* to all joint tenants, if the conveyance states the co-owners take title "as joint tenants":

- a transfer by grant deed, quitclaim deed or assignment, from an owner of the fee, leasehold or life estate, to themselves and others;
- a transfer from co-owners vested as tenants in common to themselves; or
- a transfer from spouses or domestic partners holding title as community property, tenants in common or separately, to themselves.[11]

For the small percentage of joint tenants who are not spouses or domestic partners — typically family members or life-long friends — a valid joint tenancy is created when all co-owners take title under the same deed as

10 CC §683

11 CC §683

joint tenants, without stating their *fractional interest* in ownership. Their unstated but actual fractional ownership is a function of the number of individuals who took title as joint tenants when severed or transferred to others.

Joint tenant's right of survivorship

The sole advantage of a joint tenancy vesting for co-owners is the *extinguishment* of a co-owner's entire co-ownership interest in the property on their death. On death, the **right of survivorship** extinguishes the deceased's interest and the interest no longer exists. This extinguishment leaves the *surviving joint tenant(s)* with the entire ownership of the property which they *share equally* among themselves.

Thus, the ownership interest previously held by the deceased co-owner avoids probate or conveyancing procedures since no interest remains to be transferred.

The same result occurs on death if a married couple or domestic partners use the community property with right of survivorship vesting to hold title to real estate or personal property.

Other than the *right of survivorship* on death, a joint tenancy vesting neither adds nor diminishes the legal or tax aspects of the ownership interest held in the real estate by each co-owner.

For example, whether the interests held by the co-owners are separate property or community property, a joint tenancy vesting neither enlarges nor reduces the nature of the ownership interest, until death.

Thus, the *right of survivorship* is the distinguishing feature of a joint tenancy vesting and is legally referred to as *jus accrescendi*. It is a doctrine developed by case law and now codified in California.

The right of survivorship only becomes operative at the *time of the death* of a joint tenant. Ultimately, on the death of all other joint tenants, the last surviving joint tenant becomes the sole owner of the property originally owned by all the joint tenants.

The mesh of ownership rights

Joint tenancy rights and community property rights held by married couples *overlap* in California law when community property is placed in a joint tenancy vesting. This overlap is a by-product of California legal history.

Joint tenancy, with its inherent right of survivorship, arises out of the English common law, and is called a *common law estate*.

Community property, with its implicit partnership aspect, is a creature of Spanish civil law, dating from the time California was a Spanish colony.

Historically, community property and joint tenancy were treated as mutually exclusive, i.e., meaning property acquired by the community could not be held in a joint tenancy vesting and retain its community property status.

Thus, a *transmutation* from community property to the separate property of each spouse occurred by taking title or a transfer into a joint tenancy. Today, this transmutation is accomplished by vesting community property in a tenancy in common vesting.[12]

The "mutually exclusive" rule, which controlled legal results by the type of vesting, not by the community nature of the ownership between spouses, was eliminated in 1975.

Today, a joint tenancy vesting is merely a vesting used by co-owners solely *to avoid probate*. The joint tenancy vesting provides no other advantage to the co-owners (except for the defense against creditor claims based on separate property expectations from the vesting). The underlying community or separate property character of the real estate between spouses or domestic partners is not affected when spouses vest their co-ownership as joint tenants.

For instance, spouses who take title as joint tenants do not by the vesting *transmute* their community property into separate property owned 50:50 by each spouse.

Community property presumption

A joint tenancy vesting allows two spouses to *renounce the community property presumption* if they claim they intended the joint tenancy vesting to establish separate property interests in the real estate. Thus, the community property presumption can be rebutted by either spouse, and is occasionally exercised by spouses to deter creditors.[13]

A similar result altering community property rights occurs in federal *bankruptcy* proceedings when spouses hold title as joint tenants. The interest of each spouse vested as a joint tenant is treated in bankruptcy as separate property in order to attain the objective of federal bankruptcy law to free individuals of onerous debt.

Thus, a spouse's one-half interest in community property vested as joint tenants is *not liable in bankruptcy* for debts which were incurred solely by the other spouse and not on behalf of the community.[14]

However, unless a couple can demonstrate their intent by their use of a joint tenancy vesting to transmute their community property into separate property, the property is *presumed* to be a community asset without concern for the joint tenancy vesting.

Conveying community property

Both spouses or domestic partners need to consent to the sale, lease for more than one year, or encumbrance of the community real estate no matter how it is vested.[15]

If one spouse sells, leases for more than one year or encumbers community real estate without the consent of the other spouse, the nonconsenting spouse

12 **Tomaier** v. **Tomaier** (1944) 23 C2d 754
13 **Abbett Electric Corporation** v. **Storek** (1994) 22 CA4th 1460
14 In re Pavich (1996) 191 BR 838
15 Fam C §1102(a)

may either *ratify* the transaction or have it *set aside*. The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to set the transaction aside.

However, if the other party to the transaction — the buyer, tenant or lender — has no notice of the marriage, actual or constructive, the transaction cannot be set aside by the nonconsenting spouse who has failed to make the community interest known.[16]

Conveying community property as joint tenants

The ability of a married joint tenant to sell, lease or encumber their interest in the real estate depends on whether the real estate interest vested in the individual is their *separate property* or the *community property* of the individual's marriage.

When community real estate is vested in joint tenancy, both spouses' signatures are required to execute an enforceable purchase agreement or trust deed lien, or to enter into a lease agreement with a term exceeding one year.[17]

Thus, a sale, long-term lease or encumbrance of the community property executed by only one spouse is *voidable* since the transaction may be set aside by the *nonconsenting spouse* if acted upon within one year after commencement.

Further, a purchase agreement for the sale of community property entered into by only one spouse may not be enforced in any part by the buyer through an action for specific performance.

Thus, a purchase agreement entered into by one spouse to sell only their one-half interest in the community property is unenforceable unless consented to by the other spouse. Community property *may not be conveyed*, leased or encumbered without the consent of both spouses.[18]

However, if *record title* to the community real estate is vested in the name of *one spouse only*, a sale, lease or encumbrance executed solely by the title-holding spouse is presumed valid if the buyer, tenant or lienholder has no actual or constructive knowledge of the marriage. This includes any knowledge of the agent representing the buyer, landlord or lender, about the owner's marital status.[19]

Separate property joint tenancy vestings

When real estate held in a joint tenancy vesting is the *separate property* of each joint tenant, such as three siblings or a parent and child, each joint tenant may sell or encumber their interest in the real estate *without the consent* of the other joint tenants.

16 Fam C §1102(c)
17 Fam C §1102(a)
18 **Andrade Development Company** v. **Martin** (1982) 138 CA3d 330
19 Fam C §1102(c)

Also, when the real estate owned by a joint tenant is their separate property, the joint tenant may *lease* out the entire property since a lease is a transfer of possession, and each joint tenant has the *right to possession* of the entire property.

However, consider spouses who own real estate which is *community property*. They hold title as joint tenants. One spouse enters into an agreement to lease the property to a tenant for a term of over one year. The other spouse does not enter into the lease agreement with the tenant.

Under joint tenancy rules, any joint tenant acting alone may lease the entire property to a tenant. However, under community property rules (which apply to property acquired during the marriage with community assets), both spouses need to execute a long-term lease agreement for the tenant to avoid challenges to set aside the lease for failure of both spouses to sign the lease.

This one-spouse leasing scenario is an example of the misunderstanding created by the overlay and *superiority of community property rights* when community property is placed in a joint tenancy vesting.

Although no case or statute addresses this set of leasing facts, existing case law suggests the joint tenancy vesting be viewed as controlling the landlord-tenant relationship. Thus, the joint-tenant spouses are individually allowed to lease the property.

Also, the *doctrine of ratification* would influence the result (in favor of the tenant) if the nonconsenting spouse knowingly enjoyed the benefits of the lease before attempting to set the lease aside.[20]

The agent's role and employment under a listing

Agents sometimes list community property for sale, lease or financing by entering into a listing agreement signed by one spouse only. The issue created by not getting the other spouse to sign is whether enforcement of the promise given by one spouse to pay a fee under a listing when it has been earned by the agent can be avoided by their assertion of *community property defenses*. If the owner can avoid payment of the fee earned, a loss is inflicted on the agent and their broker.

For example, a broker obtains an exclusive right-to-sell listing signed only by one of the spouses. The real estate listed is vested in the name of both spouses either as community property or as joint tenants.

During the listing period, the couple acting independent of the broker sells the property without the payment of a fee to the seller's broker. The listing entitles the broker to a fee, payable by the person who signed the listing, if the property is sold by anyone during the listing period. [See **RPI** Form 102]

The broker claims both spouses are liable for the broker fee since the spouse who signed the listing agreement committed the community to the payment of a fee and the property sold during the listing period.

---

20 CC §2310

The spouse claims the listing is unenforceable without the other spouse's signature since no part of the property listed can be sold and conveyed without the written consent of both.

Is the broker entitled to collect their fee?

Yes! The spouse who signed the listing agreement is personally liable for the fee since they *employed the broker* when they signed the listing agreement. The broker can enforce collection of their fee due under the listing in an action for money against the spouse. However, the spouse who did not sign the listing agreement is not personally liable for the broker fee.[21]

Further, on recording the broker's abstract of the judgment against the liable spouse for the broker fee, the judgment becomes a *lien on all community* real estate owned by the couple. The non-liable spouse's *separate property*, however, is not liened and remains unaffected by the abstract which attaches as a lien to the liable spouse's separate property and the couple's community property.

In contrast to a listing employing a broker to locate a buyer, an action for specific performance by a buyer to enforce a real estate purchase agreement signed only by one spouse will not be successful. An *agreement to sell* community real estate requires both spouses' signatures. When the property is community property, m*anagement and control* is in both, not just one co-owner, no matter how vested.

Severing a right of survivorship

Spouses are the vested owners of a parcel of real estate which is community property. The vesting provides for the right of survivorship under either a joint tenancy vesting or a community property with right of survivorship vesting.

However, every co-owner vested as a joint tenant or community property with right of survivorship has the right to *unilaterally sever* the right of survivorship. The severance by a co-owner *terminates* the right of survivorship in that co-owner's interest, whether their interest in the real estate is separate or community property. The *nature of the co-owner's interest* in the property, as separate or community property, remains the same after severing the right of survivorship from the co-owner's interest.

A co-owner terminating the right of survivorship in their interest is not required to first *give notice* or seek consent from the other co-owner(s).[22]

To *sever* the vesting, the co-owner prepares and signs a deed from themselves "as a joint tenant" or "as community property with right of survivorship," back to themselves. On recording the deed, the right of survivorship is severed by having merely *revested* the co-owner's interest. The deed revesting title includes a statement noting that the transfer is intended to sever the prior vesting.[23]

---

21 **Tamimi** v. **Bettencourt** (1966) 243 CA2d 377

22 **Riddle** v. **Harmon** (1980) 102 CA3d 524

23 CC §683.2(a)

Alternatively, the co-owner may transfer title to themselves as trustee under the co-owner's revocable inter vivos (living) trust agreement. The conveyance into *the trust vesting* also severs the right of survivorship. Additionally, by the conveyance, the trust vesting avoids the probate process while gaining *control over succession* of the co-owner's interest on death. Again, community property remains community property even when vested in the living trust of the individual spouse (or domestic partner).

Further, any transfer of a joint tenant's separate interest in the joint tenancy property to a third party, such as from a joint tenant parent to a child, *automatically severs* the joint tenancy. Thus, a tenancy in common is created.

Termination of interest on death

Again, when the co-ownership of property is vested as joint tenants or community property with right of survivorship, the death of a co-owner *automatically extinguishes* the deceased co-owner's interest in the real estate. Thus, the surviving co-owner(s) becomes the sole owner(s) of the property.

However, **title** to the deceased co-owner's interest in the property needs to be cleared away before the surviving co-owner(s) are able to properly sell, lease or encumber the property as the owner(s).

The enlarged ownership interest of a surviving joint tenant — clear of the deceased's interest — is documented by simply recording an **affidavit**, signed by anyone, declaring the death of a joint tenant who was a co-owner and describing the real estate.[24] [See Form 460 accompanying this chapter]

Likewise, the half interest in **community property** held by the deceased spouse at the time of death vested "as community property with right of survivorship" is *extinguished* by the same affidavit procedure used to eliminate the interest of a joint tenant. However, the surviving spouse (or the surviving spouse's representative) is the only one authorized to make the declaration. [See **RPI** Form 461]

Judgment against a spouse

Now consider a co-owner who encumbers community property with a trust deed, executed by them alone and without the consent of their spouse. The trust deed secures a note which evidences a debt or other monetary obligation undertaken by the co-owner.

Later, the trust deed lien is set aside in a judicial action by their spouse since they did not consent to the encumbrance of the community property.

The co-owner defaults on the now unsecured mortgage. The lender obtains a money judgment against the co-owner individually and records an abstract of the judgment *naming only the co-owner* as the judgment debtor, and not their spouse.

---

24 Calif. Probate Code §210(a)

Form 460

Affidavit of Death of Joint Tenant

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

AFFIDAVIT OF DEATH OF JOINT TENANT

NOTE: This form is used by a surviving joint tenant or their agent when another joint tenant on title to property has died, to remove the deceased joint tenant from title.

DATE: _____, 20_____, at _____, California.

_____,

is the deceased named in the attached certified copy of Certificate of Death and the same person named as one of the joint tenants vested as owner of the following property situated in the County of _____, California, referred to as:

APN#: _____

I have personal knowledge of the facts in this affidavit.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

☐ See attached Signature Page Addendum. **[RPI Form 251]**

Date: _____,20_____. _____ _____

(Print name) *(Signature)*

Date: _____,20_____. _____ _____

(Print name) *(Signature)*

A notary public or other officer completing this certificate verifies only the identity of the individual who signed the document to which this certificate is attached, and not the truthfulness, accuracy, or validity of that document.

STATE OF CALIFORNIA
COUNTY OF _____
SUBSCRIBED and SWORN to (or affirmed) before me on this _____ day of _____, 20_____, by _____, proved to me on the basis of satisfactory evidence to be the person(s) who appeared before me.

Signature: _____

(Signature of notary public)

(This area for official notarial seal)

FORM 460 03-15 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

On *recording the abstract*, the judgment debt attaches as a lien to all community property in which the co-owner presently has an interest, as well as their separate property interests in other real estate. The spouse's separate property is unaffected by the recorded abstract.

Now, the same community property which had been previously encumbered by the judicially voided trust deed lien is now encumbered by the judgment which attached as a lien by recording the abstract.

Later, the couple's marriage is dissolved and the spouse is awarded sole ownership of the community property, now as their separate property.

The spouse claims the money judgment lien did not attach to the property since the debt which became the money judgment had been secured by the same property under a trust deed the court declared void.

Here, the recording of the abstract of judgment created a *valid lien* on all community property owned by the couple, including the property which later became property solely owned by the spouse. The judgment against the co-owner was attached to the property while it was still community property, before a property settlement conveyed the property or the marriage had been dissolved.[25]

Joint tenancy tax aspects

For tax purposes, the main question raised for spouses when the surviving spouse becomes the sole owner of what was community property at the time of death, no matter how vested, is: What is the surviving spouse's **cost basis** in the property as the sole owner on the death of their spouse?

stepped-up basis The readjustment of an appreciated asset's cost basis to fair market value for future tax purposes when transferred by inheritance.

The surviving spouse who becomes the sole owner of community real estate on the death of their spouse receives a "fully" **stepped-up cost basis** to the property's *fair market value (FMV)* on the date of the death which terminated the community.

Thus, the surviving spouse is entitled to a fully *stepped-up basis* in real estate previously owned by the community without concern for whether the *community property* was vested as community property, as joint tenants or in a revocable inter vivos trust. State law controls how marital property is characterized for federal tax purposes, while Federal law is unconcerned with "the form in which title is taken" to community property.[26]

By California law, all property acquired by spouses during marriage (or by partners during a domestic partnership) is community property — regardless of the vesting — if it is acquired, managed and operated as a community asset by the couple.[27]

Thus, the real estate owned by spouses or domestic partners (unless vested as tenants in common) is community property for federal income tax purposes. Accordingly, the surviving spouse on receiving the property receives a cost basis stepped-up to the property's FMV on the date of death, the result of becoming the sole owner of property previously owned by the community.

25 **Lezine** v. **Security Pacific Financial Services, Inc.** (1996) 14 C4th 56
26 IRS Revenue Ruling 87-98
27 Fam C §760

Chapter 24 Summary

A conveyance by the vested owner of a parcel transfers title to the next owner if the person conveying ownership rights holds title.

Real estate is owned by a person (or persons) — whether individuals or entities — either by sole ownership or a co-ownership of two or more persons. Sole ownership is reflected by use of a vesting naming an individual or entity as the one person entitled to ownership of the entire property described in the conveyance transferring title to that person. Co-ownerships exist for individuals as either vested co-owners on title or as co-owners of an entity which is the vested owner holding title to the property.

Co-owners vest title in their individual names in one of four types of ownerships:

- as joint tenants;
- as tenants in partnership;
- as tenants in common; or
- as community property, which is only available to married couples and domestic partners.

Each co-owner of a property has the right to possess the entire property, lease their possessory right to occupy and use the property, sell their ownership interest in the property and encumber their ownership interest in the property. A co-owner may not exclude other co-owners form their right to possession of the property or create an easement on the property against another co-owner.

When two or more persons take title to real estate and the type of vesting is not stated, the co-owners are presumed to be tenants in common. Likewise, when the co-owners are spouses or domestic partners and title is not vested as a tenancy in common, the property is presumed to be community property. As tenants in common, co-owners retain the ability on death to transfer their interests in real estate to individuals other than the remaining co-owners of the property.

Groups of investors numbering often acquire property as co-owners, to hold and operate as income-producing property. As a critical fact, their common venture necessitates a joint effort for the collective benefit of all the individual co-owners. Here, a tenancy in partnership is the result for ownership purposes.

Any number of co-owners can take title to real estate as joint tenants as long as they share equally in ownership. On death, the interest of a deceased co-owner is absorbed by the surviving joint tenant(s) to share equally.

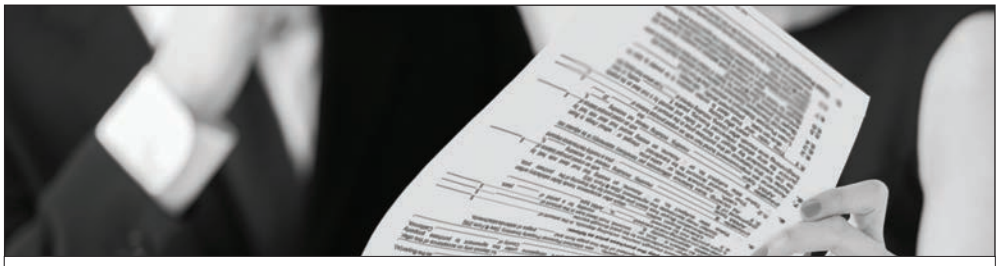
For community property, both spouses or domestic partners need to consent to the sale, lease for more than one year or encumbrance of community real estate no matter how it is vested.

Every co-owner vested as a joint tenant or community property with right of survivorship has the right to unilaterally sever the right of survivorship. The severance by a co-owner terminates the right of survivorship in that co-owner's interest.

By California law, all property acquired by spouses during marriage or by partners during a domestic partnership is community property — regardless of the vesting — if it is acquired, managed and operated as a community asset by the couple.

Thus, the real estate owned by spouses or domestic partners (unless vested as tenants in common) is community property for federal income tax purposes. Accordingly, the surviving spouse on receiving the property receives a cost basis stepped-up to the property's FMV on the date of death, the result of becoming the sole owner of property previously owned by the community.

Chapter 24 Key Terms



Chapter 25

Preliminary title reports

Learning Objectives

After reading this chapter, you will be able to:

- explain the function of a preliminary title report in real estate transactions; and
- distinguish between a preliminary title report and an abstract of title for reliance on their content.

Key Terms

abstract of title

date-down search

encumbrance

preliminary title report (prelim)

An offer to issue title insurance

A **preliminary title report**, also known as a **prelim**, is intended to disclose the current vesting and encumbrances which may be reflected on the public record affecting a property's title. Encumbrances set out in 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 is not a representation of the conditions 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.

preliminary title report (prelim)
A report constituting a revocable offer by a title insurer to issue a policy of title insurance, used by a buyer and escrow for an initial review of the vesting and encumbrances recorded and affecting title to a property.

No duty to accurately report title conditions

A title insurer has no duty to accurately report **encumbrances** affecting title on the prelim, shown as *exceptions* for the proposed policy of title insurance.

A prelim is no more than an *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 the policy is issued.

The closing of purchase escrows is contingent on the buyer's approval of items in the prelim to set the conditions of title consistent with the expectations of the buyer on entering into a purchase agreement. The buyer, their agent and escrow review the report for encumbrances on title inconsistent with the terms for the seller's delivery of title set in the purchase agreement and escrow instructions.

encumbrance
A claim or lien on title to a parcel of real estate, such as property taxes, assessment bonds, trust deeds, easements and covenants, conditions and restrictions (CC&Rs).

Both the seller's agent and the buyer's agent review the prelim immediately for any reported conditions that may interfere with closing the transaction. In practice, the buyer's agent looks for title conditions which conflict with any intended use or change in the use of the property contemplated by the buyer. Interferences with use come in the form of unusual easements or use restrictions (CC&Rs) which obstruct known plans the buyer has to make improvements.

Escrow reliance

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 insured.

Typically, escrow instructions call for closing when the deed can be recorded and insured, subject only to taxes, CC&Rs and any 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.

date-down search
A further search of the public records performed by a title insurer after preparing a preliminary title report and immediately prior to issuance of a policy of title insurance.

The prelim and a last-minute **date-down search** of title conditions are used by escrow and the title insurer to reveal any title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents when recorded.

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 by error on the part of the insurer or by a recording after the preparation of the prelim. In any case, the title company *withdraws its offer* under the prelim. The title company then issues a new prelim, offering to issue a policy on different terms.

Title companies have long been aware of the public's reliance on their prelims. This reliance was so imbedded in real estate transactions 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.

Prelim vs. abstract of title

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.

abstract of title
A representation issued by a title company as a guarantee to the named person, not an insurance policy, listing all recorded conveyances and encumbrances affecting title to the described real estate.

An abstract of title is a *statement of facts* collected from the public records. It 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 recorded conditions of title in the abstract they issue.

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 conditions of title. Instead, the prelim is defined as a report furnished in connection with an application for title insurance.

The prelim has become and is simply an *offer* by a title company to issue a title insurance policy. 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 actually issuing the policy of title insurance.

Chapter 25 Summary

A preliminary title report (prelim) is a report furnished by a title insurance company in connection with an application for a policy of title insurance which discloses the current vesting and encumbrances reflected on the public record. A title insurer has no duty to accurately report all title defects and encumbrances on the prelim.

Encumbrances set out in 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.

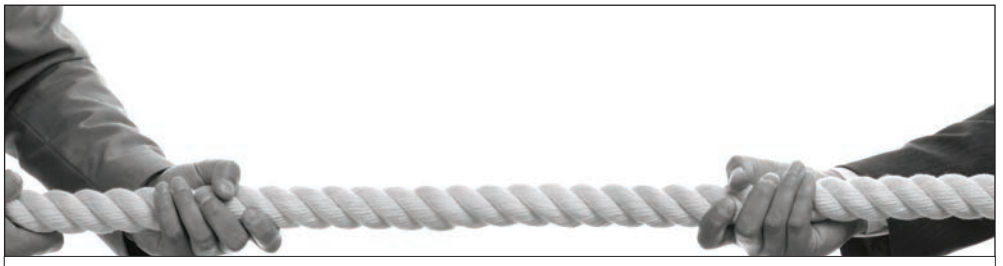
A prelim is not a representation of the conditions of title or a policy of title insurance and cannot be relied on by anyone. A prelim is no more than an offer to issue a title insurance policy based on the contents of the prelim and any modifications made by the title company before the policy is issued.

The prelim and a last-minute date-down search of title conditions are used by escrow and the title insurer to reveal any title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents when recorded.

Conversely, 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.

Chapter 25 Key Terms

Chapter
26



The counteroffer environment

Learning Objectives

After reading this chapter, you will be able to:

- advise a client on their options for responding to their receipt of a purchase offer or counteroffer which contains unacceptable terms;
- assist a seller or buyer to renegotiate an offer or counteroffer they have received; and
- prepare and submit a counteroffer from a seller or buyer.

Key Terms

counteroffer **interlineation**

defacing

The seller's objectives face a buyer's offer

The preparation of a counteroffer allows a seller's agent and seller to take control of negotiations a prospective buyer has commenced by submitting a purchase agreement offer. For the seller's agent, the **counteroffer** is the proper moment to care for and protect the seller by:

- addressing property disclosures to be made by the seller to perfect any agreement the seller may enter into with the prospective buyer;
- *clarifying* any uncertainties about the buyer's ability to close escrow; and
- reviewing changes in terms or conditions sought by the seller different from those of the buyer's offer.

A counteroffer allows the seller's agent to eliminate contingencies regarding disclosures, which tend to bring about a cancellation or re-pricing of the sale for the seller. At the same time, the seller's agent can take steps to establish the buyer's qualifications for any purchase-assist financing requirements and the source of other funds needed by the buyer to close the transaction.

counteroffer
An alternative response to an offer received consisting of terms different from those of the offer rejected. [See **RPI** Form 180]

The seller's agent's analysis

The environment surrounding the agent's analysis of the buyer's offer and review of the offer with the seller is nearly always within the control of the seller's agent. They need to use the opportunity to clean up the transaction before it becomes a binding contract with fixed expectations.

A prompt, initial review of the buyer's offer by the seller's agent — alone and before advising the seller — is necessary to prepare the agent for their submitting and reviewing of the offer with the seller.

The seller's first comments typically focus on the price, transactional costs, the buyer's ability to close escrow, and when the seller may pick up the net sales proceeds. Conversely, the seller's agent is primarily concerned with:

- the agent's preparation for their appointment with the seller which will cover information needed to be reviewed by the seller before a decision can be made to accept or reject (by use of a counteroffer) the buyer's purchase agreement offer; and
- the seller's obligation to the prospective buyer to disclose their knowledge about the property which, if improperly disclosed after entering into a purchase agreement, can:
    - affect the price the buyer is willing to pay for the property;
    - lead to the buyer's cancellation of the purchase agreement; or
    - reduce the seller's net proceeds if the seller has to eliminate undisclosed conditions exposed by a late disclosure which are unacceptable to the buyer.

The diligent seller's agent

A *seller's agent's duty* owed to the seller on submission and review of a prospective buyer's offer includes:

- advice on the *seller's obligations* to disclose property conditions and obtain clearances or eliminate defects the buyer's due diligence investigation will discover;
- a review of the agent's concerns about the acceptability or modification of *contingency provisions* which affect closing;
- disclosure of the likely *net sales proceeds* the offer will generate; and
- if the property is other than the seller's personal residence, the agent's knowledge about the profit *tax liability* the seller will most likely incur on the sale.

For example, an agent representing a prospective buyer submits a purchase agreement offer without first obtaining a copy of the seller's agent's marketing package on the property. The package contains all the required seller disclosures the seller and seller's agent are required to deliver to prospective buyers.

Thus, the buyer does not take into consideration any adverse property conditions *disclosed* in the marketing package when the buyer made their decision about the price and terms on which they are willing to buy the property.

Accordingly, the seller's agent advises the seller to counter the offer and include as addenda all the required disclosures. The disclosures, at the agent's insistence when listing the property, have already been prepared and are available for the prospective buyer to approve before a purchase agreement is entered into.

The pre-contract disclosures eliminate most of the contingencies which affect the price, the amount of the seller's transactional expenses and the buyer's ability to cancel the purchase agreement.

By a thoughtful analysis of the buyer's offer prior to meeting with the seller, the seller's agent prepares to advise the seller on the use of a counteroffer to best respond to the offer. Thus, the agent seeks to reduce the uncertainties about the consequences of an unmodified acceptance of an offer.

Various responses to an offer

Several procedures exist for a seller to respond to an unacceptable offer, especially an offer that needs only a few minor changes to be acceptable to the seller.

Minor changes regarding the selection of the escrow company, the deadline for loan approval, verification of down payment funds or the sale or purchase of other property each constitute a counteroffer.

The seller's agent handling negotiations for a change in the terms of the buyer's purchase offer needs to reduce the seller's (counter) offer to a writing signed by the seller before it is submitted to the buyer. The seller's signed counteroffer manifests their intent to be bound by their offer to sell, if the buyer accepts.

Countering an unacceptable offer

To counter an unacceptable purchase agreement offer by the buyer, the seller's agent may:

- Prepare the seller's offer on a *new purchase agreement form*. No reference is made in the seller's new offer to the rejected purchase agreement offer previously submitted by the buyer. This new original offer prepared by the seller's agent is signed first by the seller and the seller's agent, then submitted to the buyer for the buyer's acceptance or rejection. [See **RPI** Form 150]
- Prepare the seller's offer on a *counteroffer form* which includes, by reference, the terms and conditions of the buyer's offer. Modifications are then entered on the counteroffer form stating the terms and conditions sought by the seller which are different from those in the buyer's offer that are unacceptable to the seller. [See Form 180 accompanying this chapter]
- Dictate *escrow instructions* based on an agreement orally negotiated with the buyer (or buyer's agent) to resolve the seller's dissatisfaction regarding the terms and conditions in the buyer's offer. The instructions are submitted to the seller and buyer for signatures. On receipt by escrow of copies of the instructions containing the signatures of all parties, the

escrow instructions then become the only agreement entered into by both the buyer and seller. Here, the escrow company becomes a sort of secretarial service used by agents who do not take the time to prepare a written counteroffer. [See **RPI** 401]

- *Alter the buyer's original written offer* by deleting unacceptable provisions from the face of the document and entering the differing provisions sought by the seller, a process called **deface and interlineate**. The altered purchase agreement is then signed by the seller in the acceptance provision and returned to the buyer as the seller's counteroffer. This counteroffer and acceptance procedure is called **change-and-initial**, and is used when a counteroffer form is not made available and prepared by the seller's agent.
- Set up an *auction environment* (if the current market is composed of too many buyers for too little inventory) by calling for the submission of all offers on a date and at a time set for the seller to accept the best offer presented by prospective buyers, or by creating some other auction situation short of the seller signing multiple counteroffers, an awkward (and typically misguided) response to the receipt of multiple purchase offers.
- *Orally advise* the buyer's agent about the changes required before the seller accepts the buyer's offer. If the buyer is interested in the property based on those changes, the buyer's agent is asked to prepare and submit a new purchase agreement offer signed by the buyer for the seller to consider. This situation requires the buyer to "negotiate with themselves," while the seller remains uncommitted to sell on any terms. Here, either the seller's agent does not take the time to prepare a counteroffer stating the seller's terms and conditions, or the seller does not want to become uncommitted.
- Let the *offer expire*, then resume negotiations with the buyer and their agent if the buyer still has an interest in the property.

Analyzing the counteroffer form

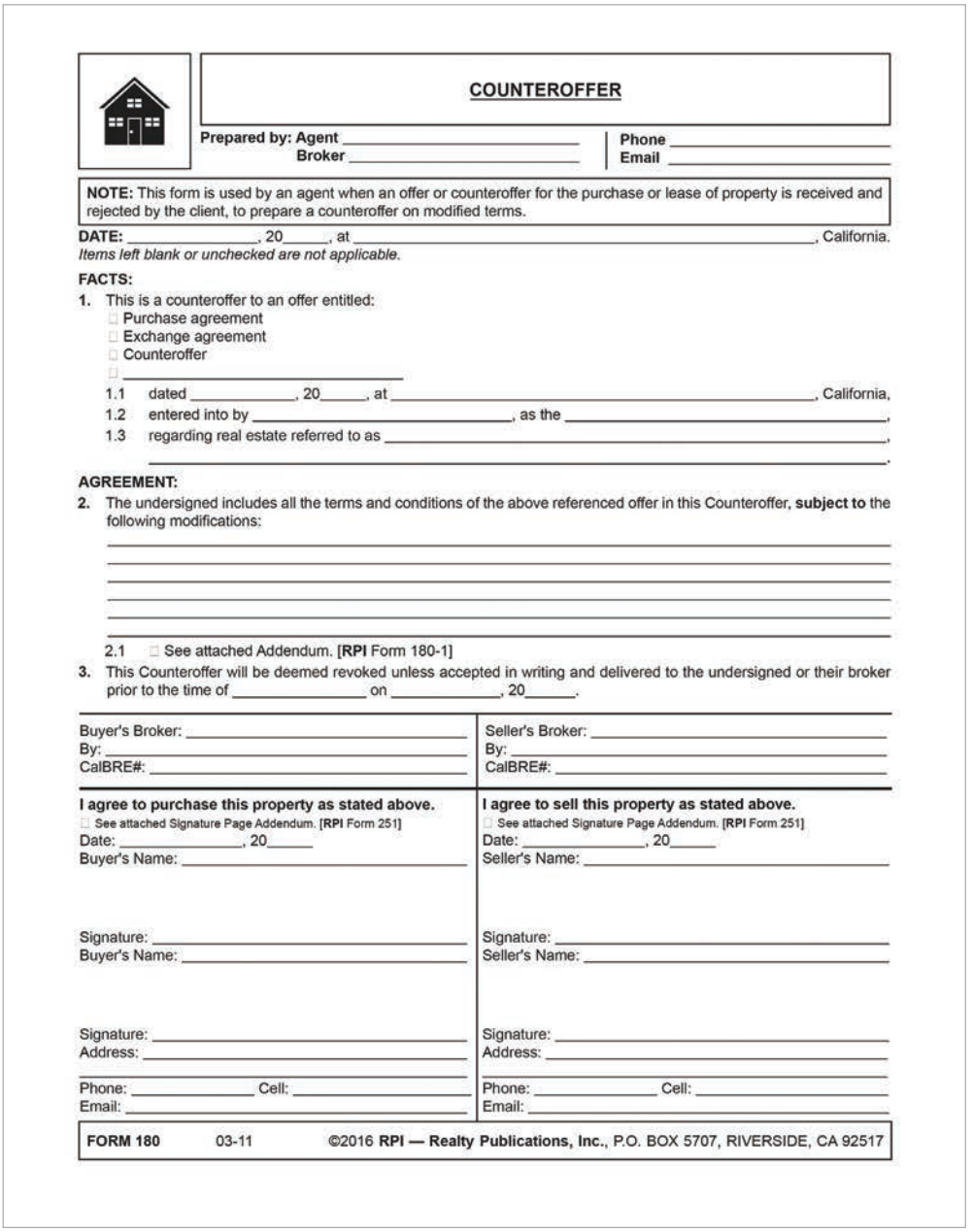
A *rejection* does occur by delivering a written rejection stating no counteroffer will be forthcoming, as provided at the end of most purchase agreement forms, or by submitting a counteroffer. After a rejection has been communicated, the original offer can no longer be accepted to form a binding agreement. [See **RPI** Form 184]

The rejection on receipt of a purchase agreement offer by preparing and submitting a counteroffer takes place in one of two circumstances:

1. The use of a counteroffer form with wording that incorporates all the terms in the offer submitted which are then modified by entering alternative or additional provisions on the counteroffer form; **or**
2. The use of a different purchase agreement form to prepare an entirely *new offer* which is submitted as a counteroffer.

Form 180

Counteroffer



COUNTEROFFER

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

NOTE: This form is used by an agent when an offer or counteroffer for the purchase or lease of property is received and rejected by the client, to prepare a counteroffer on modified terms.

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This is a counteroffer to an offer entitled:
   - ☐ Purchase agreement
   - ☐ Exchange agreement
   - ☐ Counteroffer
   - ☐ _____

   1.1 dated _____, 20_____, at _____, California,
   1.2 entered into by _____, as the _____,
   1.3 regarding real estate referred to as _____,
   _____.

AGREEMENT:

2. The undersigned includes all the terms and conditions of the above referenced offer in this Counteroffer, **subject to** the following modifications:
   _____
   _____
   _____
   _____
   _____
   _____

   2.1 ☐ See attached Addendum. **[RPI** Form 180-1]
3. This Counteroffer will be deemed revoked unless accepted in writing and delivered to the undersigned or their broker prior to the time of _____ on _____, 20_____.

Buyer's Broker: _____	Seller's Broker: _____
By: _____	By: _____
CalBRE#: _____	CalBRE#: _____
I agree to purchase this property as stated above.	**I agree to sell this property as stated above.**
☐ See attached Signature Page Addendum. **[RPI** Form 251]	☐ See attached Signature Page Addendum. **[RPI** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer's Name: _____	Seller's Name: _____
Signature: _____	Signature: _____
Buyer's Name: _____	Seller's Name: _____
Signature: _____	Signature: _____
Address: _____	Address: _____
Phone: _____ Cell: _____	Phone: _____ Cell: _____
Email: _____	Email: _____

FORM 180 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

The counteroffer form has four sections, each with a separate purpose:

1. *Reference to prior offer*: The purpose of a counteroffer is to reference a prior written offer and state the terms and conditions contrary or in addition to those in the original offer which are agreeable to the party countering.
2. *The agreement offered*: The offer submitted and rejected by a counteroffer has all its terms and conditions "incorporated" into the counteroffer. Terms which are additional to or in conflict with those of the prior offer are then entered on the counteroffer to create the terms and conditions of the new offer. Any terms in conflict with the terms of the original offer override and become the terms of the counteroffer.

3. *Time for acceptance*: The counteroffer expires at the time and on the date stated in it for expiration. If no specific date is given, a reasonable time to accept is permitted, unless the counteroffer is first withdrawn.
4. *Signatures*: The party making the counteroffer signs and dates the offer. The brokers sign the counteroffer only to acknowledge their participation in the negotiations.

The counter is an offer

The rules for preparing, submitting and accepting a counteroffer in a real estate sales transaction are the same rules applied to determine whether an offer made by a buyer has been submitted to the seller and an acceptance by the seller has occurred to form a **binding agreement**.

Real estate agents instinctively consider submitting written offers from a buyer to a seller to comply with the rule requiring a written agreement, signed by the buyer and seller to form a real estate agreement. Likewise, agents need to automatically submit written counteroffers from sellers to buyers when the seller will not accept all aspects of the buyer's offer but is willing to commit themselves to terms of a sale if the buyer will accept them.

For example, on the buyer's receipt of a seller's counteroffer, the buyer may be unwilling to accept the terms stated, but be willing to submit an offer on different terms — a counter to the counter. The buyer's agent also uses a counteroffer form to prepare the buyer's new offer. Occasionally, the transaction agents will discuss what arrangements will be mutually satisfactory before actually writing up the new counteroffer, otherwise this exchange of offers can go on forever.

The buyer's counteroffer, by reference, includes all the terms and conditions of the seller's counteroffer (which itself may reference and include all the provisions in the buyer's original offer). These referenced terms from the seller's counter are then modified by entry on the counteroffer form of the buyer's terms and conditions contrary to those sought by the seller.

Alternatively, the buyer's agent may draft an entirely fresh purchase agreement offer setting forth the terms agreeable to the buyer.

Forms for entering into agreements are usually worded flexibly for the buyer and seller to merely reflect their agreement to the terms stated above. The wording eliminates concern over whether the buyer or seller must first sign a purchase agreement to make an offer or counteroffer. Either may sign it first, which makes it their offer on the terms stated.

Defacing a signed document

Seller's agents sometimes delete terms or provisions in a signed purchase agreement they have received by lining them out with a pen or covering them with white-out, called **defacing**. The agent then adds copy to the document to replace the deleted material, called **interlineation**.

The seller signs the altered document agreeing to the terms of the offer as modified, a counteroffer technique called **change-and-initial**. However, this is improper conduct since it alters the contents of an original document after it has been signed.

defacing
When a document is modified on its face, usually by striking copy and interlineation, after it is signed by one or both parties.

Further, the change-and-initial method of preparing a counteroffer often creates uncertainty as to when and who placed which terms in the agreement. Legally, the agreement is interpreted against the individual creating the uncertainty, typically the seller who countered by defacing and initialing a signed original document.[1]

Modifying a purchase agreement

Consider the plight of a buyer's agent who industriously works to locate unimproved land for a client. The agent contacts the owners of several suitable properties by mail, soliciting information as to whether they will consider selling their property. One absentee owner indicates they would review any offer submitted by the agent's buyer.

The agent prepares an offer which their buyer signs, agreeing to purchase the land on an installment sale arrangement payable over a ten-year period. The agent sends the signed purchase agreement to the absentee seller. On receipt, the seller calls the buyer's agent to discuss increasing the price and setting an earlier payoff date for the carryback mortgage. The terms discussed are acceptable to the buyer.

interlineation
The process of modifying an instrument or document by inserting additional language between the lines to clarify a particular provision, usually adding something that was omitted.

The buyer's agent then prepares another purchase agreement offer reflecting the changes sought by the seller, which the buyer signs as a fresh, new offer. On the seller's receipt of this offer, the seller contacts the buyer directly and they orally negotiate a cash price payable in 20 days.

To write up the new terms, the seller makes extensive changes to the buyer's second purchase agreement offer by *striking out* the price, terms of payment, closing date, title changes, due diligence investigation contingency provision, etc. On the face of the document, the seller then enters the terms and conditions which replace the stricken ones.

The seller signs the purchase agreement indicating they agree to the terms as stated and returns it to the agent. The changes correctly reflect the changes the buyer agreed to by phone. To accept the modified purchase agreement, the buyer then *initials* all the significant changes made by the seller, but does not initial every minute and minor entry made by the seller. No changes or additions to the document are made by the buyer. The buyer does not re-sign the original purchase agreement in addition to initialing the changes.

Enforcing the altered terms

Continuing with the example, the purchase agreement with the buyer's initials throughout is returned to the seller. The agent dictates escrow instructions which are prepared reflecting the final terms as agreed to in the changed-and-initialed counteroffer. The buyer signs and returns their copy of the instructions, but the seller does not.

1 Calif. Civil Code §1654

The agent calls the seller asking them to sign and return the escrow instructions and the deed. The seller says they have no deal since the buyer did not initial each and every entry made by the seller on the purchase agreement. The seller claims the failure to initial each minute change they made was a *qualified acceptance* which did not form a binding agreement.

Here, the seller and buyer did enter into a binding and enforceable purchase agreement. The *essential terms* needed as a minimum to provide the certainty and clarity required to establish an enforceable real estate purchase agreement between them existed and were initialed.

Further, the buyer did not make any changes or add any wording to the offer. By returning the initialed and unaltered counteroffer, the buyer indicated their intention to accept the seller's (counter)offer as submitted by the seller.

Signature confirms new terms

The failure to initial minor and nonessential provisions was inadvertent and not necessary to determine the performance required of the seller to deliver a deed in exchange for cash.[2]

In such cases, a buyer's agent directly involved in the final counter-proposal made by the seller will prepare yet another new original purchase agreement offer to be signed by the buyer and sent to the seller to sign and return.

However, here, the seller did commit themselves in the counteroffer to sell on terms which were certain. The buyer merely needed to sign their name at the end of the altered agreement and date it to demonstrate they also agreed to the terms stated above. On signing, the terms include all changes made by the seller on the face of the document.

Had the seller been represented by a seller's agent, their agent would have prepared the counteroffer on either a counteroffer form or a new purchase agreement form for the seller to sign. The prepared form would have contained those terms the seller entered by *interlineation* into the buyer's original purchase agreement offer.

Thus, the buyer's acceptance of the counter would have been simple. The buyer would agree to buy on the terms stated in the seller's counteroffer by merely signing the seller's (counter)offer and delivering the counteroffer with the signed acceptance.

2 **Kahn** v. **Lischner** (1954) 128 CA2d 480

Chapter 26 Summary

The preparation of a counteroffer allows a seller's agent and seller to take control of negotiations a prospective buyer has commenced by submitting a purchase agreement offer. A seller's agent's duty owed to the seller on submission and review of a prospective buyer's offer includes:

- advice on the seller's obligations to disclose property conditions;
- a review of the contingency provisions which affect closing;
- disclosure of the likely net sales proceeds the offer will generate; and
- if the property is other than the seller's personal residence, the agent's knowledge about the profit tax liability the seller will likely incur on the sale.

By a thoughtful analysis of the buyer's offer prior to meeting with the seller, the seller's agent prepares to advise the seller on the use of a counteroffer to best respond to the offer. Thus, the agent seeks to reduce the uncertainties about the consequences of an unmodified acceptance of an offer.

The seller's agent handling negotiations for a change in the terms of the buyer's purchase offer needs to reduce the seller's (counter) offer to a writing signed by the seller before it is submitted to the buyer. The seller's signed counteroffer manifests their intent to be bound by their offer to sell, if the buyer accepts.

To counter an unacceptable purchase agreement offer by the buyer, the seller's agent may:

- prepare the seller's offer on a new purchase agreement form;
- prepare the seller's offer on a counteroffer form;
- dictate escrow instructions based on an agreement orally negotiated with the buyer (or buyer's agent);
- alter the buyer's original written offer by deleting unacceptable provisions and entering the differing provisions sought by the seller;
- set up an auction environment by calling for the submission of all offers;
- orally advise the buyer's agent about the changes required before the seller accepts the buyer's offer; or
- let the offer expire, then resume negotiations with the buyer and their agent if the buyer still has an interest in the property.

Seller's agents sometimes delete terms or provisions in a signed purchase agreement they have received by lining them out with a pen or covering them with white-out, called defacing, and then adding copy to the document to replace the deleted material, called interlineation.

However, this is improper conduct since it alters the contents of an original document after it has been signed. Further, the change-and-initial method of preparing a counteroffer often creates uncertainty as to when and who placed which terms in the agreement.

Chapter 26 Key Terms

Chapter 27

Real estate purchase options

Learning Objectives

After reading this chapter, you will be able to:

- understand the nature and function of an option form as a method to purchase property;
- explain the pros and cons of using an option to purchase for both a buyer and a seller; and
- advise on the exercise of an option to purchase real estate.

Key Terms

consideration
constructive notice
option money
option period
option to buy

An irrevocable offer to sell

Consider a real estate syndicator searching for investment-grade, income-producing real estate. A property is located which appears to be financially suitable for a group investment, a real estate brokerage activity called **syndication**.

However, the syndicator will not commit themselves to purchase the property until they have fully investigated the condition of the property's improvements, operating data, location and record title as well as the availability of mortgage financing, an effort called **due diligence**.

Further, if conditions are found to be acceptable on completing the due diligence investigation, the syndicator needs additional time to prepare an investment memorandum and locate willing and able investors. The memo contains a narrative report on the significant information the syndicator gathered concerning the worth of the property. The report is circulated among equity investors as a solicitation to form a group to fund the acquisition of the property for long-term ownership.

First, before the syndicator begins an in-depth analysis of the property, an enforceable purchase agreement needs to be entered into with the seller. Without an agreement to acquire the property, the property may be sold to someone else before completion of the property investigation and determination of its suitability for acquisition. For these reasons, the syndicator chooses not to engage in the use of a *letter of intent*, other than for the initial contact for negotiations. [See **RPI** Form 185 and 186]

The right to buy and contingencies

To acquire the right to buy the property without unconditionally committing themselves to purchase the property, the syndicator submits an offer. Its provisions call for the occurrence of several events before committing to close escrow and acquiring the property, called **contingency provisions**.

The *contingency provisions* include approval of:

- the property's physical condition;
- its leasing income and operating expenses;
- available mortgage financing;
- title and zoning restrictions on use; and
- the existence of equity investors to fund the closing.

The seller fully understands the contingencies are designed primarily to enable the syndicator to confirm their understanding of the property's condition as represented by the seller and to obtain the mortgage and equity financing needed to fund the close of escrow. However, the seller is concerned the syndicator's inability to satisfy and remove the contingencies may interfere with the seller's ability to promptly cancel the agreement if the syndicator fails to close or cancels the transaction by the date scheduled for closing.

Thus, the seller decides not to accept the syndicator's purchase offer due to uncertainty regarding the syndicator's ability to perform.

The option to buy as a counteroffer

Continuing the previous example, the seller is willing to grant the syndicator an **option to buy** the property at the same price and for the same time period sought by the syndicator in their offer to purchase. Thus, the seller rejects the offer by submitting a counteroffer.

option to buy
An agreement granting an irrevocable right to buy property within a specific time period. [See **RPI** Form 161]

However, a counteroffer form will not be used to respond to the syndicator's offer. A counteroffer incorporates the terms of the syndicator's purchase offer, subject to any contrary or alternative provisions entered on the counteroffer, a bilateral contract.

In this situation, the seller simply prepares and hands the syndicator an *offer to grant an option*, a formal rejection of the syndicator's offer. [See Form 160 accompanying this chapter]

The seller's offer to grant an option requires the syndicator to accept the offer and the terms of the proposed option agreement before the seller is bound to deliver the signed option agreement. To accept the seller's offer to grant an option, the syndicator needs to sign the acceptance provision in the offer and return it to the seller. Acceptance is to occur *before* expiration of the seller's offer to grant the option.

Unlike a real estate purchase agreement, the buyer holding an option to buy has no obligation to purchase the property.

An irrevocable offer

Conversely, the option contains the seller's *irrevocable offer* to sell the property on the terms stated in the option agreement. The syndicator only agrees to become obligated to buy the property when they timely accept the seller's irrevocable offer to sell, an acceptance called *exercising the option*. If the syndicator decides to buy the property, they will exercise the option within the time period set for agreeing to buy the property, called the **option period**.

option period
The time period during which an optionee/buyer may exercise their right to buy under an option agreement. [See **RPI** Form 161 §4]

In exchange for the seller's grant of an option to buy the property, the syndicator pays the seller **option money**. The amount of *option money* is the price the syndicator pays to buy the option and "tie up" the property by effectively removing it from the market. [See Figure 1]

option money
Consideration given by a buyer to a seller for granting the buyer an option to purchase the property.

Here, the option agreement gives the syndicator control over the property without committing themselves to purchase it until they exercise the option, if ever. Successful completion of the property analysis and solicitation of investors will indicate whether they exercise the option or not.

Obligation to perform

When the syndicator *exercises the option*, a **bilateral sales contract** is automatically formed, no differently than accepting an offer from the seller to sell the property under a purchase agreement containing nearly identical terms but without contingency provisions. Thus, on exercise, both parties become obligated to perform as agreed and need to proceed with closing the sale.[1]

If the syndicator allows the option period to expire by not exercising the option, the seller is able to sell the property to another buyer, unaffected by the option since the seller's irrevocable offer to sell represented by the option has expired.

In an option agreement, the owner is referred to as the *optionor* and the potential buyer is referred to as the *optionee*. They become the seller and buyer, respectively, on the optionee's exercise of the option.

Editor's note — An option granted to a buyer is to be distinguished from an exclusive right-to-sell employing a broker. On entering into a listing, the seller incurs no obligation to sell the property to anyone. The property owner only employs the broker as their agent to find a buyer and represent

1 **Caras** v. **Parker** (1957) 149 CA2d 621

the seller in negotiations. The broker does not receive the power-of-attorney authority needed to commit the seller to a sale of the property and the listing is not an offer to sell anything.

Granting an option

Consider a broker employed by a seller under a listing agreement containing the seller's promise to pay the broker a fee if they negotiate a sale, exchange or the grant of an option to purchase the seller's property. [See **RPI** Form 102 §10]

An agent of the broker locates a qualified buyer. The seller grants the buyer — the *optionee* — an option on the receipt of option money paid by the buyer. The broker receives no fee on the grant of the option (though one is permitted) and the option does not contain a fee provision. However, the broker has earned a fee and is entitled to payment under the listing due to the seller entering into the option agreement.

After the listing expires, the buyer exercises the option and acquires the property.

The broker makes a demand on the seller for a fee under the listing agreement. The seller refuses, claiming the broker is not entitled to a fee since the buyer exercised the option *after* the listing agreement expired and the option did not provide for a fee on its exercise.

Here, the broker did earn a fee. During the listing period, the seller granted the buyer an option to buy the property, which the buyer later exercised to acquire the property.[2]

Thus, when an option is exercised, the sale relates back to the time the option was granted, i.e., during the listing period. This relation back is comparable to entering into a purchase agreement or opening an escrow during the listing period, and closing the transaction after the listing expires.

Alternatively, consider a seller who agrees to pay a broker a partial fee on the granting of an option without any reference to payment of a further fee on the exercise of the option. To avoid the lost expectations (without a fight) for payment of the remainder of the fee on exercise, the broker and their agent need to include a fee provision in the body of the option. [See Form 160 §5]

Benefits for opposing positions

An option agreement provides benefits for both buyer and seller.

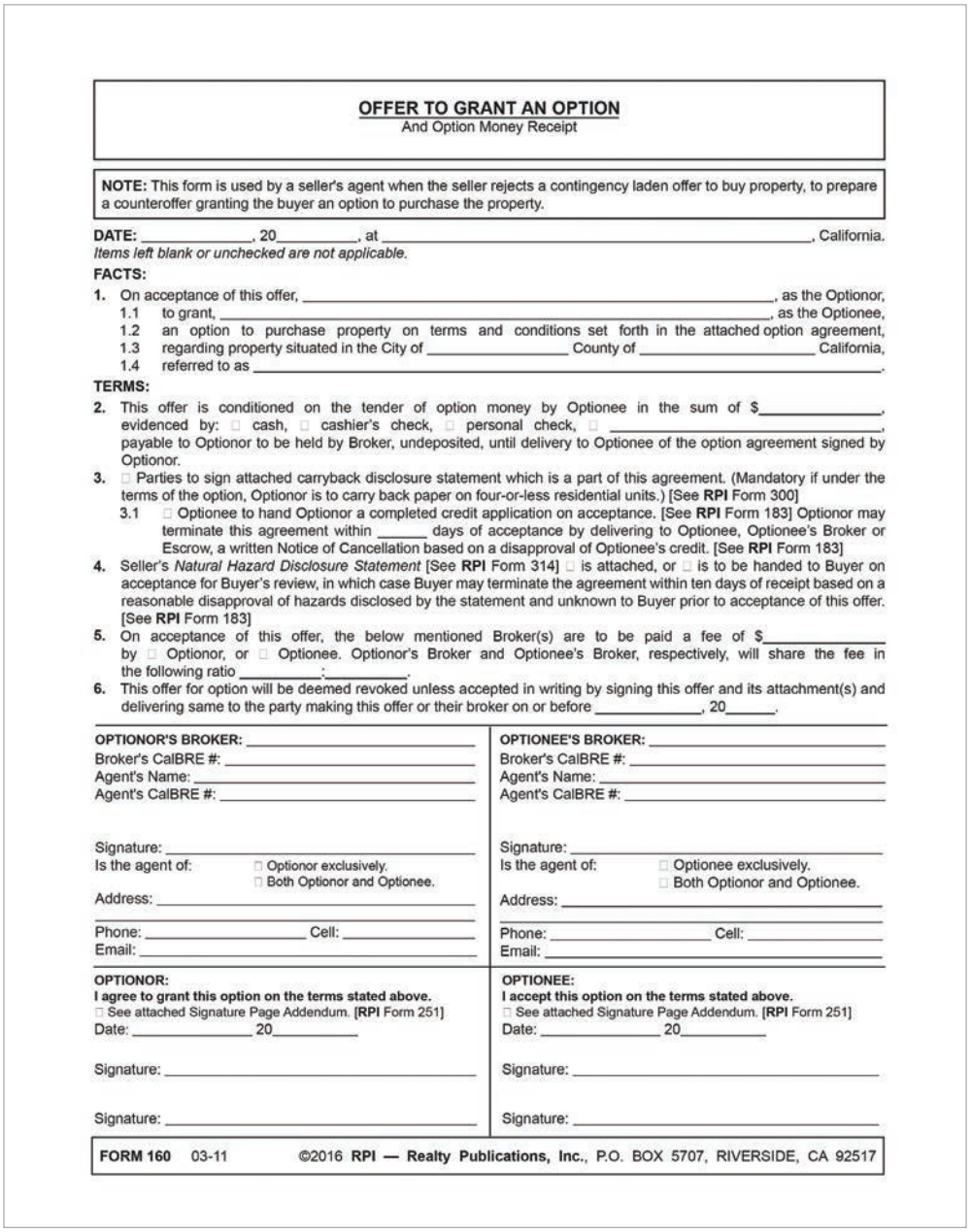
A *buyer* considers acquiring an option when they:

- do not yet want to commit themselves to buy;
- are speculating in a depressed market and believe values will soon rise;
- need time to investigate and determine whether the property will operate profitably;

2 **Anthony** v. **Enzler** (1976) 61 CA3d 872

Form 160

Offer to Grant an Option



OFFER TO GRANT AN OPTION
And Option Money Receipt

NOTE: This form is used by a seller's agent when the seller rejects a contingency laden offer to buy property, to prepare a counteroffer granting the buyer an option to purchase the property.

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. On acceptance of this offer, _____, as the Optionor,
   1.1 to grant, _____, as the Optionee,
   1.2 an option to purchase property on terms and conditions set forth in the attached option agreement,
   1.3 regarding property situated in the City of _____ County of _____ California,
   1.4 referred to as _____.

TERMS:

2. This offer is conditioned on the tender of option money by Optionee in the sum of $_____, evidenced by: ☐ cash, ☐ cashier's check, ☐ personal check, ☐ _____, payable to Optionor to be held by Broker, undeposited, until delivery to Optionee of the option agreement signed by Optionor.
3. ☐ Parties to sign attached carryback disclosure statement which is a part of this agreement. (Mandatory if under the terms of the option, Optionor is to carry back paper on four-or-less residential units.) [See **RPI** Form 300]
   3.1 ☐ Optionee to hand Optionor a completed credit application on acceptance. [See **RPI** Form 183] Optionor may terminate this agreement within _____ days of acceptance by delivering to Optionee, Optionee's Broker or Escrow, a written Notice of Cancellation based on a disapproval of Optionee's credit. [See **RPI** Form 183]
4. Seller's *Natural Hazard Disclosure Statement* [See **RPI** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review, in which case Buyer may terminate the agreement within ten days of receipt based on a reasonable disapproval of hazards disclosed by the statement and unknown to Buyer prior to acceptance of this offer. [See **RPI** Form 183]
5. On acceptance of this offer, the below mentioned Broker(s) are to be paid a fee of $_____ by ☐ Optionor, or ☐ Optionee. Optionor's Broker and Optionee's Broker, respectively, will share the fee in the following ratio _____:_____.
6. This offer for option will be deemed revoked unless accepted in writing by signing this offer and its attachment(s) and delivering same to the party making this offer or their broker on or before _____, 20_____.

OPTIONOR'S BROKER: _____	**OPTIONEE'S BROKER:** _____
Broker's CalBRE #: _____	Broker's CalBRE #: _____
Agent's Name: _____	Agent's Name: _____
Agent's CalBRE #: _____	Agent's CalBRE #: _____
Signature: _____	Signature: _____
Is the agent of: ☐ Optionor exclusively. ☐ Both Optionor and Optionee.	Is the agent of: ☐ Optionee exclusively. ☐ Both Optionor and Optionee.
Address: _____	Address: _____
Phone: _____ Cell: _____	Phone: _____ Cell: _____
Email: _____	Email: _____
OPTIONOR: **I agree to grant this option on the terms stated above.** ☐ See attached Signature Page Addendum. [**RPI** Form 251] Date: _____ 20_____	**OPTIONEE:** **I accept this option on the terms stated above.** ☐ See attached Signature Page Addendum. [**RPI** Form 251] Date: _____ 20_____
Signature: _____	Signature: _____
Signature: _____	Signature: _____

FORM 160 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

- need time for promotional work such as syndicating, subdividing, rezoning, obtaining permits or mortgage commitments, or to complete a §1031 reinvestment; or
- are a tenant and may want to own the leased premises in the future.

A *seller* considers granting an option when they:

- want to retain ownership rights to the property for a fixed period into the future (for tax purposes);
- aim to sell at a price based on higher future market values;
- need to provide an incentive to induce a prospective tenant to lease the property; or

- want to give a promoter or developer incentive to work up a marketing or use plan and buy the property.

Multiple option periods

Developers require a longer initial option period — or the right to extend the option period — to provide time in which to study a property, obtain government clearances and locate financing for development. If these objectives are met, the developer is able to purchase the property on a previously agreed set of terms.

Thus, it is foreseeable a developer may need additional time beyond the initial option period to complete their due diligence and approval process before committing themselves to the purchase of the "optioned" property. Here, the option agreement is to include the right to buy one or more extensions of the option period on the payment of additional option money before the expiration of the preceding option period. [See **RPI** Form 161-1]

The developer who determines they are unable to develop or successfully market a development of the property will simply not extend or exercise the option.

Lease with option

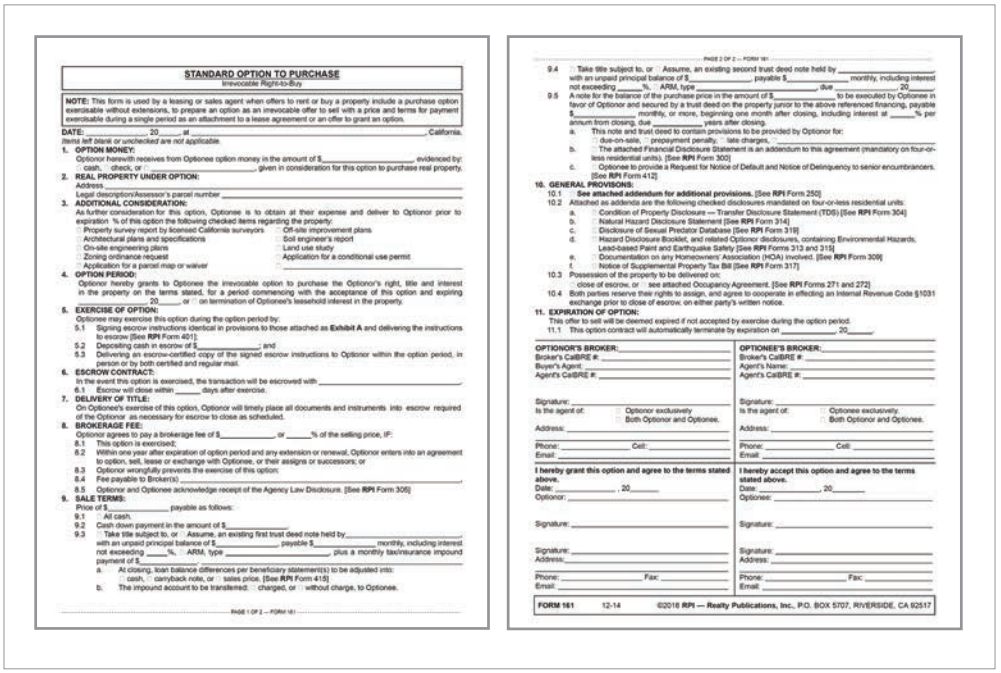
The other significant use of an option to buy relates to residential and commercial leasing arrangements. Prospective tenants may want the ability to later acquire ownership of the property they will be occupying.

Tenants often need to invest substantial dollar amounts in tenant improvements (TIs) to tailor the property to their needs. Whether contracted for by the tenant or the landlord, the tenant pays for the improvements either by a lump sum, up front expenditure or by payments amortized over the initial life of the lease as part of the monthly rent. Landlords need a return of their capital, as well as a return on the capital they invest in the TIs to stay in business.

Additionally, installation of racks, cabinets, shelving, trade fixtures, lighting and other interior improvements are needed to make the premises fully suitable for the tenant's occupancy. These too are paid for by the tenant.

As always, a degree of "goodwill" is built up with customers due to the location of the business on the property. Thus, the location becomes part of the value of the tenant's business so long as they remain at the location.

All these opportunities are lost if the landlord refuses to extend the lease or their demands for increased rent under an unpriced *option to extend the lease* compels the tenant to relocate. A tenant with even a small degree of insight into their future operations at the location will attempt to negotiate some sort of option to purchase the property. If not, at least an option to renew at lesser rental rates is negotiated, as the tenant improvements (TIs) will have been paid for by the tenant and the landlord will have fully recovered the costs incurred.



STANDARD OPTION TO PURCHASE
Irrevocable Right-to-Buy

NOTE: This form is used by a leasing or sales agent when offers to rent or buy a property include a purchase option exercisable without extensions, to prepare an option as an irrevocable offer to sell with a price and terms for payment exercisable during a single period as an attachment to a lease agreement or an offer to grant an option.

DATE: _____, 20____, at _____, California.
Items left blank or unchecked are not applicable.

1. **OPTION MONEY:**
Optionor herewith receives from Optionee option money in the amount of $_____, evidenced by: ☐ cash, ☐ check, or ☐ _____, given in consideration for this option to purchase real property.

2. **REAL PROPERTY UNDER OPTION:**
Address _____
Legal description/Assessor's parcel number _____

3. **ADDITIONAL CONSIDERATION:**
As further consideration for this option, Optionee is to obtain at their expense and deliver to Optionor prior to expiration ☐ % of this option the following checked items regarding the property:
☐ Property survey report by licensed California surveyors
☐ Architectural plans and specifications
☐ On-site engineering plans
☐ Zoning ordinance request
☐ Application for a parcel map or waiver
☐ Off-site improvement plans
☐ Soil engineer's report
☐ Land use study
☐ Application for a conditional use permit
☐ _____

4. **OPTION PERIOD:**
Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property on the terms stated, for a period commencing with the acceptance of this option and expiring _____, 20____, or ☐ on termination of Optionee's leasehold interest in the property.

5. **EXERCISE OF OPTION:**
Optionee may exercise this option during the option period by:
5.1 Signing escrow instructions identical in provisions to those attached as **Exhibit A** and delivering the instructions to escrow [See **RPI** Form 401];
5.2 Depositing cash in escrow of $_____; and
5.3 Delivering an escrow-certified copy of the signed escrow instructions to Optionor within the option period, in person or by both certified and regular mail.

6. **ESCROW CONTRACT:**
In the event this option is exercised, the transaction will be escrowed with _____.
6.1 Escrow will close within _____ days after exercise.

7. **DELIVERY OF TITLE:**
On Optionee's exercise of this option, Optionor will timely place all documents and instruments into escrow required of the Optionor as necessary for escrow to close as scheduled.

8. **BROKERAGE FEE:**
Optionor agrees to pay a brokerage fee of $_____ or _____% of the selling price, IF:
8.1 This option is exercised;
8.2 Within one year after expiration of option period and any extension or renewal, Optionor enters into an agreement to option, sell, lease or exchange with Optionee, or their assigns or successors; or
8.3 Optionor wrongfully prevents the exercise of this option;
8.4 Fee payable to Broker(s) _____
8.5 Optionor and Optionee acknowledge receipt of the Agency Law Disclosure. [See **RPI** Form 305]

9. **SALE TERMS:**
Price of $_____ payable as follows:
9.1 ☐ All cash.
9.2 ☐ Cash down payment in the amount of $_____.
9.3 ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____, with an unpaid principal balance of $_____, payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, plus a monthly tax/insurance impound payment of $_____.
a. ☐ At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price. [See **RPI** Form 415]
b. ☐ The impound account to be transferred, ☐ charged, or ☐ without charge, to Optionee.

PAGE 1 OF 2 — FORM 161

PAGE 2 OF 2 — FORM 161

9.4 ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____, with an unpaid principal balance of $_____, payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, due _____, 20____.
9.5 A note for the balance of the purchase price in the amount of $_____, to be executed by Optionee in favor of Optionor and secured by a trust deed on the property junior to the above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____ years after closing.
a. ☐ This note and trust deed to contain provisions to be provided by Optionor for:
☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ _____
b. ☐ The attached Financial Disclosure Statement is an addendum to this agreement (mandatory on four-or-less residential units). [See **RPI** Form 300]
c. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **RPI** Form 412]

10. **GENERAL PROVISIONS:**
10.1 ☐ **See attached addendum for additional provisions.** [See **RPI** Form 250]
10.2 Attached as addenda are the following checked disclosures mandated on four-or-less residential units:
a. ☐ Condition of Property Disclosure — Transfer Disclosure Statement (TDS) [See **RPI** Form 304]
b. ☐ Natural Hazard Disclosure Statement [See **RPI** Form 314]
c. ☐ Disclosure of Sexual Predator Database [See **RPI** Form 318]
d. ☐ Hazard Disclosure Booklet, and related Optionor disclosures, containing Environmental Hazards, Lead-based Paint and Earthquake Safety [See **RPI** Forms 313 and 315]
e. ☐ Documentation on any Homeowners' Association (HOA) involved. [See **RPI** Form 309]
f. ☐ Notice of Supplemental Property Tax Bill [See **RPI** Form 317]
10.3 Possession of the property to be delivered on:
☐ close of escrow, or ☐ see attached Occupancy Agreement. [See **RPI** Forms 271 and 272]
10.4 Both parties reserve their rights to assign, and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice.

11. **EXPIRATION OF OPTION:**
This offer to sell will be deemed expired if not accepted by exercise during the option period.
11.1 This option contract will automatically terminate by expiration on _____, 20____.

OPTIONOR'S BROKER: _____
Broker's CalBRE #: _____
Buyer's Agent: _____
Agent's CalBRE #: _____
Signature: _____
Is the agent of: ☐ Optionor exclusively ☐ Both Optionor and Optionee.
Address: _____
Phone: _____ Cell: _____
Email: _____
I hereby grant this option and agree to the terms stated above.
Date: _____, 20____
Optionor: _____
Signature: _____
Signature: _____
Address: _____
Phone: _____ Fax: _____
Email: _____

OPTIONEE'S BROKER: _____
Broker's CalBRE #: _____
Agent's Name: _____
Agent's CalBRE #: _____
Signature: _____
Is the agent of: ☐ Optionee exclusively. ☐ Both Optionor and Optionee.
Address: _____
Phone: _____ Cell: _____
Email: _____
I hereby accept this option and agree to the terms stated above.
Date: _____, 20____
Optionee: _____
Signature: _____
Signature: _____
Address: _____
Phone: _____ Fax: _____
Email: _____

FORM 161 12-14 ©2016 **RPI** — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

Figure 1

Form 161

Standard Option to Purchase

A lease with an option to purchase needs to be distinguished from the preemptive rights to acquire property held by a tenant under a right of first refusal agreement or the purchase rights of a buyer under a lease-option sales arrangement. [See **RPI** Form 163 and 579]

Option money as the consideration needed

An option agreement is not enforceable unless the owner receives some sort of **consideration**. If the owner is not given something in exchange for surrendering the right to revoke their offer to sell or to sell the property to another buyer, the option fails for **lack of** *consideration*. Without the owner's receipt of consideration, the agreement is merely an offer to sell which may be withdrawn at any time by the owner.[3]

While consideration is needed to create an option agreement which is binding on an owner, the **amount of the consideration** paid for an option may be a minimal amount.

Further, the consideration given for the option does not need to be in cash. For instance, when an option to purchase is granted to a tenant when entering into a lease, the consideration given for the grant of the option rights is the tenant's signature which obligates the tenant to perform on the lease. The option granted concurrent with entering into the lease agreement is part of the leasing arrangements.

In the case of a syndicator or developer using an option to control property they are not yet certain they want to purchase, the consideration is the option money paid to the owner to grant the irrevocable offer to sell. The option money is typically set at an amount which compensates the owner

3 **Kowal** v. **Day** (1971) 20 CA3d 720

consideration Anything given or promised by a party to induce another to enter into a contract. It may be a benefit conferred upon one party or a detriment suffered by the other.

for the time the property is kept off the market, similar to a payment of rent or interest (less any actual and implicit income produced for the owner by the property).

Typically, a small amount of option money is paid for a short initial option period, sometimes called a *"free-look" period*. The term of the free-look option may be twenty to thirty days, granted on the payment of a small amount of option money, such as $100.

If the buyer is given extensions to continue the option after the free-look period, they are usually required to put up a more substantial amount of option money.

Any number of additional option periods may be agreed to, one following the expiration of another. The number of extensions depends only on the owner's willingness to grant the extensions and the buyer's willingness to provide more option money to pay for those extensions. [See **RPI** Form 161-1]

Sufficiency of terms for enforcement

While consideration is necessary for a purchase option to be enforceable, the method for payment of the **purchase price and the time for closing** are not.

Consider an owner and a tenant who sign a lease agreement granting the tenant an option to purchase the leased property. The option includes the identities of the owner and the buyer, a description of the property and the price to be paid. However, it does not specify an escrow period for delivery of the price and deed after exercise of the option.

The tenant timely exercises the option and escrow is opened.

The owner responds by placing conditions on the escrow period not included in the option, negotiating to prolong the close of escrow until they locate a §1031 replacement property.

The tenant counters, attempting to resolve the owner's demand for an extended escrow and their need to record a purchase-assist mortgage to fund the purchase price.

The owner then refuses to perform, claiming the option cannot be enforced since ongoing negotiations to resolve the time for payment of the price and delivery of the deed are essential terms and did not exist in the option.

Does the lack of terms regarding time for payment of the price and the delivery of the deed make the purchase option unenforceable?

No! An option agreement need only identify the parties involved, the property in question and the price to be paid. When the option does not state the method for payment of the price or the length of the escrow period,

the method for payment of the price is implied to be cash through escrow. Similarly, the time for payment of the price in exchange for the deed is implied to be of a reasonable time period (60 days) after exercise of the option.[4]

Exercising the option

Unless a particular **manner for exercising** the option is specified in the option agreement, any communication from a buyer to an owner of their intention to exercise the option is sufficient.[5]

However, if the option agreement requires the buyer to take specific steps to exercise the option, the buyer is required to follow the conditions set in order to exercise the option and acquire the property.[6]

For instance, consider an option agreement that requires a buyer to sign escrow instructions and deposit cash in escrow to exercise the option. If the instructions are not signed, or if signed and the deposit is not made, the option has not been exercised. Thus, the buyer has not exercised their right to acquire the property.

Proposed escrow instructions need to be prepared and attached as an addendum to an option agreement to avoid any conflict over the content of the instructions required to exercise the option. The instructions remain unnumbered, undated and unsigned until exercise of the option. [See **RPI** Form 401]

The escrow opened to exercise an option needs to call for escrow to close within a short period of time, i.e., the number of days required to prepare documents, order title reports and close. Unless an option agreement requires the buyer to sign escrow instructions, deposit funds and close escrow within a short period of time, the buyer's exercise of the option merely creates an enforceable bilateral purchase agreement with no escrow, funds or clear closing date.

Recording the option

When a purchase option or **memorandum** of the option is recorded, it becomes part of the property's chain of title, imparting **constructive notice** of the outstanding option rights to anyone later obtaining an interest in the property. A buyer, lender or tenant acquiring an interest in the property with *actual or constructive notice* of the existence of an option to purchase the property takes their interest in the property subject to the buyer's option rights.

Conversely, a buyer, lender or tenant who does not have actual knowledge of an unrecorded and unexpired option, takes their interest in the property free of the option.

constructive notice
To be charged with the knowledge of conditions existing on the property by recorded documents or an occupancy of the property at the time of a transaction.

4 **Patel** v. **Liebermensch** (2008) 45 C4th 344
5 **Riverside Fence Co.** v. **Novak** (1969) 273 CA2d 656
6 **Palo Alto Town & Country Village, Inc.** v. **BBTC Company** (1974) 11 C3d 494

Constructive notice required

Consider an owner who grants a buyer an option to purchase property. Before the option is recorded or the buyer takes possession, the owner conveys the property to a second buyer. The second buyer did not have actual knowledge of the first buyer's option on the property.

The buyer who was granted the option later exercises the option by depositing the full amount of the purchase price into an escrow they have opened as agreed in the option agreement.

However, the owner who granted the option is no longer the owner of the property. Thus, they have no interest in the property to convey. Further, the option agreement is not enforceable against the second buyer since the second buyer, who is now the owner of the property, had no knowledge of the first buyer's option when they acquired ownership.

Thus, the conveyance of the property to the second buyer without notice of the unexpired option wiped out the first buyer's right to buy the property under the option.[7]

A recorded option ceases to constitute constructive notice of a buyer's option rights when:

- six months have run after the expiration date stated in the recorded option agreement or memorandum without the prior recording of an exercise or extension of the option; or
- six months have run after the option or memorandum was recorded if the expiration date of the option cannot be determined from the recorded instrument or memorandum.[8]

Extinguishing the recorded option from title protects buyers and owners of property from old, unexercised and expired option rights which are of record. However, no such statutory scheme exists for the "outlawing" of unrecorded options which have expired.

7 **Utley** v. **Smith** (1955) 134 CA2d 448

8 Calif. Civil Code §884.010

Chapter 27 Summary

An option to buy contains the seller's irrevocable offer to sell the property on the terms stated in the option agreement. The buyer only agrees to become obligated to buy the property when they timely accept the seller's irrevocable offer to sell, an acceptance called exercising the option.

If the buyer decides to buy the property, they will exercise the option within the time period set for agreeing to buy the property, called the option period. In exchange for the seller's grant of an option to buy the property, the syndicator pays the seller option money.

A buyer considers acquiring an option when they:

- do not yet want to commit themselves to buy;
- are speculating in a depressed market and believe values will soon rise;
- need time to investigate and determine whether the property will operate profitably;
- need time for promotional work, or to complete a §1031 reinvestment; or
- are a tenant and may want to own the leased premises in the future.

A seller considers granting an option when they:

- want to retain ownership rights to the property for a fixed period into the future (for tax purposes);
- aim to sell at a price based on higher future market values;
- need to provide an incentive to induce a prospective tenant to lease the property; or
- want to give a promoter or developer incentive to work up a marketing or use plan and buy the property.

An option agreement is not enforceable unless the owner receives some sort of consideration. Without the owner's receipt of consideration, the agreement is merely an offer to sell which may be withdrawn at any time by the owner.

An option agreement need only identify the parties involved, the property in question and the price to be paid. When the option does not state the method for payment of the price or the length of the escrow period, the method for payment of the price is implied to be cash through escrow.

When a purchase option or memorandum of the option is recorded, it becomes part of the property's chain of title, imparting constructive notice of the outstanding option rights to anyone later obtaining an interest in the property.

A buyer, lender or tenant acquiring an interest in the property with actual or constructive notice of the existence of an option to purchase the property takes their interest in the property subject to the buyer's option rights.

Chapter 27 Key Terms

Chapter
28

Contingency provisions

Learning Objectives

After reading this chapter, you will be able to:

- use contingency provisions when preparing a purchase agreement to condition the further performance or cancellation of the agreement by the buyer or seller;
- categorize contingency provisions based on whether an event or activity is to first occur or be approved before further performing on a purchase agreement;
- distinguish a condition precedent, requiring an event to occur before taking further action to close a purchase agreement, from a condition concurrent, requiring an activity to be performed without concern for the other person's performance; and
- determine how to eliminate or act on contingency provisions in a purchase agreement.

Key Terms

condition concurrent
condition precedent
event-occurrence contingency provision
further-approval contingency provision

Conditioning the close of escrow

The contents of a purchase agreement are a collection of provisions generally called **terms and conditions**. While *terms* focus on the price and the terms for payment of the price, *conditions* address:

- the **performance** of activities by the buyer and seller prior to closing; and
- **occurrence of events** required before escrow is able to close.

event-occurrence contingency provision
A purchase agreement provision requiring an event or activity to take place which is not subject to the approval of the buyer or seller. [See **RPI** Form 150 §11.1]

further-approval contingency provision
A provision in an agreement calling for the further approval of an event or activity as a condition precedent to the further performance or cancellation of the transaction by the persons benefiting from the provision [See **RPI** Form 185 §9 and 279 §2]

Thus, each condition which is the subject of a provision calls for an event or activity to either exist or come into existence, by its occurrence or approval, before the purchase agreement may be enforced and escrow closed. Alternatively, the condition may be waived as though it was never part of the purchase agreement.

Conditions made the subject of **contingency provisions in a purchase agreement** are categorized based on whether they:

- are to occur (events and activities), called **event-occurrence contingencies**; or
- are to be approved (information, data, documents and reports) by one or both of the parties, called **further-approval contingencies** or *personal-satisfaction contingencies*.

These *contingency provisions* grant the buyer or seller, or both, the *power to terminate* any further performance of the purchase agreement if:

- an identified activity or event fails to occur; or
- a condition is not approved.

Precedent and concurrent

Conditions are also classified by the sequence or order in which they are to occur or be performed by the buyer or seller. Thus, the event or activity which is to occur or be approved as called for in the provision is classified as either:

- a **condition concurrent**; or
- a **condition precedent** .

A *condition concurrent* requires the performance of an activity by a person without concern for the other person's activities. A *condition precedent* requires the occurrence of an event or the performance of an activity by one person to be completed before the other person is required to perform an activity.

Further, conditions may be *breached* or *excused* on the failure of the event or activity to occur. Some conditions **are required to be performed**, such as the seller's delivery of title, making the failure to perform them a breach of the purchase agreement. Other conditions which are the subject of contingency provisions might not occur or be approved, thus excusing one or both parties from further performing and closing escrow.

However, under any type of contingency provision, the buyer or seller benefitting from the contingency holds an option to "do away with" any further performance of the purchase agreement and escrow instructions, called **cancellation**.

Contingent and non-contingent provisions

As another distinction for conditions in a purchase agreement, all contingency provisions are conditions, but not all conditions are contingencies.

Contingency provisions are unique as they deal with uncertainties. They authorize the cancellation of the purchase agreement and excuse a party from any further performance toward closing the purchase agreement and escrow. Other conditions are about events or activities which have to be met — performed — since they are not contingencies, in which case a failure to perform becomes a **breach**.

Conditions precedent

Conditions precedent are the subject of contingency provisions calling for the occurrence or approval of an event or activity which **may or may not occur**. Examples include:

- the buyer obtaining a written loan commitment;
- the recording of a purchase-assist loan;
- approving due diligence investigations; or
- the sale or acquisition of other property.

condition precedent
A provision in an agreement calling for the occurrence of an event or performance of an act by another person before the buyer or seller is required to further perform.

Here, the contingency provision may be eliminated by its occurrence and the transaction proceeds toward closing. Alternatively, when the event or approval is not forthcoming, the person authorized to cancel may exercise their right to terminate the transaction by cancellation, doing away with any further performance of the purchase agreement and escrow instructions.

Conditions concurrent

Conditions concurrent are non-contingent, mandatory performance provisions calling for the buyer or seller to perform some required activity. If the activity does not occur, the purchase agreement has been breached by the person who promised to perform or was obligated to cause the activity or event to come about. Examples include the failure of the seller to:

- produce promised information, data, documents and reports on the property; or
- deliver a clearance, grant deed or title insurance policy as agreed.

condition concurrent
A provision in an agreement calling for the performance of an activity by a buyer or seller without concern for the performance of the other person.

The failure to deliver is a breach which allows the other person to either:

- terminate the transaction by notice of cancellation and recover their money losses; or
- pursue specific performance of the purchase agreement.

Eliminating contingency provisions

Before escrow is able to close, contingency provisions need to be eliminated. Contingency provisions (conditions precedent) included in purchase agreements are **eliminated** by either:

- *satisfaction* of the condition, accomplished by either an **approval** of the data, information, documents or reports identified as the subject of the provision by the person holding the right to terminate the transaction, or by the **occurrence** of the event or activity called for in the provision; or

- *waiver* (or expiration) of the right to cancel the transaction by the person authorized to cancel, if the identified event or activity has not been satisfied by its approval or occurrence.

Often, the buyer or seller does not have the right to terminate the transaction under a provision calling for that person to act. Thus, they cannot cancel and avoid closing the transaction. This is an example of a condition concurrent provision, not a contingency provision (condition precedent), since all parties are required to perform all their obligations remaining under the purchase agreement and escrow instructions and close escrow.

The buyer or seller acts without concern for the other person's performance under the purchase agreement, unless the other person is to first perform some activity before they are able to comply. For example, the seller needs to provide a *Natural Hazard Report* before the buyer is able to review and approve its contents. [See **RPI** Form 314]

The obligation of a buyer or seller to complete non-contingent (concurrent) activities is necessary on their part to close escrow. This performance requirement exists in spite of the fact the other person may not have yet fully performed, or that the other person has a right to later cancel the purchase agreement. For example, the inability of a buyer to originate a purchase-assist loan and cancel the transaction is an event that takes place after the seller has fully performed their concurrent activities by delivering all closing documents to escrow.

Content of a contingency provision

Regardless of the type of contingency involved, agents need to make sure the contingency provision is in writing, even though oral contingencies are generally enforceable (but troublesome to establish their existence). Written contingencies avoid confusion over content, enforceability and forgetfulness.

The content of a written contingency provision includes:

- a description of the event addressed in the contingency (i.e., what is to be approved or verified);
- the time period in which the event called for in the contingency provision has to occur;
- who has the right to cancel the purchase agreement if the event does not occur (i.e., whether the buyer, the seller, or both, is able to enforce the contingency provision by cancelling the transaction);
- any arrangements in the alternative to avoid cancellation if the contingency is not satisfied or waived (i.e., offsets to the price or time to cure the failure or defect); and
- the method for service of the notice of cancellation on the other person.

Provisions for uncertainties

Contingency provisions in a purchase agreement protect an agent's client from agreeing to do or cause to occur that which might not occur. The goal

at closing is to avoid being forced to accept a situation inconsistent with the client's original expectations or ability to perform when they entered into the purchase agreement.

Without **authority to terminate** the agreement on the failure of the client's expectations, the client's inability or refusal to continue to further perform under the purchase agreement constitutes a breach. The client risks being held liable to the other person due to their breach, unless the client's nonperformance was justified by some pre-contract misrepresentation (or omission) of facts which led to the client's lost expectations.

To avoid a **breach or be excused** from closing escrow when expected events or activities do not occur, an *exit strategy* needs to be agreed to by inclusion of a provision in the purchase agreement.

Often events and conditions develop which do not meet the expectations or anticipations of the client during escrow. Their agent needs to **foresee the need** to condition the client's continued performance by making the event or activity the subject of a contingency provision included in the purchase agreement. [See **RPI** Form 150]

But before lacing a purchase agreement with the uncertainties created by contingency provisions, a prudent agent first attempts to gather information and clear uncertainties the client has about the property or the transaction *before submitting an offer*.

Use of contingency provisions

It is the buyer's agent who, along with the buyer, is the primary user of contingency provisions in purchase agreements.

From a buyer's point of view, and thus the buyer's agent's perspective, every activity, event or condition which is the responsibility of the buyer to further investigate and approve or cause to occur prior to closing needs to be the subject of a contingency provision in the purchase agreement. [See **RPI** Form 260 through 279]

Also for the benefit of buyers, the period for exercise of the right to cancel needs to be as long as possible. Thus, the right to cancel needs to be structured to expire no earlier than the date scheduled for the close of escrow. The possibility always exists that the event or approval needed by the buyer to close escrow is never going to occur.

When preparing the purchase agreement, the buyer's agent relies on their experience to decide which events and approvals the buyer is responsible for and thus their need to be the subject matter of a contingency provision.

Then, if the event does not occur, such as the recording of mortgage financing, or are unacceptable, such as the failure of the property on a due diligence investigation to meet expectations, the buyer may cancel and be excused from proceeding. Thus, the buyer is able to avoid closing and not be in breach on the purchase agreement.

Contingency provisions in practice

Many events and disclosures are the subject of contingency provisions contained in stock forms used by agents. [See Form 159 §11]

However, the boilerplate wording used by different publishers of pre-printed contingency provisions varies greatly regarding:

- the time for gathering and delivering data, information, documents and reports;
- the time period for review of the material received or the occurrence of an event (such as a loan commitment or sale of other property);
- the date set for expiration of the right to cancel the transaction after failure of the event or approval to occur;
- whether a written waiver is to be delivered evidencing the elimination of the contingency provision, without which the other party is able to then cancel;
- the requirement of a written notice of cancellation if the right to cancel is exercised on failure of an event or condition to occur; and
- the time period for the other person's response to a notice of cancellation to cure the defect or failure, and thus avoid a termination of the purchase agreement.

Terminating the agreement

Typically, several contingency provisions are included in a purchase agreement. Thus, a **uniform method** for terminating the agreement is employed. Termination provisions call for a written notice of cancellation, and how and to whom it is to be delivered, including instructions to escrow. [See **RPI** Form 150 §10.5]

Contingency provisions are considered to be the *grant of an option* to terminate a transaction by exercise of the right to cancel prior to the expiration of the option period.

The person authorized to cancel or otherwise benefit from a contingency provision who does not use the provision to cancel the purchase agreement need do nothing. They simply allow the "option period" for cancellation to expire.

A need does not exist to *approve or waive* the contingency in order to do away with the right to cancel and proceed to close escrow. However, some purchase agreements are worded to require active approval or waiver to keep the contract alive. This situation is not conducive to furthering performance and closing.[1]

Conditions not contingent

The condition of the property, namely the physical integrity of the land and improvements, too often fails to be disclosed to the buyer before a purchase agreement is entered into with the seller.

---

1 **Beverly Way Associates** v. **Barham** (1990) 226 CA3d 49

Most delayed disclosures fail to comply with the statutory mandates imposed on sellers and seller's agents to hand the information to prospective buyers as soon as possible (ASAP).[2]

The seller's agent has a mandated duty to visually inspect the listed property and note their observations and awareness of property conditions adversely affecting the value on the seller's statutory disclosure document, called a **Condition of Property or Transfer Disclosure Statement (TDS)**. [See **RPI** Form 304]

Not only is it *reasonably possible* for the seller's agent to deliver the TDS before their seller enters into a purchase agreement with a buyer, it is mandated by code and **case law** and the economic imperative of transparency to deliver property disclosures before a price is set in property transactions. Without prior disclosure, the placing of the property under contract is corrupted due to **asymmetric knowledge** of property facts by the buyer and seller.

However, **trade union purchase agreement forms** published by the California Association of Realtors (CAR) convert the failure of the seller's agent to deliver a TDS before the acceptance of an offer into an unavoidable contingency.

Here, the contingency provision merely complies with the statutorily imposed penalty placed on the seller for failure of pre-acceptance disclosures. As the subject matter of the statutory contingency, the buyer is granted the right to cancel the transaction when the TDS is belatedly received, delayed until under contract.

Cancellation after tardy disclosure

If, on review of the tardy disclosures, the property conditions do not meet the expectations held by the buyer at the time they entered into the purchase agreement, *the buyer may cancel* the purchase agreement — all due to the tardy and misleading conduct of the seller's agent, a type of fraud called **deceit**.

However, if the buyer chooses not to cancel as provided by the contingency, the buyer may proceed and force the seller to close escrow, the buyer taking title to the defective property. Thus, the buyer becomes the owner of property which is not in the **condition or value** they were lead to believe existed when they entered into the purchase agreement. This misrepresentation is the result of omitted facts on the part of the seller and the seller's agent by the time of contracting. This situation exposes the seller's broker to liability for the lost value.

Seller's late delivery

Any significant discrepancies in the property's condition disclosed in the TDS, and not observed or known to the buyer before entering into the purchase agreement, allows the buyer to notify the seller of the defects and make a demand on the seller to cure them by:

- repair;

2 Calif. Civil Code §§2079 et seq.; Calif. Attorney General Opinion 01-406 (August 24, 2001)

- replacement; or
- correction.

If the buyer fails to give notice, they have let their right expire to demand the correction of previously undisclosed defects noted in the untimely TDS and are now required to proceed to close escrow. [See **RPI** Form 269]

However, if the buyer makes a demand on the seller to cure defects discovered on their in-escrow review of the tardy TDS, the seller is required to make the corrections before closing. If the seller does not make the corrections, they suffer a reduction in price equivalent to the cost to cure the noticed defects.

Of course, the disclosure of the property's condition before the purchase agreement (or counteroffer) is accepted relieves the seller (and the buyer) of the need to activate this performance provision regarding repairs. [See **RPI** Form 150 §11.2]

The time set for delivery of data, information, documents and reports under a contingency provision for approval or disapproval, as well as the date set for delivery of a notice of cancellation given for any valid reason, is always subject to **time-essence rules.** These rules are liberally enforced to best meet the initial objectives of the buyer and seller to close the transaction on entering in the purchase agreement.[3]

Unless delivered and until satisfied

Frequently, a contingency provision calls for two events to occur in tandem, i.e., a condition concurrent (routine activity), which has to occur, followed by a condition precedent (approval), which may or may not occur.

Consider the seller of a condominium unit who provides documents on the **homeowners' association (HOA)** to the buyer (the condition concurrent) for the buyer's review (the condition precedent).

Here, the seller is required to deliver the HOA documents as a prerequisite to the buyer's review of their content for approval or disapproval. The seller needs to obtain the documents or otherwise cause them to be handed to the buyer. If the seller does not, they have breached the contingency provision and the purchase agreement. [See **RPI** Form 150 §11.9]

As for the buyer who receives the *HOA* documents, they are required to then enter upon a good-faith review of the document's content under their *further-approval contingency provision*. After the review and completion of any further inquiry or investigation (which might extend the time for cancellation) into the implications contained in the HOA document's content, the buyer is to either express approval by waiving or letting the right to cancel expire.

However, if they have good reason and an honest belief that they cannot approve of their content, they disapprove the documents by cancelling the transaction.

3 **Fowler** v. **Ross** (1983) 142 CA3d 472

Here, the seller is initially obligated (condition concurrent) to gather the documents and deliver them to the buyer without concern for what steps the buyer is taking to perform (conditions concurrent) any of their obligations under the purchase agreement, such as applying for a loan.

Seller's review of buyer creditworthiness

Consider another tandem-events provision in which the buyer agrees to execute a **promissory note** in favor of the seller in a carryback transaction. The buyer, in a further-approval contingency provision, agrees to prepare and hand the seller a **credit application** (a condition concurrent)**.** On receipt, the seller is to review and then approve or cancel the transaction (condition precedent) on a reasonable disapproval of the buyer's creditworthiness.

The buyer's obligation to deliver the *credit application* is a compulsory event they are required to perform. The failure to deliver the credit application is a *breach* of the further-approval provision since the buyer's delivery of the application is not conditioned on anyone (read: the seller) first doing something. [See **RPI** Form 150 §8.4]

On the other hand, the seller on receipt of the credit application is required to review the buyer's creditworthiness. However, they are not required to approve the buyer's creditworthiness, and if disapproved based on reasonable grounds, the seller is excused from closing escrow if they elect to cancel the transaction. [See **RPI** Form 150 §8.5]

Act to close without concern

Other contingency provisions require one person, such as the buyer, to first enter upon an activity (such as signing and returning escrow instructions) without concern for whether the other person, such as the seller, is performing their required obligations, such as obtaining a pest control clearance.

Consider a purchase agreement containing a contingency provision calling for the buyer to obtain a purchase-assist mortgage. If the buyer fails to obtain the mortgage as anticipated, the buyer has the option to cancel the transaction, excusing themselves from further performance.

However, the buyer is obligated to promptly initiate the loan application process without concern for whether the seller has commenced any performance of the seller's obligations, such as ordering out inspections and reports the seller is required to obtain.[4]

A person's performance of an activity which **has to occur** versus taking steps to bring about an event or approve a condition which **may or may not occur** is an important distinction to be made.

One is a **breach** of the purchase agreement if the mandatory activity does not occur; the other **excuses** any further performance by cancellation if the described event does not occur. Both failures permit the purchase agreement to be cancelled by the opposing party, but a breach carries with it **litigation and liability exposure**.

4 **Landis** v. **Blomquist** (1967) 257 CA2d 533

Contingency provision excuses nonperformance

Consider the buyer of a nonresidential income property who is willing to purchase the property only if the seller cancels a disadvantageous lease held by a tenant. The buyer's agent prepares a purchase agreement with a provision calling for the seller to deliver title and assign all existing leases except the one the buyer is unwilling to accept.

While the seller believes they have the ability to negotiate a cancellation of the lease, the seller's agent does not want the seller committed to delivering title and then fail to be able to negotiate the cancellation of the lease.

Accepting the purchase agreement with provisions calling for delivery of title and assignment of all leases places the seller in breach if they are unable to negotiate a cancellation of the objectionable lease. The seller risks being exposed to liability for the decrease in the value of the property resulting from the lease.

Here, the seller needs to submit a **counteroffer** prepared by the seller's agent calling for the delivery of title to be contingent on the seller's termination of the lease, an example of an *event-occurrence contingency provision*. This provision is also classified as a condition precedent as it might not occur and needs to be satisfied for the transaction to proceed to closing.

Thus, the seller is only obligated to make a good-faith effort to negotiate the cancellation of the lease. If the seller fails to deliver title clear of the lease, they may cancel the transaction and be excused from any further performance. Importantly, the seller is then free of any liability for the failure to deliver title as agreed.

Performing without concern

Many contingency provisions authorize the buyer to exercise their right to cancel at any time up to and including the date scheduled for closing if an identified condition or event fails to occur.

In the interim, the seller is required to fully perform all of their obligations to deliver to escrow in a timely manner all documents needed from the seller for escrow to close. After the seller has fully performed, the buyer, at the time of closing, has the option to cancel on failure of the condition or event.

The rights of a seller in the buyer's contingency provision include assurances that:

- the buyer needs to act on any cancellation before *the right to cancel expires*; and
- the cancellation is the result of a good-faith effort by the buyer to act reasonably to *satisfy the contingency* so the transaction is able to close.

Consider a purchase agreement containing a loan contingency. The buyer has the right to cancel they are unable to obtain a purchase-assist mortgage. [See **RPI** Form 150 §10.3]

However, the seller has not handed escrow any of the documents or information requested by escrow as needed to close. The buyer refuses to

submit their loan application and fees to their lender until the seller fully performs all their obligations for escrow to close. The buyer claims it is futile for them to proceed if the seller has not performed.

In turn, the seller cancels the transaction, claiming the buyer has breached their duty to make a good-faith effort to eliminate the loan contingency by applying for the loan.

Here, the buyer's obligation to take steps to satisfy the loan contingency and the seller's obligation to deliver requested documents to escrow are *independent obligations*, examples of conditions concurrent. Thus, the buyer and seller have to each perform their part of the closing activities without concern for whether the other person is performing.

The time-essence contingency provision

Sellers who agree to loan contingency provisions for buyers often require a separate and specific *time-essence contingency provision* to assure themselves that the buyer will act promptly to arrange a mortgage.

In the provision, the buyer authorizes the seller to cancel the transaction if the buyer does not produce a loan commitment or a statement from a qualified lender by a specific date demonstrating that the buyer has been approved for a mortgage in the amount sought. [See **RPI** Form 150 §4.1]

In this instance, if the buyer fails to timely act on an application to negotiate a loan and arrange for a statement of their creditworthiness to be handed to the seller by the deadline for satisfaction of the condition, the seller is able to cancel the transaction.

Purchase agreement as binding

The existence of an oral or written contingency provision in a purchase agreement does not render the agreement void. On the contrary, when an offer is accepted, a **binding agreement** is formed. The overriding issue on forming a *binding purchase agreement* which contains a contingency provision is whether the purchase agreement will ever become enforceable. **Enforceability** occurs when the contingencies have been eliminated as satisfied or waived.

For example, the board of directors of a corporation decides the company needs to purchase a warehouse to store inventory. To meet the corporate objectives, the president, on behalf of their corporation, employs a broker who locates a suitable building. However, the property may be sold to another person before the board authorizes the corporation to enter into a purchase agreement to acquire it.

As the agent authorized to bind the corporation to perform under a purchase agreement, the president submits a signed purchase agreement offer to the seller's agent agreeing to buy the real estate, conditioned on the further approval of the board within 20 days of acceptance.

The seller accepts the offer after their agent explains the purchase agreement will not be enforceable until the board of directors approves the purchase, and thus eliminates the contingency.

The corporation, based on the offer submitted by its president and the seller's acceptance, has effectively taken the seller's property off the market while the president completes their *due diligence investigation*. Further, the board gets a "free look" by controlling the property before deciding on the property's suitability as a warehouse, or whether the terms of the purchase agreement are acceptable.

Here, the seller has a *binding commitment* from the corporate buyer to purchase the real estate, subject to presenting the purchase agreement and the property selection to the board for approval or rejection and cancellation under the contingency provision.[5]

If conditions are unacceptable, the board rejects the purchase agreement by preparing a resolution stating their reasonable basis for exercising the corporation's rights under the contingency provision to disapprove of the property selection or the terms of purchase. A **notice of cancellation** is then prepared, signed and delivered to the seller, together with the corporate resolution, as required by the purchase agreement to terminate the transaction.[6] [See **RPI** Form 159]

5 **Moreland Development Company** v. **Gladstone Holmes, Inc.** (1982) 135 CA3d 973

6 **Jacobs** v. **Freeman** (1980) 104 CA3d 177

Chapter 28 Summary

The contents of a purchase agreement are a collection of provisions generally called terms and conditions. While terms focus on the price and the terms for payment of the price, conditions address:

- the performance by the buyer and seller of their closing activities; and
- occurrence of events required before escrow is able to close.

When conditions are the subject of contingency provisions, the conditions are categorized based on whether they:

- are to occur (events and activities), called event-occurrence contingencies; or
- are to be approved (information, data, documents and reports), called further-approval contingencies.

Further, provisions containing conditions are classified by the sequence in which they are to occur or be performed by the buyer or seller. Thus, the occurrence or approval called for is either:

- a condition precedent; or
- a condition concurrent.

A condition precedent requires the occurrence of an event or the performance of an activity by one person to be completed before the other person is required to perform an activity. A condition concurrent requires the performance of an activity by a person without concern for the other person's activities. Under any type of contingency provision, the buyer or seller benefitting from the contingency holds an option to "do away with" any further performance of the purchase agreement and escrow instructions, called cancellation.

Before escrow is able to close, contingency provisions have to be eliminated. Contingency provisions are eliminated by either:

- satisfaction of the condition; or
- waiver (or expiration) of the right to cancel the transaction by the person authorized to cancel.

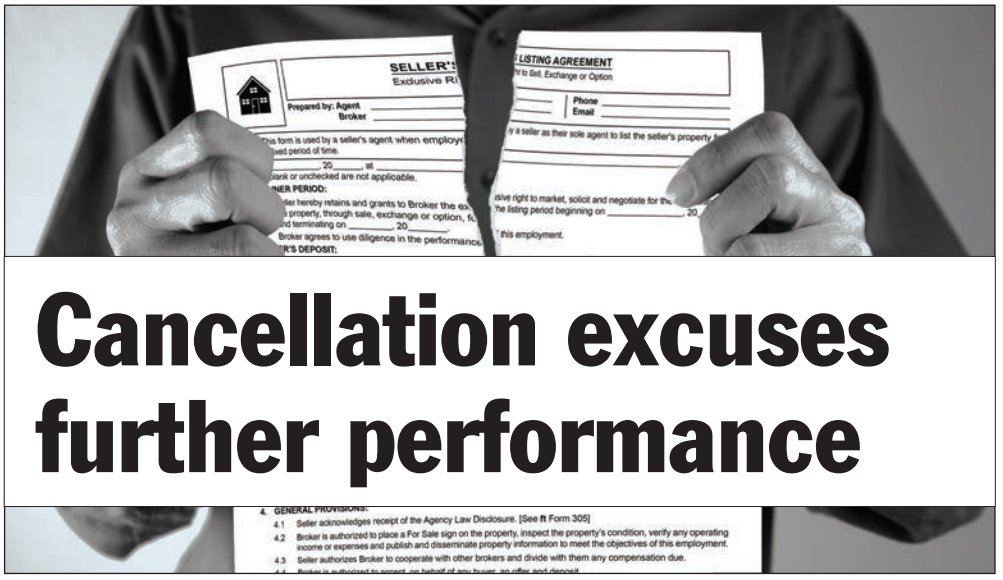
Further, conditions may be breached or excused on failure to occur. Some conditions are required to be performed, such as the seller's delivery of title, making the failure to perform a breach of the purchase agreement. Other conditions which are the subject of contingency provisions might not occur or be approved, thus excusing one or both parties from further performing and closing escrow.

Chapter 28 Key Terms

Your DRE-approved
Video Renewal Course™
is now playing on **firsttuesday.us**

Sign up for just $119.50 and start watching your CE today

Enroll now



Chapter 29

Cancellation excuses further performance

Learning Objectives

After reading this chapter, you will be able to:

- determine when a breach of the terms and conditions of a purchase agreement entitles a buyer or seller to exercise their right to cancel;
- identify conduct which implies disapproval of a condition and is an exercise of the right to cancel; and
- distinguish a unilateral cancellation to terminate further performance under a purchase agreement from a bilateral recession of a purchase contract which restores the buyer and seller to their pre-contract positions.

Key Terms

bilateral rescission
further-approval contingency provision
restoration
unilateral cancellation

Exercising the option to terminate

A seller who agrees to carry back a note secured by a trust deed junior to an existing mortgage the buyer will assume. The purchase agreement entered into with the buyer contains a **further-approval contingency provision** which grants the right to cancel the transaction to:

- the seller if the buyer's *creditworthiness* is unacceptable to the seller [See **RPI** Form 150 §8.5]; and
- both the buyer and the seller if either one disapproves of the existing trust deed lender's *terms for an assumption* of the mortgage by the buyer when the terms offered exceed the mortgage parameters agreed to in the purchase agreement. [See Form **RPI** 150 §§8.6 and 10.3]

further-approval contingency provision
A provision in an agreement calling for the further approval of an event or activity as a condition precedent to the further performance or cancellation of the transaction by the persons benefiting from the provision. [See **RPI** Form 185 §9 and 279 §2]

On the seller's receipt of the buyer's credit application form, the seller's agent orders and receives a report on the buyer's creditworthiness from a credit reporting agency. [See **RPI** Form 302]

The seller, on review of the credit report information with their agent, is concerned about the buyer's payment history. The seller's agent acts on these concerns by asking the buyer for financial statements including:

- a *balance sheet* listing assets and liabilities; and
- an end-of-year *financial statement* on the buyer's income and expenses for the past two calendar years.

The buyer promptly supplies the additional financial data. The seller notes that the buyer is cash poor, with insufficient cash on hand to make the down payment called for in the purchase agreement.

Meanwhile, the seller's agent learns the buyer is going to use a line of credit at a bank to finance the down payment. This debt-leveraging information may affect the carryback seller's decision to exercise their right to cancel the transaction under the credit approval contingency. Thus, the seller's agent relays the information to the seller.

The seller now has all the relevant credit information readily available and known to the seller's agent. The seller determines they have *justification* for exercising their option to cancel the purchase agreement and escrow. However, the seller has not yet decided what to do about allowing the transaction to continue.

Gather facts and timely respond

The seller's agent is mindful of the upcoming expiration date of the seller's right to cancel and of their duty to protect the interests of the seller. Seeing their client's inaction, the agent advises the seller that if they do nothing to cancel before the expiration of their right they will lose their ability to be *excused* from completing the transaction.

The seller understands they need to serve the buyer with a notice of cancellation before the expiration date set in the contingency provision. Otherwise, the period for cancellation will expire and they will need to proceed to close escrow.

By the expiration date of the seller's right to cancel, the seller decides to do nothing. The seller is willing to undertake the additional risks, including the possible need to foreclose presented by the buyer's insufficient creditworthiness to become owner of the property subject to the seller's carryback mortgage.

The existing mortgage lender processes the buyer's application to assume the loan and forwards assumption documents to escrow for the buyer to sign and return. The terms for an assumption demanded by the lender include a modification of the interest rate, a new amortization schedule for payments

and a due date not previously included in the note. However, these terms exceed and are more financially burdensome than the mortgage assumption parameters agreed to in the purchase agreement.

Seller's refusal to subordinate

The buyer promptly signs the mortgage documents and returns them to escrow, along with the assumption fee demanded by the lender. Thus, the buyer, by conduct inconsistent with their right to cancel granted by the mortgage assumption contingency provision, *waived* their right to cancel the transaction. The buyer now no longer has the authority to terminate the purchase agreement based on different terms for an assumption than agreed to in the purchase agreement. [See **RPI** Form 150 §10.3]

However, the seller determines the terms for assumption and modification of the existing mortgage are financially unacceptable and that they exceed the parameters of the mortgage assumption terms agreed to in the purchase agreement. They instruct their seller's agent to prepare a notice of cancellation to terminate the transaction and escrow. The notice is immediately signed by the seller and delivered to the buyer and escrow. [See Form 183 accompanying this chapter]

Here, the seller has a valid reason for refusing to subordinate. The risk of loss presented by the mortgage modification accompanying the assumption agreement is greater than the risks presented by the terms agreed to in the purchase agreement.

The seller's notice of cancellation terminated the purchase agreement and escrow. The seller (as well as the buyer) on cancellation avoids any *further performance* of the purchase agreement or escrow since all obligations to close escrow have been *excused*.

An authorized unilateral cancellation

Unilateral cancellation of a real estate purchase agreement and escrow is due either to:

- a *breach* of the agreement by the other party; or
- the *failure* of an event to occur or a condition to be approved as called for in a contingency provision.

Unilateral cancellation does away with whatever remains to be performed under the purchase agreement, called *termination of the contract*.

Thus, a cancellation eliminates any *future enforcement* of the agreement from the moment of cancellation. However, the cancellation of a purchase agreement does not affect the legal consequences and liabilities for activities and events which *preceded* the cancellation.

Here, the purchase agreement is cancelled by a **unilateral act** since the cancellation is undertaken by one person only.

unilateral cancellation
A situation under a purchase agreement when one party acting alone terminates the agreement, eliminating the requirement for the buyer and seller to perform on the terms stated.

Conversely, a **rescission** of either an unexecuted purchase agreement (i.e., escrow has not yet closed) or of a completed real estate transaction (i.e.,

bilateral rescission
An agreement by a buyer and a seller mutually agreeing to terminate their purchase agreement.

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

escrow has closed) is a **bilateral agreement.** Under a *bilateral rescission*, both the buyer and seller act in concert to *retroactively annul* the purchase agreement from the moment it was entered into.

Thus, by a *cancellation* a purchase agreement is brought to a standstill. Future obligations under the agreement are eliminated. In contrast, a *rescission* returns the buyer and seller to their respective positions they held *prior to entering into* the purchase agreement. When a contract is rescinded, it as though the parties had never agreed to the transaction. The retroactive return to their former, pre-contract positions is called **restoration**.

When both the buyer and seller enter into a rescission agreement, the *restoration* of the buyer and seller to their pre-contract positions eliminates all claims they may have had against each other for conduct which occurred after entering into the purchase agreement and prior to its rescission. A rescission is a voluntary activity by a mutual agreement to eliminate the purchase agreement, called a *release and waiver agreement*. [See Form **RPI** 181]

Escrow instructions cancelled separately

The cancellation of a purchase agreement is distinguished from either a unilateral or mutual cancellation of only the **escrow instructions**. Here, the cancellation of escrow only does not cancel by reference the purchase agreement. Often, due to a dispute or failure of a contingency, escrow will not close. Here, escrow issues instructions calling for the return of funds and documents to the party who deposited them in escrow, part of the cancellation of escrow instructions.

These *escrow cancellation instructions*, signed by both the buyer and seller, may but do not need to also call for a cancellation of the purchase agreement. If the purchase agreement is not also cancelled by its reference as cancelled, the cancellation instructions handed to escrow do not interfere with any rights the parties may have to enforce the purchase agreement. Thus, the purchase agreement remains intact to be enforced to buy, sell or recover money losses since it has not been cancelled or rescinded, just escrow.[1]

Sometimes negotiations by the transaction agent to resolve the misunderstandings or differences and close escrow might not be successful. If the escrow dispute becomes unresolvable, the agents need to consider advising the buyer and seller to *terminate* not only escrow, but the purchase agreement. Here, the property is released and placed back on the market by the seller – and the buyer is free to look for another property

When the buyer and seller terminate the transaction, it may be in everyone's best interest for the buyer and seller to also release each other and all the brokers and escrow from any claims they may have against one another. They do so by entering into a *cancellation, release and waiver agreement* to put the transaction to rest forever. [See **RPI** Form 181]

1 Calif. Civil Code §1057.3(e)

Cancellation for a valid reason

A seller or buyer occasionally refuse or are unable to hand escrow the instruments (funds and documents) needed to close the transaction or otherwise comply with the escrow instructions. Unless their nonperformance is *excused* they have breached the agreement.

Nonperformance is excused and the refusal to act is not a breach of the purchase agreement, if:

- a *contingency provision exists authorizing* the buyer or seller or the person benefitting from the contingency to terminate the purchase agreement on the failure of an event to occur or on disapproval of data, information, documents or reports;
- the *event fails* to occur or the condition reviewed is *disapproved*; and
- a person authorized or benefiting from the contingency provision *acts to terminate* the agreement by delivering a notice of cancellation prior to the expiration of their right to cancel. [See **RPI** Form 183]

When a *valid reason* exists which triggers the buyer's or seller's right to exercise their option to cancel and they choose not to serve a notice of cancellation on the other party, their option to be excused from further enforcement *expires*.

Conduct less than disapproval

Consider a buyer who enters into a purchase agreement to acquire an income producing property. A provision calls for the buyer to review and approve the operating income and expenses experienced by the property. The buyer is handed a property operating cost sheet for review and approval, called an *income and expense statement* or an *Annual Property Operating Data sheet (APOD)*. The receipt of the data commences a *period of review* for the buyer to determine whether to exercise their right of approval. [See Form 352 accompanying Chapter 35]

The data tends to confirm the general information received by the buyer before making the offer. However, the breadth and depth of the information seems inadequate for a large, long-term investment. The buyer's agent asks the seller to supply additional data and information, including access by the buyer for a review of all supporting documents regarding the property's operating history — leases, unit occupancy rates, expense records; the works.

The seller claims the buyer's request for more data and documents constitutes disapproval of the information and a cancellation of the agreement since the information already handed over sufficiently discloses the property's operating history. The seller says the deal is dead and they are no longer required to perform.

Has the buyer, by seeking additional information, disapproved of the condition of the income and expenses, and thus exercised their right to terminate the agreement?

No! The buyer's *request for additional data* on the property's operations is an expression of concern, not disapproval. Implicit in a request for more information is the notion a decision of any type has not yet been made.

Further, the seller has not fulfilled their obligation to deliver sufficient information to allow the buyer to complete their review and make an informed decision about the acceptability of the property's operations.

Termination of the agreement

Before an agreement is terminated by a buyer exercising a contingency provision, the buyer's conduct needs to rise to the level of an *unequivocal disapproval* of the conditions presented by the data, information, documents and reports supplied by the seller.

Form 181

Cancellation of Agreement

CANCELLATION OF AGREEMENT
Release and Waiver of Rights with Distribution of Funds in Escrow

NOTE: This form is used by an agent when cancelling escrow, to release the buyer, seller, and their agents from all claims and obligations arising out of the cancelled purchase or exchange agreement.

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This mutual cancellation and release agreement with waiver of rights pertains to the following agreement:
   ☐ Purchase agreement
   ☐ Exchange agreement
   ☐ _____
   1.1 dated _____, 20_____, at _____, California,
   1.2 entered into by _____, as the Buyer, and _____, as the Seller,
   1.3 whose real estate brokers (agents) are
   Buyer's Broker _____
   Seller's Broker _____
   a. If an exchange is involved, the first and second parties to the exchange are here identified as Buyer and Seller, respectively.
   1.4 regarding real estate referred to as _____.
   1.5 Escrow Agent _____ Escrow Number _____

AGREEMENT:

2. Buyer and Seller hereby cancel and release each other and their agents from all claims and obligations, known or unknown, arising out of the above referenced agreement.
3. The real estate broker(s) and escrow agent(s) are hereby instructed to return all instruments and funds to the parties depositing them.
4. Costs and fees to be disbursed and charged to ☐ Seller, or ☐ Buyer.
   4.1 $_____ to _____
   4.2 $_____ to _____
   4.3 _____
5. The parties hereby waive any rights provided by Section 1542 of the California Civil Code, which provides: "A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor."

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**RPI** Form 251]	☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer's Name: _____	Seller's Name: _____
Signature: _____	Signature: _____
Buyer's Name: _____	Seller's Name: _____
Signature: _____	Signature: _____

FORM 181 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Form 183

Notice of Cancellation

NOTICE OF CANCELLATION
Due to Contingency or Condition

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

NOTE: This form is used by a transaction agent when a sale is the subject of a contingency provision that has not been satisfied and the transaction is to be cancelled, to prepare a notice for their client to sign cancelling the transaction.

DATE: _____, 20_____, at _____, California.

TO: _____

Items let blank or unchecked are not applicable.

FACTS:
This is a notice of cancellation and ermination of the following contract:

- ☐ Purchase agreement
- ☐ Escrow Instructions
- ☐ Exchange agreement
- ☐ Counteroffer
- ☐ _____

dated _____, 20_____, at _____, California,
entered into by you and the undersigned, regarding real estate referred to as _____
_____.

CANCELLATION AND TERMINATION:
The above referenced contract and any underlying agreements are hereby cancelled and terminated.
The cancellation is based on:

1. _____
2. _____
3. _____
4. The contract is further cancelled for any other legally sufficient grounds not mentioned here.
5. If approved by all parties, the real estate broker(s) and escrow agent(s) are hereby instructed to return all instruments and funds to the parties depositing them.

I agree to this notice and instructions.
☐ See attached Signature Page Addendum. [RPI Form 251]
Date: _____, 20_____, at _____, California.

Signature: _____

Signature: _____

RECEIPT AND CONSENT TO CANCELLATION
I acknowledge receipt of a signed copy of this notice and agree to this cancellation and instructions.
Date: _____, 20_____, at _____, California.

Signature: _____

Signature: _____

FORM 183 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

For a termination of the purchase agreement to occur, the buyer must either:

- deliver a notice of cancellation, as called for to exercise the right granted to terminate the agreement; or
- otherwise communicate an *unequivocal rejection* of the disclosed condition to the seller.

The seller who fails to comply with a good faith request for more information to assist the buyer in the decision making process of approval or disapproval of the condition under review has breached their obligation under the contingency provision to hand over data, information, documents and reports.

Thus, the seller has *defaulted* on their obligations. This default is a breach

which excuses the buyer's *further performance* until the seller complies with the requests. Further, the seller's breach of the provision allows the buyer to either cancel the agreement or pursue enforcement by a *specific performance* suit.

Post-cancellation waiver attempt

Consider a prospective buyer of commercial property who includes a further-approval contingency provision in their purchase agreement offer calling for their approval of a survey to be furnished by the seller or cancellation by written notice. The seller accepts the offer and a survey is conducted.

The surveyor's observations are delivered to the buyer as agreed in the contingency provision. On the buyer's review of the survey and accompanying report, the buyer discovers the location of structures does not conform to building permits. Thus, the buyer has a reasonable basis for exercising their right to cancel the transaction under the contingency provision.

However, the buyer's agent does not prepare a notice of cancellation form for the buyer to sign and deliver to the seller as called for in the purchase agreement to terminate the transaction. Instead, the buyer advises the seller of their disapproval of the survey in letter form, but does not state they are canceling the transaction due to their disapproval.

The seller does not respond to the buyer's disapproval letter. The seller makes no effort to work out the discrepancies found in the survey so the buyer can approve the survey and waive the further-approval contingency.

Unequivocal disapproval terminates escrow

Prior to the date originally scheduled for escrow to close, the buyer's agent prepares a notice of waiver of the further-approval contingency which the buyer signs. On the seller's receipt of the notice of waiver, the seller has escrow prepare unilateral cancellation instructions which the seller signs and hands escrow. The buyer then demands a conveyance of the property as agreed in the purchase agreement, which the seller rejects.

The seller claims the letter disapproving the survey *terminated* the transaction and *excused* the seller (and the buyer) from further performing on the purchase agreement or escrow.

The buyer believes their communication did not cancel the transaction, but merely disapproved of the survey without exercising the contingency provision which they waived to allow the transaction to close.

Here, the buyer *unequivocally disapproved* the conditions disclosed by the survey. As a result, their rejection of the survey by the disapproval was itself an *exercise* of the buyer's right under the contingency provision to terminate the purchase agreement and escrow. The disapproval is as effective as though they had signed a notice of cancellation and delivered it to the seller.

Thus, the buyer is left without a contract, much less a right to cancel which they may later attempt to waive.[2]

2 **Beverly Way Associates** v. **Barham** (1990) 226 CA3d 49

Chapter 29 Summary

Cancellation of a real estate purchase agreement and escrow is due either to:

- a breach of the agreement by the other party; or
- the failure of an event to occur or a condition to be approved as called for in a contingency provision.

Cancellation is a unilateral act eliminating any future enforcement of the agreement from the moment of cancellation. However, the cancellation of a purchase agreement does not affect the legal consequences and liabilities for activities and events which preceded the cancellation.

Conversely, a rescission of either an unexecuted purchase agreement (i.e., escrow has not yet closed) or of a completed real estate transaction (i.e., escrow has closed) is a bilateral agreement.

Under a rescission, both the buyer and seller, act in concert to retroactively annul the purchase agreement from the moment it was entered into. A rescission returns the buyer and seller to their respective positions they held prior to entering into the purchase agreement.

The cancellation of escrow only does not cancel by reference the purchase agreement.

Nonperformance is excused and the refusal to act is not a breach of the purchase agreement, if:

- a contingency provision exists authorizing the buyer or seller or the person benefitting from the contingency to terminate the purchase agreement on the failure of an event to occur or on disapproval of data, information, documents or reports;
- the event fails to occur or the condition reviewed is disapproved; and
- a person authorized or benefiting from the contingency provision acts to terminate the agreement by delivering a notice of cancellation prior to the expiration of their right to cancel.

Before an agreement is terminated by a buyer exercising a contingency provision, the buyer's conduct needs to rise to the level of an unequivocal disapproval of the conditions presented by the data, information, documents and reports supplied by the seller.

Chapter 29 Key Terms

Chapter 30

Time to perform

Learning Objectives

After reading this chapter, you will be able to:

- identify conduct which places a buyer or seller in a real estate transaction in default on a material condition permitting the other person to terminate the purchase agreement;
- establish when a buyer or seller may exercise their right to cancel and terminate a purchase agreement;
- allow for extensions of time to perform to avoid premature termination of a purchase agreement; and
- recognize conduct which constitutes a person's waiver of their right to cancel due to a time-essence provision

Key Terms

authorization-to-extend provision
condition concurrent
condition precedent
Notice of Cancellation
seller-may-cancel provision
time-essence provision

The litigious time-essence provision

The seemingly harmless **time-is-of-the-essence provision** stands stark amongst the boilerplate provisions of purchase agreement forms purchased by some California publishers, such as the California Association of Realtors (CAR). By its plain words, the *time-essence provision* gives notice to the buyer and seller that their compliance by the date set in other provisions in the purchase agreement which call for an event to occur or an activity to be performed is **essential to the continuation** of the transaction.

Thus, the apparent bargain built into the purchase agreement by the presence of the **time-essence provision** gives the buyer or seller the right to **immediately cancel** the transaction on:

- the failure of an event to occur; or

time-essence provision
A purchase agreement provision declaring that dates for performance of any activity or occurrence of an event are to be strictly enforced as essential to the continuation of the transaction.

- failure of the other party to act, usually by approval, by the appointed date.

Drawbacks of the time essence provision

By virtue of the number of tasks a buyer undertakes to close a transaction — contrasted with the very few tasks imposed on a seller — the time-essence clause "stacks the odds" against the buyer. This condition exists even though the buyer and all third-parties involved on their behalf may have acted with diligence at all times, or that a particular event or activity is not material for the transaction to proceed to closing.

Further, for a vast majority of agents who work diligently to clear conditions and close a transaction, the time-essence clause places an unreasonable **risk of cancellation** on a transaction. Foreseeable delays in closing a transaction exist in all real estate sales.

Worse yet, the time-essence clause has, over the years, consistently demonstrated an ability to **produce litigation** over rights to money or ownership which have been lost or forfeited by a cancellation typically initiated by the seller.

*Editor's note — **RPI** purchase agreement forms do not contain a time-essence clause. Instead, the purchase agreements authorize agents to extend performance dates by up to one month, destroying any claim the performance is material and thus cancellation is the appropriate remedy. [See **RPI** Form 150 § 10.2; see Chapter 23]*

Purpose of the time-essence provision

The stated purpose for including a time-essence clause in a purchase agreement is to **protect the seller from delays** in the buyer's payment of the sales price. Delays "tie up" both the seller's ownership of the real estate and receipt of the net sales proceeds beyond the date or period fixed for the transfer of ownership.

Another less logical theory is the purported inability of courts to estimate the compensation owed a seller for losses resulting from a delay in the close of escrow due to the buyer's failure to perform by the date agreed.

However, delays in closing of a few days — or even a few weeks or more — rarely cause any compensable loss of money, property value, rights or property for the person attempting to cancel due to the passing of a performance deadline. Typically, the cancellation by a seller is motivated not by time, but by greater profits to be had elsewhere.

Even if a money loss is incurred due to a delay in performance, the loss is usually sustained by the seller and is easily calculable. Seller losses typically consist of *lost rental value* or *carrying costs* of the property for the period beyond the appointed closing date to the actual date of closing. An infrequent exception which occurs generally arises out of the seller's actions in different transactions, such as the seller's reliance on the closing of a sale to complete some other transaction.

A buyer's losses on a seller's default usually arise out of:

- a missed closing deadline needed in order to receive tax benefits; or
- a locked-in (low) interest rate mortgage.

Termination of rights

An effective **Notice of Cancellation** interferes with the completion of a transaction as initially envisioned by the buyer and seller when they entered into the purchase agreement and escrow instructions.

Notice of Cancellation
A notice from either the buyer or seller given to the other party cancelling the transaction. [See **RPI** Form 181]

On a proper cancellation for cause, the person terminating the purchase agreement transaction **does not need to further perform** any act called for, including the close of escrow. Further, the transaction has been terminated and the obligations of both the buyer and seller to further perform no longer exist. [See **RPI** Form 183]

For example, the person who **properly cancels** a purchase agreement has the unfettered right:

- in the case of a seller, **to retain ownership** or resell the property to other buyers at a higher price; and
- in the case of a buyer, to keep their funds or use them to purchase other property on more favorable terms.

These rights to act, free of purchase agreement and escrow obligations, are the very objectives met by cancelling the purchase and escrow agreements. The alternative to cancelling both agreements is an attempt to keep the transaction together by determining the additional time reasonably needed by the other person to perform as originally contemplated, and then granting an extension of time in which to do so.

If the "grace period" of additional time is granted, and then expires without compliance, a cancellation for failure to perform is understandable by all involved, and enforceable.[1]

Cancellation forfeits rights

An effective **cancellation** by one person forfeits the rights held by the other to close the transaction and receive the benefits bargained for on entering into the purchase agreement. Further, on an effective cancellation, all parties involved are adversely affected by the cancellation's ripple effects since they all lose the time and effort they invested to get the transaction closed, including:

- the agents;
- escrow;
- lender; and
- title company.

1 **Fowler** v. **Ross** (1983) 142 CA3d 472

For example, when a seller cancels, the buyer loses, by *forfeiture*, their contract right to become the owner of the property. Conversely, if the buyer cancels, the seller loses the right to receive funds and be relieved of the obligation of ownership.

Thus, a cancellation by either the buyer or seller, if proper and enforceable, is the final moment in the life of a purchase agreement and escrow. Cancellation spells the end to all expectations held by everyone directly or indirectly affiliated with the sale.

Editor's note — For simplicity's sake, the following discussion will mostly refer to the timing of a seller's cancellation. However, the discussion fully applies to a buyer's cancellation as well.

Cancellation factors

For a seller to successfully cancel an escrow based on the failure of an event to occur or a condition to be approved, the **purchase agreement** or escrow instructions are to contain:

- a clear **description of the event** which is to occur or the **condition** to be approved;
- an appointed date or **expiration of a time** period by which the event or approval described is to occur; and
- a written provision stating in clear and unmistakable wording, understandable to the buyer, that the seller has the *right to cancel* the transaction as the consequence of a failure of the event or the approval to occur by the appointed date. [See Chapter 29]

If provisions in the purchase agreement or escrow instructions meet all of the above criteria, the seller may **cancel** if:

- the seller has performed all acts which are required to precede, by agreement or necessity, the event or approval triggering the cancellation (in other words, the seller cannot be in default);
- the event or approval **fails to occur** by the appointed date; and
- the seller **performs or stands ready**, willing and able to perform all other acts necessary on the part of the seller to close the transaction on the appointed date for the failed event or approval.

Consequences of nonperformance

The notice given by the existence of the time-essence provision advises the buyer their performance of the event which is to occur or be brought about by the date scheduled is **critical to the continuation** of the purchase agreement and escrow instructions. Thus, the time-essence provision sets the buyer's reasonable expectations of the consequences of their failure to perform, i.e., the risk that the seller may cancel the transaction and the buyer's right to buy the property will be *forfeited*.

However, the consequences of the failure of the buyer to perform or for an approval or event to occur depend upon the type of **time-related provision** contained in the purchase agreement and escrow instructions. The different provisions which may be included are:

- a **time-essence provision**, which gives the seller the right to cancel if the event or approval of a condition called for does not occur by an appointed date;
- a **seller-may-cancel contingency** provision, which authorizes the seller to cancel if the condition or event does not occur, whether or not a time-essence clause exists;
- an **authorization-to-extend** provision, which grants the agents the power to extend performance dates up to 30 days (or other wording indicating an accommodation for delays), whether or not a time-essence clause or a *seller-may-cancel clause* exists [See **RPI** Form 150 §10.2]; and
- an *extension of time granted* by the seller, typically in supplemental escrow instructions, with wording imposing strict adherence to the new performance deadlines and authorizing the seller to cancel on expiration of the extension if the event or approval is not forthcoming.

seller-may-cancel provision
A purchase agreement provision authorizing the seller to cancel if a specified condition or event does not occur, whether or not the agreement contains a time-essence provision.

authorization-to-extend provision
A purchase agreement provision granting authority to extend performance dates before the transaction may be cancelled.

Elements of a default

Before either a buyer or seller may effectively cancel a transaction, they are required to *place the other person in default*. Thus, in order for a person to exercise the right to cancel, that person cannot also be in default themselves on the date scheduled for the other person's performance or the event to occur.

For the buyer or seller to place the other in default, three transactional facts need to exist:

- a date crucial to the continuation of the transaction needs to have passed;
- the condition called for in the purchase agreement did not occur by the scheduled date; and
- the person cancelling is required to have fully performed all activities required in order for the other person to perform by the scheduled date, called **conditions precedent**, and have performed or be ready, willing and able to perform, at the time of cancellation, all activities they were obligated to perform in order to close escrow, called **conditions concurrent**. [See Chapter 28]

condition precedent
A provision in an agreement calling for the occurrence of an event or performance of an act by another person before the buyer or seller is required to further perform.

condition concurrent
A provision in an agreement calling for the performance of an activity by a buyer or seller without concern for the performance of the other person.

Was the cancellation timely?

The **setting of a time** for an act or event to occur does not, by itself, automatically allow a purchase agreement transaction to be terminated by one person when the appointed date has passed and the other person has not yet performed.

To permit a cancellation immediately following the expiration of the appointed time for performance, the purchase agreement or escrow

instructions needs to clearly state it is the intention of both parties that the failure by one or the other person to perform by the appointed day is to subject their contract rights to forfeiture.

Thus, clear cut wording throughout the purchase and escrow documents needs to consistently manifest an intent to **make time for performance crucial** to the continued existence of the transaction. If not, the appointed date has insufficient significance to justify instant cancellation.

For example, sometimes the only wording regarding any right to cancel a transaction appears in the escrow instructions. Escrow is generally instructed to close at any time after the date scheduled for closing if escrow is in a position to do so, provided escrow has not yet received instructions to cancel escrow and return documents and funds.

Closing as a target date

In the prior example, neither the purchase agreement nor the escrow instructions contain a clause stating "time is of the essence in this agreement."

Further, no clear, unequivocal or unmistakable wording in any contingency provision shows an intent on the part of the buyer and seller to make time of the essence, such as wording giving the seller or buyer the "right to cancel" on the failure of either the other person to perform a described activity or for an event to occur by a scheduled date.

Under these examples, which lack time-essence provisions, the time appointed for the delivery of such items as funds for closing or clearance of encumbrances from title is merely a "target date" preliminary to establishing the right to cancel.

Time to close extended by notice

To establish the **right to cancel** when time is not stated or established in the purchase agreement or escrow instructions as crucial, the person in default needs to be **given notice** that the date set as the "new deadline" will be strictly adhered to.

Further, the person in default needs to be given a realistic period of time after receiving a notice to perform before any cancellation is considered effective. Continued nonperformance past the new deadline date noticed will be treated as a **default** and escrow may immediately be canceled. [See Form 181-1 accompanying this chapter]

For example, a purchase agreement calls for a buyer to close escrow within 45 days after acceptance. No time-essence clause, cancellation provisions or agent *authorization to extend* performance dates exists. [See **RPI** Form 150 §12.2]

The seller agrees with the buyer's request to extend the date of closing an additional 30 days during which the buyer is to complete their arrangements to close escrow. Two days after the extension expires, the seller cancels the transaction.

Form 181-1

Notice to Perform and Intent to Cancel

NOTICE TO PERFORM AND INTENT TO CANCEL

NOTE: This form is used by the agent of the party seeking performance under a purchase agreement when the other party has failed to perform, to notify the other party the agreement will be cancelled if they fail to perform by a specified date.

DATE: _____, 20_____, at _____, California.

1. This notice regards the performance of a Purchase Agreement

1.1 entered into between _____, as the Seller,
and _____, as the Buyer,

1.2 dated _____, 20_____, at _____, California,

1.3 regarding real estate referred to as _____, and

1.4 escrowed with _____,
escrow number _____, under instructions dated _____, 20_____.

NOTICE TO PERFORM:

2. Demand is hereby made on you under the above referenced agreement and escrow instructions to perform

2.1 on or before _____, 20_____,

2.2 as follows: _____

3. It is the intent of the undersigned to cancel this transaction if the performance demanded of you in this notice does not occur during the time period given.

I agree to this notice.
Date: _____, 20 _____
By: _____

Signature: _____
By: _____

Signature: _____

FORM 181-1 09-15 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Is the seller's cancellation of the transaction effective?

Yes! The 30-day extension was a **reasonable amount of time** for the buyer to perform before the seller **exercised** their right to cancel. A further unilateral extension of time is not needed for the cancellation to be reasonable and effective.[2]

The seller is on notice

Consider an example of strict compliance with performance dates established as "deadlines," after which the purchase agreement and escrow are able to be terminated by cancellation for failure of the described activity or event to

2 Fowler, *supra*

take place. The purchase agreement contains a simple time-essence clause. Authority is not granted to the agents to extend performance dates if the appointed date for performance proves to be an inadequate amount of time for either the buyer or seller to complete or bring about all of their closing activities.

Consistent with the time-essence clause in the purchase agreement, the escrow instructions authorize escrow to close at any time after expiration of the escrow period, unless escrow receives instructions calling for the return of documents and funds.

One day after the passing of the date scheduled for closing, the buyer cancels escrow. Twelve days later, the seller, using diligence at all times, is able to clear title and close. The seller challenges the buyer's cancellation as premature and ineffective, claiming the buyer is required to grant the additional time needed to close escrow before the buyer is able to **forfeit the seller's right** to enforce the buyer's promise to purchase the property.

Is the seller entitled to the additional time needed to close escrow?

No! The seller was **on notice** by the existence of the time-essence clause in the purchase agreement and the wording of the escrow instructions that the buyer had the right to cancel on failure of escrow to close by the date scheduled. No provision in any document expressed an intent which was contrary to the time-essence provision in the purchase agreement.

Thus, the buyer's cancellation, one day after the appointed closing date, was in accordance with the **intent stated** in the purchase agreement and escrow instructions, i.e., that timely performance was essential to the continuation of the agreement.

More importantly, **escrow was authorized** to return the money and instruments on the demand of either the buyer or seller if the closing did not occur on or before the date set. Thus, the buyer was not required to grant the additional time reasonably necessary for the seller to close the transaction.[3]

Intent in conflict with time-essence clause

Consider a sale under a purchase agreement which contains a provision **authorizing the agents to extend** the time for performance of any act for a "period not to exceed one month." The purchase agreement also includes a boilerplate provision that "time is the essence of this agreement."

Escrow is for a 60-day period, the end of which is the appointed date for closing the transaction. As usual, the escrow instructions state escrow may close at any time after the date scheduled for closing, unless instructions to the contrary have been received.

On the date scheduled for closing, escrow is not in a position to close due to the buyer's inability to immediately record their purchase-assist loan. The seller immediately cancels escrow in an attempt to terminate the transaction, claiming time was of the essence by agreement.

3 **Ward** v. **Downey** (1950) 95 CA2d 680

Is the seller able to cancel without giving an extension of time when both a time-essence and an authority-to-extend provision exist?

No! The bargain struck by the conflicting provisions controlling performance dates did not contemplate time for the occurrence of activities or events by their appointed dates to be so essential that the transaction may be cancelled on the mere passing of the appointed date. The use of a purchase agreement (or escrow instructions) containing wording that "time is of the essence" does not allow for the forfeiture of contract rights on a failure to perform within the agreed time period when **other provisions express a contrary intent**.

Original bargain enforced

When logically possible, courts ignore boilerplate time-essence clauses and enforce the original bargain, if no financial harm results from the delay.

In the prior example, the purchase agreement (or escrow instructions) gave the agents the unconditional right to extend performance dates. Thus, being able to close by the date set for closing escrow is hardly considered crucial to the continued viability of the transaction. Accordingly, the seller has to give the buyer a **reasonable amount of time** to close escrow, i.e., the additional days needed to record the buyer's loan before the buyer's failure to perform justified exercising any cancellation rights. [See **RPI** Form 181-1]

Default needed to justify cancellation

Before a buyer or seller may consider cancelling a transaction, the other person has to have **defaulted** on their completion of an activity or an event has failed to occur.

For example, a seller cancels a 30-day escrow the day after the date it is scheduled to close. The purchase agreement granted the agents authorization to extend performance dates, including the date for closing, up to 30 days. [See Figure 1]

33 days later, for a total of 63 days from the date of acceptance, the buyer, using diligence in the pursuit of a loan, obtains final loan approval and has all the funds needed to close escrow.

Is the seller's cancellation effective without first giving an extension of additional time for closing when the buyer has not performed by the date scheduled for the close of escrow?

No! The buyer is not yet in default. Sixty-three days is a reasonable period of time for the buyer to obtain the purchase-assist mortgage funds agreed to in the purchase agreement. Most instructive for buyers and agents, time for closing was not made crucial to the continuation of the agreement.

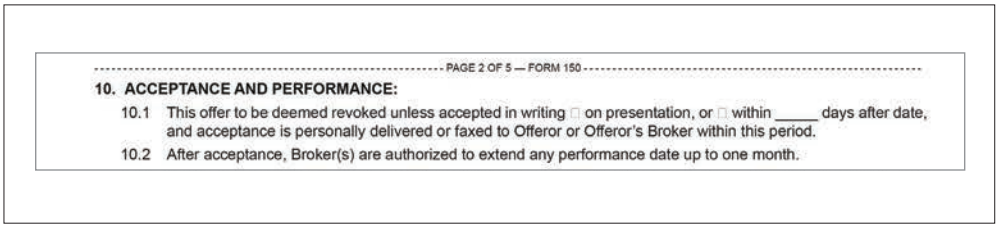
Thus, a reasonable period of time has to pass before the buyer is in default. Only when the buyer is in default on expiration of a reasonable time extension may the seller **exercise** their right to cancel.[4]

4 **Henry** v. **Sharma** (1984) 154 CA3d 665

Figure 1

Excerpt of Form 150

Purchase Agreement



PAGE 2 OF 5 — FORM 150

10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

Reasonable period to open escrow

Now consider an agent who prepares a purchase agreement and inadvertently fails to set a fixed time period for the opening of escrow. However, the purchase agreement does state an appointed date for closing escrow as 60 days from the date the purchase agreement was entered into.

The buyer fails to sign and return escrow instructions to open escrow. The seller cancels the transaction 12 days after the date escrow was scheduled to close.

Was the buyer in default at the time of cancellation?

Yes! The buyer was in default for their failure to sign and return escrow instructions. The buyer had an obligation to open escrow within an unstated period of time. Since the time for opening escrow was not agreed to, a **reasonable period of time** for opening escrow is allowed.

A reasonable period for opening escrow is a date sufficiently in advance of the date set for the close of escrow to give escrow enough time to perform its tasks by the date scheduled for closing. The cancellation 12 days after the closing date was effective to terminate the transaction. A reasonable period for the buyer to open escrow ended well before the scheduled closing date.

The buyer, having failed to open escrow before the closing date, was in default on the closing date. Thus, the buyer lost their right to buy the property since they did not cure the default by opening escrow before the date set for closing and the seller's cancellation.[5]

However, a one day delay by a buyer before signing and delivering instructions to open escrow does not allow a seller to cancel the transaction and avoid closing escrow. Reasonably, a **one day delay in opening escrow** is not a default at all, even when time is unequivocally declared to be of the essence in the purchase agreement.

To cancel you needs to first perform

Consider a seller who wants to cancel a transaction since the buyer is in default under the purchase agreement or escrow instructions. Before the seller may cancel, the seller is required to:

- **perform all acts** and cause all events to occur which, by agreement or necessity, are the seller's obligation and need to occur before the buyer

5 **Consolidated World Investments, Inc.** v. **Lido Preferred Ltd.** (1992) 9 CA4th 373

becomes obligated to perform, called **conditions precedent**, such as delivering disclosures, reports, etc., or completing repairs requiring the buyer's approval [See Chapter 28];

- **fully perform all activities** and obligations imposed on the seller which are to **occur at the same time** as the buyer's performance, without concern for whether the buyer has performed, called **conditions concurrent**, such as handing escrow a grant deed and all other information and items required of the seller for escrow to clear title and close [See Chapter 28]; and
- **perform or demonstrate** they are able to perform all other activities or bring about events which are the obligation of the seller for closing the transaction, whether or not the buyer ever performs, called **conditions subsequent**, such as meeting any requirements of the buyer's lender for repairs or clearances.
- Thus, while the buyer may have failed to perform by the time agreed, the seller may not cancel until the seller has performed or stands ready, willing and able to perform under the above three conditions (precedent, concurrent and subsequent), conditions which exist in most purchase agreements and escrow instructions.

When failure to fund is not a default

On the date set for the close of escrow, buyers often have not deposited their down payment funds into escrow as called for in the purchase agreement and escrow instructions. When the deposit of closing funds or the lender's wire of loan funds does not occur as scheduled, the buyer clearly has not yet performed their obligation to close escrow. However, the failure to fund does not necessarily mean the buyer is in default.

The question which arises for a seller who is attempting to cancel when time has been established as essential and the buyer or the buyer's lender has not delivered closing funds, is whether the buyer is either in **default** or is **not yet obligated** to deposit funds.

Escrow, as a matter of custom, will not call for a wire of closing funds from the mortgage lender or the buyer until **escrow is in a position to close**. Escrows, as an entirely practical matter, do not want closing funds sitting in an escrow which is not yet ready to close.

Specifically, before escrow calls for closing funds, the seller needs to have already fully performed by providing documents so the conveyance of title is able to be insured and property clearances, prorates and adjustments may be delivered and accounted for as called for in the escrow instructions. If the seller has not delivered instruments so escrow is able to be in a position to close by the date scheduled for closing, escrow will not make a demand on the buyer or lender for funds.

Thus, the buyer has no obligation to deposit any money into escrow and is not in default until escrow has received the lender's documents and requests

the buyer's funds. Until the buyer is in default due to a failure to timely respond to escrow's request for funds, any attempt by the seller to cancel is premature and ineffective.

Escrow instructions usually state the buyer is to deposit funds for use by escrow **provided the seller has performed**. Thus, the obligation of the buyer to deposit closing funds is subject to the seller first performing, a *condition precedent* to the buyer's performance. Therefore, the buyer's "failure" to deposit funds before escrow is in a position to close is **excused**. [See **RPI** Form 150 §12.2]

Consider a seller who is unable to convey title to a buyer and deliver a title insurance policy by the closing date called for in the purchase agreement and escrow instructions. The title company cannot issue a policy as ordered due to encumbrances affecting title which have not been released and the amounts needed for discharge and payoff have not yet been determined.

Here, the time for closing has arrived and the seller cannot deliver a marketable title as agreed. Thus, until the seller obtains title insurance for their deed, the buyer is not in default for not yet depositing their funds.

Cancellation right waived by conduct

Even when the date scheduled for a buyer or seller to perform is established as crucial, **inconsistent conduct** by the person entitled to cancel constitutes a **waiver** of their right to cancel. Once the right to immediately cancel has been waived, the person who failed to perform by the agreed deadline is **no longer in default**. Until the person who failed to perform is placed in default again, the right to cancel cannot be exercised.

For example, the date set for escrow to close arrives. The seller has not yet handed escrow clearances which are required before escrow may close.

A few days after escrow is scheduled to close, the seller deposits the clearances with escrow. The buyer then deposits their closing funds on a call from escrow.

Two days later, the seller cancels escrow, claiming the buyer was in default since they failed to deposit their funds by the appointed date.

Here, the cancellation is ineffective and the buyer is entitled to close escrow. The seller **waived their right** to cancel, time having been of the essence, by conducting themselves without concern for the passing of the appointed date for closing. The seller failed to deliver documents or information sufficiently in advance for escrow to meet the deadline.[6]

Affirmative conduct and time reinstatement

A **waiver by inaction** does not occur simply because a person's right to cancel the transaction is not immediately exercised on the failure of the other person to perform or an event to occur. **Affirmative conduct** needs to occur by the person entitled to cancel, not just mere inaction, before the right to cancel under a time-essence situation is waived.

6 **Katemis** v. **Westerlind** (1953) 120 CA2d 537

After a waiver of a date scheduled for approval of a condition or occurrence of an event, time needs to be **reinstated as crucial** to the continuance of the transaction, or a reasonable, additional period of time must have passed after waiver of the right to cancel, before the transaction can be cancelled.

Time is best reinstated as essential to the continuation of the transaction by notifying the person who needs to perform they are required to perform by the end of an additional period of time, set with sufficient duration as needed to provide them with a realistic opportunity to perform.

If performance is not forthcoming during the additional period of time, the transaction may be promptly cancelled since **strict compliance** with the extension is now enforceable.

Chapter 30 Summary

A time-essence provision gives notice to the buyer and seller that their compliance by a set time for an event to occur or a condition to be met is essential to the continuation of the transaction. For a vast majority of agents who work diligently to clear conditions and close a transaction, the time-essence clause places a risk of cancellation on a transaction. However, foreseeable delays in closing a transaction exist in all real estate sales.

An effective Notice of Cancellation interferes with the completion of a transaction as initially envisioned by the buyer and seller at the time they entered into the purchase agreement and escrow instructions. On a proper cancellation, the person terminating the purchase agreement does not need to further perform any act called for, including the close of escrow. Further, the transaction has been terminated and the obligations of both the buyer and seller to further perform no longer exist.

To establish the right to cancel when time is not stated or established in the purchase agreement or escrow instructions as crucial, the party in default needs to be given notice that the date set as the "new deadline" will be strictly adhered to. Further, the person in default needs to be given a realistic period of time after being given a notice to perform before any cancellation is considered effective.

Before either a buyer or seller may effectively cancel a transaction, they are required to "place the other person in default" and cannot also be in default themselves on the date scheduled for the other person's performance or the event to occur.

For the buyer or seller to place the other in default, three transactional facts need to exist:

- a date crucial to the continuation of the transaction needs to have passed;
- the condition called for in the purchase agreement did not occur by the scheduled date; and
- the person canceling is required to have fully performed all activities required and be ready, willing and able to perform, at the time of cancellation, all activities they were obligated to perform in order to close escrow.

Even when the date scheduled for a buyer or seller to perform is established as crucial, inconsistent conduct by the person entitled to cancel constitutes a waiver of their right to cancel. Once the right to immediately cancel has been waived, the person who failed to perform by the agreed deadline is no longer in default. Until the person who failed to perform is placed in default again, the right to cancel cannot be exercised.

Chapter 30 Key Terms

Chapter 31

The seller's breach

Learning Objectives

After reading this chapter, you will be able to:

- identify a seller's interference with the closing of a real estate sales transaction and what may motivate them to avoid closing;
- discuss the remedies a buyer has on a seller's breach or cancellation of a purchase agreement; and
- advise on the monetary losses a buyer can recover upon the seller's breach of a purchase agreement.

Key Terms

bona fide purchaser (BFP)
general damages
implied covenant of good faith and fair dealing
price-to-value difference
right of first refusal
special damages

Failure to act and act timely

On occasion, a buyer's agent in a real estate sales transaction will be confronted with conduct by the seller which interferes with the close of escrow. The seller's conduct is inconsistent with or contrary to those activities the seller needs to timely so escrow can close.

Examples of *seller interference* with a buyer's acquisition of property include the seller's failure to (timely):

- return escrow instructions;
- deliver closing documents;
- provide escrow with information on the existing lenders so payoff demands, beneficiary statements or assumption papers can be ordered on existing mortgages;

- deliver seller identification information for title insurance purposes;
- eliminate agreed-to defects and previously undisclosed property defects known to the seller and unacceptable to the buyer;
- arrange or permit inspection of the property by the buyer, appraiser, home inspector, city inspector, etc.; or
- close escrow as scheduled.

Here, the seller is not fulfilling the objectives of the purchase agreement they entered into with the buyer to *voluntarily perform* by complying with instructions given to an escrow. As a result, the buyer either has fully performed or is unable to proceed further toward closing, or they have cancelled escrow and their further performance is excused. Thus, escrow cannot close due to an unexcused failure on the part of the seller to act.

Seller remorse

Typically, the seller's refusal or failure to timely act under the purchase agreement and close escrow arises during dramatic increases in the value of the type of property they have just agreed to sell to the buyer. Thus, a better bargain can be had by the seller with other buyers since the seller has either agreed to a below market price or the market value was or has risen dramatically above the price agreed to in the purchase agreement.

As a result, "seller remorse" has set in, manifested by the seller's efforts to trigger a default by the buyer which justifies the seller's termination of the purchase agreement.

Faced with the failure of escrow to close due to the seller's *nonperformance* or *obstruction* of the buyer's efforts to close escrow — and the inability of the buyer and agents to induce the seller to *voluntarily close escrow* — the buyer is forced to must make a pivotal decision regarding their bargained-for ownership of the property.

Buyer remedies

The decisions available to the buyer, called *remedies*, when the seller breaches the purchase agreement or escrow instructions include:

- **abandoning the transaction** by entering into a mutual cancellation of the purchase agreement and escrow instructions with the seller, agreeing to do nothing further to enforce the right to purchase the property or seek a money recovery from the seller, other than a return of the buyer's good faith deposit [See **RPI** Form 181];
- **acquiring the property** by pursuing *specific performance* — enforcement — of the purchase agreement and escrow instructions;
- **pursuing the recovery of money** when the buyer cannot now acquire the property but due to the seller's conveyance of the property for a measurably higher price to another person who was unaware of the pre-existing purchase rights held by the buyer; and

- **pursuing the recovery of money** when the buyer can, but *no longer wants to acquire* the property, and the value of the property was measurably higher on the date the seller canceled escrow than the price the buyer agreed to pay.

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.

An unsuspecting buyer who acquires ownership of real estate without actual knowledge or recorded notice (constructive knowledge) of a pre-existing enforceable purchase agreement held by another buyer regarding the same property is referred to as a **bona fide purchaser (BFP)**. As a BFP, the buyer pays consideration to acquire and take title to the property while having no knowledge of a claim to the property held by the other buyer.[1]

Economic motives in a rising market

Market conditions surrounding a seller's refusal to voluntarily cooperate with a buyer and transfer property under a purchase agreement usually consist of:

- seller pricing power (due to too many prospective buyers for too little inventory);
- cyclically moderate to low mortgage interest rates; and
- a generally recognized trend in price increases, commonly referred to as a "hot (seller's) real estate market."

It is during these economic "boom" or "bubble" periods of fast upward movement in real estate prices that sellers often agree to sell property before fully checking into their property's value. The seller's agent may be partially at fault for not researching and advising their client on the value of the property being sold.

The failure to ascertain the value of the property before the seller enters into a purchase agreement sometimes results in their later discovery (prior to closing) that the sales price agreed to is significantly below the present worth of the property. It is then that the seller determines additional money can be had by simply canceling what is now viewed as a "bad deal" and reselling the property to another buyer at a higher price.

The end game for all sellers of real estate is to net the most money possible on a sale under current market conditions. However, when a seller decides to cancel a sale so they can resell the property at the higher market value, they merely encourage the buyer to pursue the same end game, i.e., the recovery of money from the seller equal to the increase in price received on a resale by the seller — an amount lost by the buyer by the breach.

Thus, if the seller is pursued by the buyer for the difference in price — one of the buyer's remedies — the seller will be unable to retain the financial advantage they sought to attain by breaching and reselling at a higher price.

1 Calif. Civil Code §3395

Misplaced reliance on an adverse party

Consider an owner of commercial real estate who lives out of the area. The absentee owner is solicited by a buyer's agent seeking to locate properties suitable for their buyer. The owner responds indicating they will sell the property, but do not know its value. They ask for an indication of its value from the buyer's agent.

The owner is a sophisticated and intelligent individual capable of understanding that the buyer and the buyer's agent are their adversaries in negotiations.

After phone calls and correspondence exchanging information about the property, the buyer's agent states they do not want to express an opinion of value on someone else's property, but have shown their buyer similar properties offered at $2,000,000. The owner does not indicate what they believe the value of their property might be, but acknowledge they know the market value of nonresidential property is on the rise.

The buyer's agent prepares a purchase agreement offer for a cash price of $2,500,000. The buyer signs the offer and it is submitted to the owner.

The owner accepts the offer and the buyer's agent promptly dictates escrow instructions. A copy of the instructions and a grant deed for the transfer are sent to the seller. The buyer signs and returns the instructions to escrow. On receiving, reviewing and approving the preliminary title report, the buyer advises escrow they will place the balance of the cash price into escrow when escrow calls for funds. The owner does not return escrow instructions or the deed for conveyance of the property.

Seller's discovery of property value

Continuing our examples, the owner then visits the community where their property is located. For the first time, the owner inquires into the worth of their property by contacting local agents. On their initial superficial inquiry, the owner finds the property is worth considerably more than the price they agreed to receive.

The owner quickly determines they have entered into an extremely bad deal concerning the price the buyer has agreed to pay. Another buyer is located and a price of $7,500,000 is agreed to. Escrow is opened with the new buyer at a different escrow company and closed immediately.

Meanwhile, the original buyer is involved in a futile attempt to close their escrow with the owner. When asked by escrow to sign and return the escrow instructions and the deed, the owner claims the agreement they entered into with the buyer was never a binding contract due to the buyer's *misrepresentation of the property's value* and the owner's reliance on the agent's evaluation to set the sales price. Thus, they have no deal.

The original buyer decides they no longer want the property (or will not pursue acquiring it since the new buyer is a BFP).

However, aware they have lost their ability to buy the property under the purchase agreement the original buyer makes a demand on the owner for

$5,000,000, the difference between the price agreed to and its worth on the owner's breach based on the price the seller received on the resale of the property.

The owner refuses to pay the demand claiming their refusal to close escrow at the agreed price was justified since the property's value was known to the buyer and the buyer's agent, but not to the owner. Thus, they took advantage of the owner's ignorance of the property's true value, called *misrepresentation*.

Here, the owner owes the buyer the difference between the price agreed to with the buyer and the value of the property on the date the seller breached ($5,000,000).

Misrepresentation and deceit

Ordinarily, misrepresentation of a property's value by a prospective buyer and their agent does not, by itself, justify an owner's cancellation of the purchase agreement. Estimates of value made by prospective buyers and their agents to sellers are usually mere expressions of their opinion of value, not facts a seller may rely on. The buyer and the buyer's agent are *known adversaries* of any seller who owe no specific fiduciary duties to the seller.

More importantly, the owner in the above example was not persuaded by the buyer or the buyer's agent to forego an independent investigation into their property's value. Also, the owner was in a position to undertake a reasonable investigation into the property's value.

Before a representation of value made to an owner by the buyer or their agent is deceitful the representation needs to be coupled with some other misfeasance, bad behavior or false representation. Further, the owner was neither ignorant, nor unable to protect and care for themselves against the buyer or agent they claim took unconscionable advantage of their ignorance of the property's current value. Thus, seller's reliance on evaluations of the property's expressions of value by buyers and buyer's agents to set an acceptable price did not justify their cancellation.

To prevent this type of situation, the owner needed to take the opportunity, as they later did, to retain a broker (and pay them a fee) to determine the value of the property before agreeing to accept a price.[2]

Recover money, not the property

A buyer who seeks to recover money from a breaching seller, in lieu of ownership of the property, does so based on *monetary claims* within three categories of money losses:

- **general damages**, being money directly expended in the transaction or the monetary value lost in the transaction;
- **special damages**, also called *consequential damages*, being money collaterally lost due to the seller's breach; and
- **prejudgment interest** on all monies recovered.[3]

2 **Kahn** v. **Lischner** (1954) 128 CA2d 480

3 CC §3306

general damages
Money losses by a buyer or seller due to their expenditures and loss of value directly related to a failed property sales transaction.

General damages are monetary losses incurred by the buyer due to their expenditures and loss of value (price increase). These are losses *directly related* to their acquisition of the property which they are no longer going to acquire, including:

- *money advanced* by the buyer toward the price of the property, such as deposits held by the agent or escrow, or previously released to the seller;
- *expenses incurred* examining title conditions, inspecting the property, verifying operating income and expenses, and obtaining financing, escrow services, engineering and improvement plans, etc., all called *transactional expenses*;
- *move-in expenses incurred* preparing the property to take possession; and
- the *price-to-value difference* between the price agreed to in the breached purchase agreement and the value of the property on the date of the seller's breach.

Price-to-value difference on date of breach

right of first refusal
A pre-emptive right held by another person to buy a property if the owner decides to sell. [See **RPI** Form 579]

Consider a buyer of real estate who enters into a purchase agreement to acquire one of two adjacent lots held by the owner. The purchase agreement contains a provision granting the buyer a **right of first refusal** to acquire the adjacent lot, also called a *preemptive right to buy*.

The right-of-first-refusal provision sets the price of the adjacent lot at $900,000, but does not state an expiration date for the right to buy it. Thus, the buyer believes they have the right to buy the adjacent lot if the owner decides to sell it at any time during the owner's lifetime. A more formal documentation of the right of first refusal is not entered into and no memorandum of the right is recorded. The transaction closes.

Many years later, the owner conveys the adjacent lot to another person for $2,000,000. The person who acquires the adjacent lot has no knowledge of the outstanding right of first refusal which was triggered by their purchase. Thus, the buyer holding the right of first refusal is unable to exercise their preemptive right and acquire ownership of the adjacent lot from the other person. The person who acquired the adjacent lot is a BFP, barring any recovery of the lot by the buyer.

The buyer claims the owner has breached the right-of-first-refusal provision in their purchase agreement. Thus, the buyer makes a demand for the monetary value of the lost right to buy since they no longer have the ability to acquire the adjacent lot.

The buyer's demand on the owner is $1,100,000, the difference between the price set in the right of first refusal provision and the *value of the property* on the date of the breach. The demand also includes interest at 10% (the legal rate) on the amount from the date of the breach until the demand is paid.

The owner refuses to pay the demand, claiming the right of first refusal they granted at the time of the purchase of the first lot expired prior to the owner's sale of the lot since the provision did not contain an expiration date, and a reasonable period of time for the right to continue has passed.

Can the buyer recover money equal to the **price-to-value difference** several years later at the time of the sale of the lot covered by the right of first refusal?

price-to-value difference
The difference between the price agreed to in a purchase agreement and the value of the property on the date the agreement is breached.

Yes! The right of first refusal which the owner granted did not state a date for its expiration. Thus, the date of expiration becomes the date of the death of the owner who granted the right.

More importantly, the right to buy held by the buyer had not been previously triggered by the owner's actions to sell. Thus, the buyer never was in a position to exercise the right until the owner triggered the right to buy by deciding to sell the property.

It is the owner's decision to sell that provides the buyer, when notified of the seller's decision (which they were not in this case), with their first *opportunity to exercise* the right — to form a binding bilateral agreement. Only then can the buyer make the decision and communicate their intent to buy the property at the price on the terms called for in the preemptive right to buy provision.

The notice of intent to sell

The period *following the notice* of the owner's intent to sell controls the buyer's actions. Until notice of intent, the buyer does nothing but wait to see if the owner ever decides to sell. The owner's delivery of the notice to sell starts the running of the period during which the buyer may *exercise* their right to buy.

If this *period for exercise* is not stated in the right-of-first-refusal provision, it is limited to a *reasonable period* of time for acceptance/exercise which begins to run when the buyer receives notice from the owner of their decision to sell. [See **RPI** Form 162-2]

Thus, it is the period *after the notice* that expires, not the grant of the preemptive right to buy, unless the right-of-first-refusal provision specifically limits the term of the grant.

Accordingly, the buyer's money recovery of the price-to-value loss is the difference between:

- the *value of the property* on the date of the breach, here set by the price the owner received for the property on the resale (the event which triggered the right to buy); less
- the *price agreed* to in the right of first refusal provision as the amount the buyer was to pay for the property on exercise of the right to buy.[4]

4 **Mercer** v. **Lemmens** (1964) 230 CA2d 167

Preparing to take possession

Consider a buyer who enters into a purchase agreement with a builder to construct a new home. The buyer purchases appliances and upgrades the fixtures, which the builder installs.

Later, the builder substantially alters the construction plans for the exterior without the buyer's approval. The buyer demands the builder complete construction under the plans and specifications as agreed. The builder refuses since they have prospective buyers for the property at a significantly higher price.

The buyer decides they no longer want the new home due to their conflict with the builder. Thus, they unilaterally cancel the purchase agreement since the builder has breached the agreement and they no longer want to own the property. The buyer now seeks to recover money, not the property, from the builder.

Here, the amount of **money losses** the buyer may recover from the builder include:

- funds advanced toward the purchase price, including good faith deposits and monies released to the seller;
- the price-to-value difference between the price the buyer agreed to pay in the purchase agreement and the resale value of the property at the time of the builder's breach;
- expenses incurred to prepare the property for possession (to the extent they exceed the price-to-value difference), i.e., the expenditures made by the buyer for the additional appliances and upgraded fixtures; and
- interest from the date of the breach on all amounts of money recovered.

Recovering expenditures

A buyer is allowed to recover expenditures incurred prior to a seller breach to prepare a property so they can take possession. However, the purchase agreement by its provisions needs to reflect the intention of the buyer to incur these expenditures. Recovery of construction costs advanced by a buyer for upgrades and additions gives the buyer the *benefit of the bargain* contemplated by both the buyer and seller when they entered into their agreement.

However, the buyer cannot enjoy a double recovery for the upgrades they paid for when the price-to-value increase exceeds the cost of the upgrades.

Any expenditure a buyer may make to purchase furnishings before taking title to a new home is excluded from recovery. Recovery of personal property expenditures is typically not agreed to or contemplated when entering into a purchase agreement.

Here, money spent on furnishings is not related to the acquisition of real estate. Also, a seller cannot reasonably foresee these *collateral expenses* for home furnishings as becoming their obligation if they breach the purchase

agreement. Accordingly, it is prudent for a buyer to wait until escrow closes before actually buying furnishings for their use when in possession of the property.

Special damages, a natural result

A buyer whose seller has breached their purchase agreement is also entitled to recover related expenses incurred by the buyer *after the breach*. These post-breach expenditures only qualify for recovery if they are the *natural result* of the seller's breach, called **special damages**.

special damages
Money losses not incurred directly from another's breach of a real estate agreement, but which are naturally incurred as a result of the breach. Also known as consequential damages.

For the buyer to recover post-breach expenditures, the seller on entry into the agreement needs to know or be on notice the expenses will likely be incurred by the buyer as a *natural and unavoidable result* of the seller's breach of the purchase agreement.

For example, consider a buyer who enters into an agreement to purchase a lot from a builder. The builder agrees to complete the construction of improvements on the lot and convey the property by an agreed-to date.

Before the builder enters into the purchase agreement to sell and construct improvements on the property, the builder is informed of the adverse tax consequences the buyer will be subjected to if the construction is not completed and the property conveyed by the date scheduled for closing. Thus, *time for performance* by completion of construction and close of escrow is known by the builder on entering into the agreement to be a prerequisite to the buyer's qualification to avoid profit taxes on a prior sale of other property.

The buyer has sold real estate they used in their trade or business. They need to acquire ownership of a replacement property within 180 days after the sale closed. Unless the time constraint is met, the buyer's prior sale will not qualify for an IRC §1031 exemption. Without the exemption, the buyer is required to report profits and incur state and federal tax liability on the profits from the sale.

Recoverable special damages

The builder fails to complete construction and convey the property prior to the date set for closing. Here, due to the builder's breach, the buyer is unable to avoid incurring and paying income taxes on the profit taken on their prior sale of their trade or business property. The buyer is also forced to rent another property (and incur moving expenses) until the construction the builder promised is completed.

Here, the *special damages* recoverable by the buyer in the form of a money award include:

- the full amount of the profit tax the buyer paid;
- the rent paid for the temporary facilities until the improvements were completed (plus the cost of additional moving expenses); and
- interest at 10% from the date the amounts of rent and profit tax were paid by the buyer.[5]

5 **Walker** v. **Signal Companies, Inc.** (1978) 84 CA3d 982

Interest due accruing from date of loss

A buyer who recovers money losses is also entitled to recover *interest at the (legal) rate of 10%*, commencing on the date of the seller's breach, on amounts recovered for:

- the price-to-value differential lost;
- money paid toward the purchase price, whether held by the seller or as a deposit in escrow, until the date released to the buyer;
- funds expended on title examination and other transaction expenses incurred preparing to take title;
- expenses incurred while preparing to take possession of the property; and
- interest on consequential losses accruing from the date of their disbursement.[6]

Now consider a buyer who enters into a purchase agreement on a one-to-four unit residential property with a seller. The buyer opens escrow and deposits funds as stated in the purchase agreement.

Meanwhile, the seller receives a better offer from another buyer. The seller, without telling the original buyer, conveys the property to the second buyer.

The first buyer, whose purchase agreement has now been breached by the seller's conveyance to the second buyer, is entitled to recover:

- the amount of the increase in value of the property on the date of the breach over their purchase price;
- *interest on the price-to-value difference* at the legal rate (10%) from the date of the breach; and
- the refund of their deposits held either in escrow or by the seller; plus
- *interest on the deposits* from the date of the breach to the date the deposits are returned to the buyer.[7]

Losses you cannot recover

A buyer's expenses and losses unrelated to the real estate itself and not intended to be incurred by the buyer under the terms of the purchase agreement are not the responsibility of the breaching seller.

Losses and expenses too remote and speculative to be foreseen by the seller when agreeing to sell on the terms stated in the purchase agreement as selling obligations if they breach are *not recoverable* from the seller.

For example, a buyer enters into a purchase agreement to acquire an unimproved parcel of commercial property. The seller knows the buyer plans to develop the property. Before escrow closes, the seller determines a higher price can be had for the property from other prospective buyers and cancels escrow.

---

6 **Al-Husry** v. **Nilsen Farms Mini-Market, Inc.** (1994) 25 CA4th 641

7 **Rasmussen** v. **Moe** (1956) 138 CA2d 499

Here, the buyer can recover any increase in the value of the land on the date of breach over the agreed-to purchase price, as may be reflected by the seller's resale of the property.

However, the buyer is not entitled to recover *profits* they might earn had they acquired the land and developed it. Lost profits for the *anticipated use* of the property a buyer does not acquire are unrelated to the sale. Worse, future operating profits are too speculative to be recovered by a buyer.[8]

Also, lost income from rents a buyer might receive if they acquired property subject to a long-term lease are not recoverable. The recovery of rents is barred on a different legal theory from consequential losses. Rents are related to the value of the property as it exists at the time of purchase, a capitalization issue.

Rent produced by income property is a factor used to establish the property's *present value* — the price to be paid for the property. Allowing the buyer who does not buy the property to receive a money award for both the *increase in the resale value* and *future rents* from a breaching seller is a double recovery, i.e., present value of the future flow of rent, plus those future rents. Thus, the buyer is improperly placed in a better position than had the seller performed by conveying the property.

Further, interest serves the same economic function as rents. Both are a *return on capital*. Thus, when a buyer receives interest on the amount of their recovery, the further receipt of future rent is an *impermissible double recovery*.[9]

Commercial reality of a call for funds

Consider a buyer and seller who enter into a purchase agreement which sets the date scheduled for the close of escrow. The purchase agreement states a time for the closing of escrow on the transactions, but does not also contain a performance date by which the seller is to deliver documents to escrow prior to closing. The transaction is contingent on the buyer obtaining purchase-assist mortgage financing. Escrow is opened.

The buyer obtains a commitment letter from a lender for a purchase-assist mortgage. The lender issuing the commitment informs escrow it will prepare mortgage documents and fund escrow within five days after its receipt of an estimated closing statement from escrow.

On the day scheduled for closing, the seller has not yet submitted a current rent roll statement needed by escrow to prepare the estimated closing statement. Thus, escrow is not in a position to prepare an estimated closing statement or call for closing funds from the lender or the buyer.

Later that day, the seller submits a current rent roll statement to escrow, completing their performance of all conditions imposed on the seller by the date set for closing. Knowing the buyer has not yet deposited their funds into escrow, the seller hands escrow a written notice of cancellation.

8 **Stewart Development Co.** v. **Superior Court for County of Orange** (1980) 108 CA3d 266

9 **Stevens Group Fund IV** v. **Sobrato Development Co.** (1992) 1 CA4th 886

The buyer makes a demand on the seller to convey title as soon as the lender is in a position to fund the mortgage. The buyer claims their failure to fund escrow by the closing date is excused due to the seller's *untimely delivery* of the rent roll statement to escrow.

Nonperformance excused by tardy delivery

Here, the buyer's failure to fund escrow when they had otherwise fully performed was *excused* by the seller's dilatory delivery of closing document to escrow. The seller needs to perform in sufficient time to allow escrow to close as scheduled.

Escrow is a process which depends on the orderly receipt of documents to close the escrowed transaction, a process the seller is legally required to honor. As a matter of *commercial reality*, escrow does not call for closing funds from either the buyer or the lender until escrow is in a position to close. In turn, neither the buyer nor the lender deposit or wire funds until they receive a call from escrow for funds.

Since escrow was not ready to call for funds due to the seller's untimely delivery to escrow of documents and data only they possessed, the buyer's delivery of funds by the date scheduled for closing was excused.[10]

The seller's obligation to deliver documents and the buyer's obligation to fund escrow are considered mutually exclusive *conditions concurrent*. Thus, each are independently and separately performed by the buyer and seller by the date scheduled for closing. However, as a practical matter, escrow requires receipt of all documents needed by escrow to close before they will *call for funds*.

Even with all the buyer's and seller's documents in hand, lenders generally need five to seven days to prepare, forward and receive signed mortgage documents before they will fund.

implied covenant of good faith and fair dealing
A legal presumption that parties to an agreement will deal equitably with one another by abiding by the terms of the agreement and timely performing their obligations.

A provision might not exist in a purchase agreement calling for the seller to deliver documents to escrow prior to the date set for closing. However, in all real estate agreements an **implied covenant of good faith and fair dealing** exists. The covenant imposes a duty on the seller to timely perform by taking action to avoid frustrating the buyer's right to receive the benefits of the agreement — e.g., by allowing time for the buyer and their lender to fund escrow. [See **RPI** Form 150 §12.2]

10 **Ninety Nine Investments, Ltd.** v. **Overseas Courier Service (Singapore) Private, Ltd.** (2003) 113 CA4th 1118

Chapter 31 Summary

A seller occasionally interferes with the close of escrow and completion of a purchase by refusing to deliver closing documents, return escrow instructions, eliminate defects as agreed or fulfill other obligations. the seller's refusal or failure to timely act under the purchase agreement and close escrow arises during dramatic increases in the value of the type of property they have just agreed to sell to the buyer. As a result, "seller remorse" sets in, manifested by the seller's efforts to trigger a default by the buyer which justifies the seller's termination of the purchase agreement.

Remedies available to the buyer in these circumstances include:

- abandoning the transaction by entering into a mutual cancellation of the purchase agreement and escrow instructions;
- acquiring the property by pursuing specific performance of the purchase agreement; and
- pursuing the recovery of money, whether or not the buyer still wishes to acquire the property.

Misrepresentation of a property's value by a prospective buyer and their agent does not, by itself, justify an owner's cancellation of the purchase agreement. Estimates of value made by prospective buyers and their agent's to sellers are usually mere expressions of their opinion of value, not facts a seller may rely on. The buyer and the buyer's agent are known adversaries of any seller who owe no specific fiduciary duties to the seller.

If the seller sells the property to another buyer after acceptance of a purchase agreement offer from the original buyer, the seller may be found liable to the original buyer for the difference in price.

The buyer's monetary claims can be:

- general damages, being money directly expended in the transaction or the monetary value lost in the transaction;
- special damages, also called consequential damages, being money collaterally lost due to the seller's breach; and
- prejudgment interest on all monies recovered.

Where a buyer is entitled to the price-to-value difference on a sale of a property from a breaching seller, the value of the property is assessed at the date of the breach — even if this occurs several years after the original purchase agreement is entered into, such as in a breach of a right-of-first-refusal provision with no set expiration.

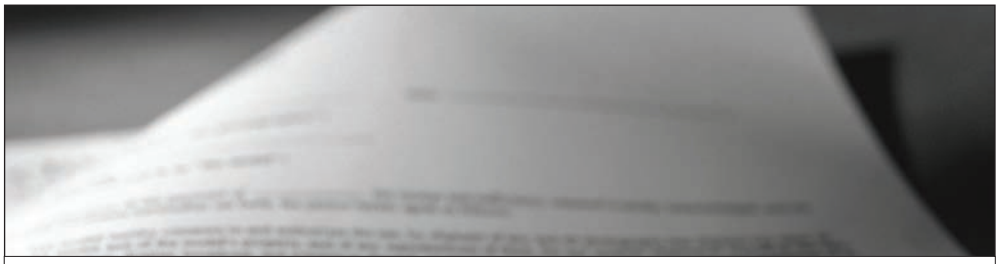
Special damages are recoverable only if they had been known by the seller to likely be incurred by the buyer in the event the seller breached the purchase agreement. Losses and expenses too remote and speculative to be foreseen by the seller when agreeing to sell on the terms stated

in the purchase agreement as seller obligations if they breach are not recoverable from the seller, such as profits from an anticipated use or income from rents.

A buyer who recovers money losses is also entitled to recover interest at the (legal) rate of 10%, commencing on the date of the seller's breach on the amounts recovered.

In all real estate agreements an implied covenant of good faith and fair dealing exists. The covenant imposes a duty on the seller to timely perform by taking action to avoid frustrating the buyer's right to receive the benefits of the agreement.

Chapter 31 Key Terms



Chapter 32

The breaching buyer's responsibilities

Learning Objectives

After reading this chapter, you will be able to:

- determine when a buyer's breach of a purchase agreement and escrow instructions entitles a seller to recover monetary losses; and
- discuss a seller's claim to recover losses on a resale following their buyer's breach of a purchase agreement.

Key Terms

general damages
implicit rent
net sales proceeds
price-to-value difference
special damages
specific performance action

First a monetary loss by the seller

Consider a prospective buyer of a residence who is informed the seller has already entered into a purchase agreement to acquire a replacement residence. The seller is relying on the sale of their current residence to fund their purchase of the replacement residence.

The prospective buyer makes a written offer agreeing to pay cash for the seller's equity and assume the existing mortgage, called a cash-to-loan transaction. The seller accepts the offer. Escrow instructions are prepared and signed, and the buyer's good faith deposit is placed in escrow.

Later, as agreed, the buyer deposits additional funds in escrow. Although escrow is not yet ready to close, the buyer agrees to release some of the down payment money held in escrow so the seller can close their purchase of the replacement residence. The funds are released and the seller acquires their new residence.

The seller vacates the old residence they have sold and moves their family and belongings into the new residence.

To consent to the buyer's application to assume the seller's existing mortgage, the lender demands a modification of the interest rate and payment schedule, and an assumption fee. The buyer refuses to proceed with the mortgage assumption and cancels escrow.

The buyer makes a demand on the seller to return all funds the buyer deposited into escrow, which the seller rejects.

The seller then makes a demand to be paid the funds remaining in escrow. The seller claims the buyer has *forfeited* all funds since they breached the purchase agreement by not assuming the mortgage.

Recovering losses

net sales proceeds
The seller's receipts on closing a sale of their property after all costs of the sale have been deducted from the gross proceeds.

The seller promptly re-lists the property and it is resold for the same price, but on terms calling for payoff of the existing mortgage, requiring the seller to pay a prepayment penalty. The seller also agrees to pay the new buyer's nonrecurring closing costs and one point on new financing to be obtained by the new buyer. On closing the resale transaction, the seller's **net sales proceeds** are less than they were to receive on the sale under the breached purchase agreement.

Can the seller recover any money from the original buyer by either:

- retaining all the funds deposited by the buyer; or
- accounting for offsets against the buyer's deposits for the seller's losses?

Yes! The seller is entitled to recover their losses. However, they need to *account for their actual money losses* caused by the buyer's breach. As always, a *forfeiture of deposits* is not allowed, no matter the wording or initialing of forfeiture provisions.

Depending on the amount of the seller's *total recoverable losses* on the resale, the buyer's deposit will be partially or totally offset by the amount of the seller's losses caused by the breaching buyer.[1]

Money a breaching buyer owes the seller for losses

A seller's total recoverable losses, summarized here and analyzed later in this chapter as offset by rental income, include:

- the *operating and carrying costs* of mortgage interest payments, taxes, insurance, maintenance and utilities, incurred by the seller during the period between the date of the breach and the date escrow closed on the resale;
- the *increased closing costs* due to the seller's payment of the new buyer's nonrecurring closing costs and financing fees on the resale which reduced the seller's net proceeds compared to the net proceeds the seller was to receive from the breaching buyer;

1 **Allen** v. **Enomoto** (1964) 228 CA2d 798

- the *additional resale costs* of the prepayment penalty demanded by the lender on the mortgage payoff; and
- *interest* on the seller's net equity from the date escrow was to close to the date of closing on the resale.

The pivotal decision: resell or retain the property

A seller of real estate who is faced with a breaching buyer and the failure of the sales transaction needs to promptly decide whether to:

- *enforce* the purchase agreement and have a court order the buyer to close escrow, called *specific performance*;
- *remarket* the property for sale and diligently seek a buyer; or
- *retain the property* and postpone or entirely forego any resale effort.

Only money losses are recoverable

A buyer, due to their breach of the purchase agreement, owes the seller their actual money losses caused by the breach, called *damages*, which are classified as:

- **general damages** which include the dollar amount of any decline in the property's fair market value as of the date of the buyer's breach below the price agreed to in the purchase agreement;
- **special damages**, also called *consequential damages*, which include:
    - transactional costs incurred by the seller while preparing to close under the breached purchase agreement;
    - marketing expenses, increased closing costs and ownership and operating costs incurred to remarket and sell the property; and
    - any further drop in property value after the buyer's breach for as long as and only if the buyer interferes and stalls the seller's resale effort; and
- *interest* from the date of the buyer's breach to the closing date of a resale of the property on all money and any carryback note the seller was to receive;[2] less
- *offsets or credits* due the buyer for:
    - any rent received from tenants or the *implicit rent* for the owner's use of the property;
    - the amount of any price increase on the resale; and
    - the amount of any reduction in the seller's expenses on the resale, so the seller will not be placed in a better financial position than had the breaching buyer fully performed.[3]

general damages
Money losses by a buyer or seller due to their expenditures and loss of value directly related to a failed property sales transaction.

special damages
Money losses not incurred directly from another's breach of a real estate agreement, but which are naturally incurred as a result of the breach. Also known as consequential damages.

2 Calif. Civil Code §3307

3 **Smith** v. **Mady** (1983) 146 CA3d 129

In a declining market its price-to-value money losses

When a seller decides to resell the property after the buyer breaches their purchase agreement and the property's value at the time of the breach had declined below the price set in the purchase agreement, the seller has incurred a *loss in value* which is recoverable from the buyer.

However, the amount of value decline recoverable is limited to two time periods:

- the initial decline in value below the purchase price during the period **before the breach**, recoverable as *general damages*; and
- any further decline in value **after the breach**, recoverable only if the buyer *interferes* with the seller's resale effort, also called *special damages*, being money.[4]

The price-to-value difference on the date of breach is recoverable by the seller whether the property is retained, remarketed or resold by the seller.

Value fluctuations in the market

During periods of reduced regional economic activity, the boom-bust cyclical nature of real estate sales typically causes California property values to drop dramatically below the price the buyer agreed to pay just a few months earlier before the bust took hold.

Further, the intangible impacts on a property's market value, due to its "shop-worn" listing status and the "fall-out syndrome" of a lost sale, give the property an aura in the local real estate market which negatively affects some buyers and their brokers. This aura is often reflected in a further dampening of the property's value on the date of breach.[5]

To limit the breaching buyer's liability, the seller's loss on a resale at a price lower than the price agreed to by the breaching buyer is limited to the amount of the value decline which occurs *by the date* of the buyer's breach, not the date of resale. Any further decline in value after the date of breach to the date of resale (or trial, if the property is not yet resold) is recoverable only if the buyer interferes with the seller's diligent resale efforts.

The same or greater net proceeds on a resale

When property is resold for the same price agreed to by a breaching buyer, or more, and the net proceeds from the resale are the same or the cash equivalent, or more, the **price-to-value difference** on the date of breach is no longer recoverable. With equal or greater net proceeds on a resale, the seller incurs no money losses since there is no lost value to recover.

price-to-value difference
The difference between the price agreed to in a purchase agreement and the value of the property on the date the agreement is breached.

To set the dollar amount of the *price-to-value difference* on the date of breach, any "noncash" terms for payment of the purchase price by the breaching buyer and "noncash" terms for payment of the resale price are adjusted to their *cash equivalency*.

4 CC §3307

5 **Bouchard** v. **Orange** (1960) 177 CA2d 521

For example, if terms for payment of a sale price include a seller carryback note, the principal amount of the carryback note is adjusted downward to reflect any discount required to convert the carryback paper to its cash equivalent, i.e., its present worth in cash.

The buyer who interferes with the owner's resale pays

A seller may *diligently remarket* the property and still be unable to resell it due to interference from the breaching buyer. Buyer interference with resale efforts typically consists of filing a **specific performance action** and recording a *Notice of Lis Pendens*, or taking possession and refusing to vacate.

When the breaching buyer interferes with the resale, the seller recovers any decline in the property's value after the date of breach until the buyer stops interfering with the seller's resale efforts.

For example, a buyer sues a seller seeking specific performance of the purchase agreement. The seller claims the buyer breached the purchase agreement by failing to satisfy contingencies as scheduled. The buyer claims the seller breached when they canceled, thus *excusing* the buyer from further performing. The buyer sues to recover the property and records a *Notice of Lis Pendens*, which *clouds title and interferes with the marketability* of the property.

specific performance action
An action to compel performance of an agreement, such as a purchase agreement or assignment of rents.

Ultimately, the buyer is held to have breached the agreement and the lis pendens is removed from the record, called *expungement*.

A seller, whether they attempt to resell or retain the property, generally bears the risk of any fluctuation in the value of the property after the buyer breaches. The breach is the cutoff date for recovery of a decline in value, unless the buyer later interferes.

However, the risk of loss due to a decline in value after the date of breach is shifted to the buyer until the date title is cleared of the recorded lis pendens if the recording interferes with the seller's prompt and diligent efforts to resell the property.[6]

Seller's expenses post-breach as a natural consequence

A seller who takes the property off the market or is not diligent in their efforts to resell it after the buyer's breach is limited in their recovery of money to their *actual transactional expenses* and any *operating expenses* incurred to fulfill the seller's performance under the purchase agreement up to the time of the buyer's breach.

Recoverable money losses the seller may incur as **transactional expenditures** include:

- escrow and title charges;
- lender charges for beneficiary statements or payoff demands;

6 **Askari** v. **R & R Land Company** (1986) 179 CA3d 1101

- lender or carryback seller charges to process the buyer's credit clearance, mortgage application or mortgage assumption; and
- other expenses and property reports incurred in reasonable reliance on the buyer's full performance of the purchase agreement.

Recoverable and nonrecoverable losses

However, *ownership and operating expenses* incurred by a seller who chooses to either retain the property or delay reselling the property are not recoverable. The seller, as the owner of the property, remains responsible for the expenses of carrying and maintaining the property since these expenses are not incurred due to a buyer's agreement to purchase or a breach by the buyer — they are incurred because the seller owns the property.

However, some *operating losses* incurred by a seller due solely to their *compliance* with the terms of a purchase agreement are recoverable, including:

- the seller's *relocation expenses* to reoccupy the property if they vacated after all contingencies allowing the buyer to cancel were eliminated;
- rental income lost after the breach on *units left vacant or vacated* by the terms of the purchase agreement;
- a *crop revenue loss* due to the planting season having passed at the time of the buyer's breach; and
- a price drop on the *late harvest* of a crop brought about due to the buyer's breach.[7]

Intended use of net proceeds to buy a replacement property

Consider a buyer who enters into a purchase agreement knowing the seller intends to acquire replacement real estate with the net proceeds from the sale. After all the buyer's contingencies are eliminated and no uncertainties remain about the buyer's full performance, the seller enters into a purchase agreement to buy replacement property without conditioning their purchase on the "sale of other property."

The buyer then breaches and the seller is unable to complete their purchase of the replacement property. The seller incurs expenses and losses to avoid liability for having unconditionally agreed to purchase the replacement property.

Expenses incurred on the replacement property transaction are recoverable since:

- the buyer knew when they entered into the purchase agreement that the seller intended to contract to purchase replacement property based on the buyer's agreement to purchase; and
- the seller agreed to purchase other property in reasonable reliance on their buyer closing the sales escrow since all contingencies had been removed and no obstacles to closing existed, except for the breach.[8]

7 **Wade** v. **Lake County Title Company** (1970) 6 CA3d 824

8 **Jensen** v. **Dalton** (1970) 9 CA3d 654

Operating losses during the resale period

A seller who promptly takes steps to diligently remarket the property for sale after the buyer breaches may recover their operating expenses and carrying costs of the property incurred *after the date of breach*, subject to offsets for rent credit, owner's use, etc.

Recoverable operating losses and carrying costs are limited to those the seller incurs during the period beginning on the buyer's breach and ending on the earlier of:

- the date a *resale closes*;
- the *trial judgment* on the breach; or
- the date of *withdrawal* of the property from the resale market.

The seller who decides to promptly resell the property and then recover any losses from the buyer has a duty to the breaching buyer to limit the operating and ownership losses, called *mitigation of damages*. To do so, the seller needs to take immediate steps to market the property for resale within the shortest possible time.[9]

Calculating the losses

To begin calculating the seller's net loss, the seller's costs of maintaining their ownership are totaled. However, the recoverable operating expenses and carrying costs of the property incurred by the seller during the resale period are limited to operating and ownership expenses understood by the buyer to exist at the time they entered into the purchase agreement.

However, the buyer is *due a credit* for the rental value of the seller's occupancy, called **implicit rent**, and any rental income received by the seller from the property after the buyer's breach.

implicit rent
The value of the use of a property by the owner.

Thus, for a seller to recover on-going losses incurred to carry the ownership of the property before resale or trial, a full accounting of income, expenses and the carrying costs of financing is required.

Interest on recovered losses

A seller is also *entitled to interest* on the losses and expenditures they recover for the decline in the property's value, expenses of the breached transaction, resale related expenses and the carrying costs of the property during the resale effort.[10]

Unless the purchase agreement states otherwise, the interest is collectable at the legal annual rate of 10%, accruing from the date the recoverable loss or expenditure was incurred, called *prejudgment interest*.[11]

If the seller *retains the property*, no property operating or value losses after the breach are recoverable on which interest can accrue.

9 **Spurgeon** v. **Drumheller** (1985) 174 CA3d 659
10 CC §3307
11 CC §3289(b)

For the seller who *diligently remarkets* the property for resale, recoverable resale costs and out-of-pocket carrying costs of the property not offset by rental income or the rental value of the seller's use of the property accrue interest from the date of the expenditures.

When the buyer performs and closes escrow, the seller no longer owns the property. On closing, the seller receives the net sales proceeds for their equity in the property.

Internet depends on property use

When escrow does not close and the seller does not receive the net sales proceeds for their equity due to the buyer's breach, the question of whether they are entitled to interest on their *net equity* hinges on the seller's use of the property at the time the purchase agreement was entered into.

For example, a *seller's use* of the subject property falls into one of two categories:

- *income-producing property* used as the seller's residence, as the seller's trade or business (implicit rent) or as a residential or commercial rental; or
- *non income-producing property*, such as vacant land or the seller's vacant residence.

Rents received from income producing property and implicit rent for the owner's use are the *economic equivalent* of *interest* on the dollar value of the property. Thus, if the seller were to also receive interest on their equity in income-producing property or property they occupied until it resells they will enjoy a nonrecoverable windfall. It is a double recovery on their equity in the form of both interest and rent, which are *economic equivalents*.

The seller who occupies the property until it is resold is charged for the value of their use, called *implicit rent*. The amount of **implicit rent** is an offset against all money recoverable from the breaching buyer, including interest on the seller's equity.

Collecting on vacant land

For vacant unused land or the seller's vacant residence, a breach by the buyer again fails to convert the seller's equity into cash or cash equivalent. Thus, the seller temporarily retains ownership of the equity, the price of which may be increasing, decreasing or remaining the same depending on price fluctuations in the local market until it is resold.

The next question becomes whether the seller can collect interest on their equity in the property?

First, any interest due on the dollar amount of the net equity can only accrue from the *scheduled closing date* of the breached contract — the date the benefits from the breached sale in the form of cash for the seller's net equity were to be received by the seller — up to and ending on the *date of resale or trial*. Any interest due accrues at the legal rate of 10%. However, if the seller agreed to an installment sale, the note rate for the carryback paper is the controlling rate.

Next, if the breached purchase agreement contains a provision limiting the dollar amount of losses the seller can collect, the losses recoverable are controlled by the agreed-to limit, except for the accrual of interest, an additional amount. [See **RPI** Form 150]

In conclusion, when the buyer breaches an agreement to purchase vacant or non-income producing property, interest is due on the net sales proceeds the seller was to receive on the sale, from the date scheduled for closing until the property is resold.

Chapter 32 Summary

A seller's total recoverable losses include:

- the operating and carrying costs of mortgage interest payments, taxes, insurance, maintenance and utilities, incurred by the seller during the period between the date of the breach and the date escrow closed on the resale;
- the increased closing costs due to the seller's payment of the new buyer's nonrecurring closing costs and financing fees on the resale which reduced the seller's net proceeds compared to the net proceeds the seller was to receive from the breaching buyer;
- the additional resale costs of the prepayment penalty demanded by the lender on the mortgage payoff; and
- interest on the seller's net equity from the date escrow was to close to the date of closing on the resale.

A seller of real estate who is faced with a breaching buyer and the failure of the sales transaction needs to promptly decide whether to enforce the purchase agreement, remarket the property for sale and diligently seek a buyer or retain the property and postpone or entirely forego any resale effort.

A buyer, due to their breach of the purchase agreement, owes the seller their actual money losses caused by the breach, called damages, which are classified as:

- general damages for the dollar amount of any decline in the property's fair market value below the price agreed to in the purchase agreement;
- special damages for transactional costs, marketing expenses and any further drop in property value after the buyer's breach if the buyer interferes with resale effort; and
- interest from the date of the buyer's breach to the closing date of a resale of the property.

To limit the breaching buyer's liability, the seller's loss on a resale at a price lower than the price agreed to by the breaching buyer is limited to

the amount of the value decline which occurs by the date of the buyer's breach, not the date of resale. Any further decline in value after the date of breach to the date of resale is recoverable only if the buyer interferes with the seller's diligent resale efforts.

Buyer interference with resale efforts typically consists of filing a specific performance action and recording a Notice of Lis Pendens, or taking possession and refusing to vacate.

A seller who takes the property off the market or is not diligent in their efforts to resell it is limited in their recovery of money to their actual transactional expenses and any operating expenses incurred to fulfill the seller's performance under the purchase agreement up to the time of the buyer's breach. Ownership and operating expenses incurred by a seller who chooses to either retain the property or delay reselling the property are not recoverable.

A seller is also entitled to interest on the losses and expenditures they recover for the decline in the property's value, expenses of the breached transaction, resale related expenses and the carrying costs of the property during the resale effort.

Chapter 32 Key Terms

Chapter 33

Liquidated damages provisions

Learning Objectives

After reading this chapter, you will be able to:

- advise a buyer on the need in a falling real estate market to agree to a limit for their liability exposure if they breach their purchase agreement;
- determine the dollar amount of a buyer's good faith deposit or more a seller is entitled to receive when a buyer breaches a purchase agreement; and
- assess the reasonableness of a seller's claim on a breaching buyer's deposit under a purchase agreement containing a liquidated damages or other liability limitation provision.

Key Terms

forfeiture
good faith deposit
liquidated damages provision
seller's net sheet

Windfalls and responsibility for losses

A fundamental premise in law: when you wrongfully cause another person to lose money, you are responsible for *repayment* of the loss, and nothing more. This economic concept was codified for California real estate transactions in 1872 and remains intact today.[1]

However, an equally fundamental premise holds that windfalls are abhorred by all since they are unearned.

These two legal precepts are disturbed by the inclusion of a **liquidated damages provision** (also called a forfeiture provision) in a purchase agreement.

liquidated damages provision
A provision stating the maximum money losses a buyer owes a seller in the event the seller incurs losses on a buyer's breach.

1 Calif. Civil Code §3307

Use of a *liquidated damages provision* is an attempt, by its wording, to:

- *limit a buyer's responsibility* for payment of losses they inflict on a seller; and
- *provide the seller with a windfall* at the buyer's expense.

The contractual liquidated damages provision creates aberrations in the natural expectations held by individuals in the transaction.

good faith deposit
A money deposit made by a buyer to evidence their good faith intent to buy when making an offer to acquire property. Also known as earnest money. [See **RPI** Form 401 §1.1

For instance, a seller expects to lose nothing of value in exchange for the buyer's **good faith deposit** if the buyer fails to close the transaction. However, the buyer expects a refund of their *good faith deposit* if they do not acquire the property.

A seller's agent, charged with a *duty of care* for their seller, needs to understand the contractual and financial nature of their seller's position under a purchase agreement. This allows the agent to properly advise the seller if a buyer breaches the purchase agreement. When the buyer breaches and the seller cancels the purchase agreement, the seller still *owns the property*, although with no further claim by the buyer of a right to acquire it.

Losses and resolving a breach

The good faith deposit, even if released to the seller after contingencies have been removed, remains the buyer's money until:

- the buyer receives *consideration* (the property); or
- the deposit is *offset to reimburse* the seller for their *actual money losses* suffered due to a breach by the buyer.

The seller's purported loss of prospective buyers and prior market synergies, and the infliction of seller frustration, stress and inconvenience — all due to the buyer's breach — are not *money losses*. Thus, these ancillary or collateral situations leave the seller with nothing of value lost to collect in terms of money.

However, the seller's agent properly focuses on *resolving* a breached and failed sales transaction by immediately turning their attention to helping their client "clear out" the transaction so the property can be remarketed to another prospective buyer. Here, the seller's agent is still obligated to locate buyers under the seller's exclusive right-to-sell agreement, unless it has expired.

Thus, cancellation instructions need to be given to escrow to terminate the breached purchase agreement and escrow instructions, unless the resale value of the property has dropped or the seller has reason to pursue a specific performance action and forego reselling or retaining the property. [See Chapter 29]

Money losses reimbursed

What is the seller's agent to do about a buyer's good faith deposit when the buyer breaches a purchase agreement?

While the agent's knee-jerk reaction may be to secure the buyer's funds for the seller so half of the deposit is earned as a broker fee, the first reasonable step to take is to analyze the extent of the seller's loss of money. The buyer owes the seller the seller's actual money losses, expenditures which will not be reimbursed on a resale. Thus, the seller has a *claim* on the buyer's good faith deposit as the *primary source for recovery* of money losses.

To the seller's benefit, the seller's recoverable losses are quite straightforward for calculating the amount of the demand to be made on the buyer. Presuming, as the seller's agent does, that the seller will not interfere with the listing and allow the agent to locate a new prospective buyer, the property is likely to be resold in the near future.

Accounting for income and expenses

A fairly accurate representation of the money losses the seller incurred is calculated by a comparison of the net proceeds received on the closing of a **resale** with the **seller's net sheet** estimating the net proceeds the seller was to receive on the **canceled sale**. If the comparison of the net sheets on each transaction presents evidence the seller received less proceeds on the resale, the seller has a factual basis for recovery.

seller's net sheet
A document prepared by a seller's agent to disclose the financial consequences of a sale when setting the listing price and on acceptance of a buyer's price in a purchase offer. [See **RPI** Form 310]

Typically, reduced net sales proceeds on the resale are due to a decline in property value, increased transactional costs and transactional costs on the failed sale not reimbursed by the resale. [See **RPI** Form 310]

The ongoing *operating and carrying costs* are not recoverable expenses if the property remains *rented or used* by the owner prior to resale. The actual or implicit rent typically remains the same, as do the operating expenses and carrying costs of the property, after the breach until the closing of the resale. If rents were decreased or costs increased by agreement with the breaching buyer and those conditions remain after the breach, the buyer is liable for those amounts as losses resulting from their breach.

Typically, operating income and expenses are not altered by the terms of the purchase agreement. Thus, little loss (if any) exists for the seller to recover on their continued ownership of the property unless the value of the property declined below the agreed sales price at the time of the breach.

Demands, challenges and limitations

The seller making a demand on a breaching buyer for the deposit is confronted with a decision about *when* to make the demand. The seller may *make a demand* for all or a portion of the good faith deposit at either:

- the *time of the breach*; or
- *after closing a resale* of the property when a loss, if any, is known.

To analyze the demand process, first look to the provisions of the purchase agreement used for the sale of a *one-to-four unit residential property* to a buyer-occupant. In contrast, liquidated damages provisions in all other types of property transactions end in the same result, but for different reasons as reviewed later in this chapter.

When a liquidated damages provision is included in the purchase agreement for one-to-four residential units and the buyer and seller both initial the provision, they have agreed by the wording that the buyer's good faith deposit is to be *forfeited* to the seller on a breach by the buyer. But like all agreements, the provisions are subject to judicial enforcement based on contract law principles that then exist.

Here, liquidated damages provisions are enforceable by a seller, but only to *set the limit* of the buyer's liability to the seller. Thus, the ceiling on the seller's recovery is set at the amount agreed to be forfeited, typically the good faith deposit.

For example, when a breaching buyer demands the deposit be refunded, the seller becomes obligated to provide an accounting showing their losses **equaled or exceeded** the amount of the deposit if they intend to keep the entire deposit.

If the losses are **less**, the seller is entitled to only that amount, not the entire deposit as actually worded in the liquidated damages provision. Here, the seller can recover the money they have lost up to the total amount of the deposit referenced in the agreed liquidated damages provision and no more, no matter the amount of the deposit.

Making a demand

When a liquidated damages provision exists, the proper initial reaction of the seller and the seller's agent is to make a demand on the buyer for the entire good faith deposit if it does not exceed 3% of the price since this amount of **forfeiture** is *presumed valid*. Note the operative word is *presumed*.[2]

Once the demand for the forfeiture has been made on the buyer — without concern for the actual money losses the seller may have experienced or will experience on a resale — the seller merely waits for the buyer's response. If it is positive and the funds are released to the seller, the seller has won without argument. Ideally for the seller, the buyer will not later realize that the seller's actual money losses were less than the amount released and make a demand for a refund.

However, if the buyer's agent and the buyer are as well informed as the seller and their agent, the buyer will *challenge* the liquidated damages provision — and the validity presumption — as *voidable* and demand a return of their deposit. In analysis, the provision's validity is a *rebuttable presumption*. Thus, the provision is a *forfeiture* and unenforceable as such.

To recover any amounts of the deposit, the seller needs to have money losses to justify their retention of any or all of the liquidated damages deposit. Thus, the total amount of the deposit — arbitrary for losses and coincidental to the price paid — has no legal relationship to the losses the seller may suffer on the buyer's breach beyond security for the recovery of actual losses.

2 CC §1675(c)

Calculating the seller's losses

When a breaching buyer challenges the liquidated damages provision as *voidable*, the seller needs to itemize and calculate their losses on the resale, along with their permissible interim operating and carrying costs of the property prior to a resale, even if:

- no liquidated damages provision exists in the purchase agreement;
- the amount of the deposit for liquidated damages is more than 3% and thus presumed invalid;
- the liquidated damages or *liability limitation provision* places a ceiling on the buyer's liability for the seller losses; or
- no provision limiting recovery existed in the purchase agreement restricting the seller's right to recover all their losses.

Under any of the above scenarios, the seller is to itemize their money losses, to include:

- any decline in the property's value by the time of the buyer's breach;
- the seller's transactional costs incurred on the lost sale which are not recoverable on a resale; and
- any increased operating costs or rent losses caused by the terms of the purchase agreement for the benefit of the buyer and incurred through the date of a resale.

Collecting from the buyer

The buyer is to cover these itemized losses from the good faith deposit up to any dollar limitation set by a liquidated damages or *liability limitation provision* in the purchase agreement.

Before the seller may *recover losses caused by the breaching buyer* when the buyer asserts their obligation to pay only the seller's actual money losses, the seller needs to:

- promptly proceed to market, resell and close a resale of the property rather than retain the property;
- calculate the total amount of the price-to-value difference at the time of the breach, lost transactional expenses on the breached sale and the loss of expenditures on non-value-adding improvements or repairs;
- make a demand on the buyer for the amount of the itemized money losses; and
- if not paid, pursue collection of the lost money and a release of the amount from the buyer's deposit — subject to any agreed limitation on the dollar amount of the buyer's liability for their breach.

Challenging the validity-of-forfeiture presumption

When the seller demands the buyer's good faith deposit, the buyer and buyer's agent need to understand:

- the funds *belong to the buyer* until escrow closes, which will not occur due to the buyer's breach;
- the seller has a *claim against the deposit* for recoverable losses; and

- the buyer is to make a demand on the seller for a statement of *itemized losses* before the buyer pays any compensable losses incurred by the seller.

Thus, when a liquidated damages provision exists on the sale of a one-to-four unit residential property and is initialed by both the seller and buyer, the buyer's demand for an itemization of the seller's money losses constitutes a *legal challenge*. The demand rebuts the presumed validity of a forfeiture-of-deposit provision for deposits not exceeding 3% of the purchase price.

On making the request of the seller for an accounting, the buyer awaits the seller's response. If the seller fails to respond with an accounting, they either did not incur a recoverable loss or waived any claim they may have to recover their losses.

Limiting the breaching buyer's liability

A seller is entitled to recover the entire amount of their money losses caused by the buyer's breach when the purchase agreement does not contain a liquidated damages provision or contract liability limitation provision.

Conversely, the seller is limited in their recovery when the purchase agreement (for the sale of one-to- four residential units to a buyer-occupant) includes an initialed liquidated damages provision or a contract liability limitation provision.

In either case, if an *accounting* is sought by the buyer for the seller's recoverable money losses, the seller needs to present an accounting in order to be reimbursed for them.

When an initialed liquidated damages provision is included in a purchase agreement, the breaching buyer avoids the forfeiture called for by challenging the *presumed validity* of any amount **up to 3%** of the purchase price.[3]

However, for the seller to enforce a forfeiture of any portion of a deposit **exceeding 3%** of the purchase agreement price, the seller needs to challenge the *presumed invalidity* of the excess by demonstrating in an accounting that their losses on the sale exceeded 3% of the purchase price.[4]

Thus, the liquidated damages provision has a "split-personality" aspect: the responsibility of the buyer is to challenge the *presumed validity* of a forfeiture of **3% or less**, while the responsibility for challenging the *presumed invalidity* of a forfeiture of **more than 3%** is the seller's.

In general, liquidated damages provisions, other than on the sale of one-to-four residential units to a buyer-occupant, are presumed to be *valid*. However, they are also classified as **forfeitures** and are unenforceable if they do not represent an amount which bears some *reasonably close relationship* to the actual losses the seller will incur due to monetary harm inflicted on them by the buyer's default.

forfeiture
Loss of money, rights or anything of value due to failure to perform, a remedy abhorred by the courts.

3 CC §1675(c)
4 CC §1675(d)

When the amount of the forfeiture exceeds the seller's losses, the buyer can *void* the provision as unreasonable. Thus, the liquidated damages provision is *voidable* as it is only presumed to be valid if the amount is reasonably close to actual losses.

Liability ceiling or forfeiture

If a buyer and seller do not agree to either a liquidated damages provision or a contract liability limitation provision, the buyer who enters into such a purchase agreement and breaches is liable for an *unlimited amount of losses* incurred by the seller due to the buyer's breach. In the economic environment of a stable resale market for property or one of generally rising prices, the buyer takes little risk when entering into a purchase agreement without a ceiling on their liability exposure.

However, it is for buyers in a static market or one following a peak in prices or when mortgage rates rise that the buyer's agent needs to be diligent in their protection of the buyer by explaining the need for a *ceiling on liability* exposure. Otherwise, when the value of the seller's property has dropped below the sales price, the defaulting buyer ends up being liable for often large amounts of seller losses.

As for the seller's agent, they are to advise their seller in times of weak or weakening pricing power to avoid agreeing to a ceiling on the buyer's liability and to obtain a larger deposit.

Seller's refusal to refund as a breach

Consider a buyer of a single family residence (SFR) who has entered into a purchase agreement containing an initialed, liquidated damages provision.

Prior to closing, the buyer waives all contingencies and releases their original and additional good faith deposit to the seller in an amount in excess of 3% of the agreed price. At the time of closing, the buyer decides not to close escrow on the purchase of the property.

The seller promptly remarkets the property, accepts an offer and quickly closes a resale of the property, but at a slightly lower price. The buyer then makes a *demand on the seller* to return that portion of the deposit now held by the seller which exceeds the seller's losses. The breaching buyer is willing to cover the seller's loss in the amount of the reduced net proceeds on the resale.

The seller rejects the buyer's demand for a refund, claiming the funds released were option money which they are entitled to keep as consideration for their *irrevocable offer* to sell the property to the buyer, which the buyer did not exercise by closing escrow, a unilateral contract situation.

A bilateral agreement

In the previous example, the liquidated damages provision in the purchase agreement indicates the agreement is *bilateral*. The purchase agreement called for a forfeiture of the deposit if the buyer fails to close escrow, the antithesis of an option agreement which is unilateral and contains no

forfeitures by its nature. Thus, the seller's defense for keeping the buyer's deposits as option money consideration for granting an option is without merit.

Also, the seller did not attempt to show that their losses caused by the buyer's breach equaled or exceeded the buyer's deposits. The seller did not produce closing statements for either the lost sale or the resale, lost transactional expenses, non-value-adding expenditures for repairs or maintenance, any recoverable operating costs for carrying the property or lost rental value until the close of the resale.

Here, the liquidated damages provision becomes a *promise by the seller* to refund that portion of the deposit which exceeds the seller's recoverable losses, due to either:

- a buyer's challenge of the forfeiture's reasonableness; or
- the forfeiture amount being in excess of 3% of the purchase price.

Thus, the seller's failure to refund (or release) the amount exceeding their losses is a *breach by the seller* of the liquidated damages provision and the purchase agreement.[5]

Further, if the purchase agreement did not contain a liquidated damages provision or other contractual liabilities limitation, the seller would still have been *limited to collecting* no more than their actual losses. Thus, the excess amount of the buyer's deposit over the seller's losses is refunded by the seller or released from escrow to the buyer.

Court-ordered forfeiture is also unenforceable

Consider a buyer and seller of a one-to-four unit residential property who enter into a court-ordered settlement agreement to resolve their dispute over their performance of the purchase agreement and agree to close escrow. The settlement agreement contains a forfeiture provision calling for the release of the buyer's good faith deposit to the seller if the buyer does not complete the sale as agreed.

However, the buyer is unable to secure purchase-assist financing and cancels escrow, a breach of the settlement agreement since closing escrow was not contingent on their obtaining a mortgage.

The seller seeks to recover the buyer's good faith deposit. However, the seller has incurred no loss due to the buyer's failure to perform. The property is resold at a higher price.

The buyer claims the seller cannot enforce the forfeiture provision in the court-ordered settlement agreement since any provision agreeing to the forfeiture of the good faith deposit is limited by existing contract law to a *provable loss*.

5 **Allen** v. **Smith** (2002) 94 CA4th 1270

The seller claims the forfeiture provision is enforceable without a proof of loss since the provision is contained in a court-ordered settlement agreement between the buyer and seller, not in a privately negotiated real estate purchase agreement.

Here, as in all forfeitures of money arising out of any real estate transaction, the seller may not enforce the forfeiture provision to recover the buyer's good faith deposit unless they can show an actual money loss. The court-approved settlement agreement is a contract agreed to by the buyer and seller, not the court. Thus, as controlled by contract law, enforcement of liquidated damages provisions in a real estate purchase is prohibited, unless the seller incurs a loss and then the recovery is limited to their money losses.[6]

6 **Timney** v. **Lin** (2003) 106 CA4th 1121

Chapter 33 Summary

Use of a liquidated damages provision is an attempt, by its wording, to:

- limit a buyer's responsibility for payment of losses they inflict on a seller; and
- provide the seller with a windfall at the buyer's expense.

The breaching buyer owes the seller the seller's actual money losses, expenditures which will not be reimbursed on a resale. Thus, the seller has a claim on the buyer's good faith deposit as the primary source for recovery of money losses. The seller may make a demand for all or a portion of the good faith deposit at either:

- the time of the breach; or
- after closing a resale of the property when a loss, if any, is known.

When a liquidated damages provision is included in the purchase agreement for one-to-four residential units and the buyer and seller both initial the provision, they have agreed by the wording that the buyer's good faith deposit is to be forfeited to the seller on a breach by the buyer.

To recover any amounts of the deposit, the seller needs to have money losses to justify their retention of any or all of the liquidated damages deposit. Thus, the total amount of the deposit — arbitrary for losses and coincidental to the price paid — has no legal relationship to the losses the seller may suffer on the buyer's breach beyond security for the recovery of actual losses.

When an initialed liquidated damages provision is included in a purchase agreement, the breaching buyer avoids the forfeiture called for by challenging the presumed validity of any amount up to 3% of the purchase price.

For the seller to enforce a forfeiture of any portion of a deposit exceeding 3% of the purchase agreement price, the seller needs to challenge the presumed invalidity of the excess by demonstrating in an accounting that their losses on the sale exceeded 3% of the purchase price.

The liquidated damages provision becomes a promise by the seller to refund that portion of the deposit which exceeds the seller's recoverable losses. Thus, the seller's failure to refund (or release) the amount exceeding their losses is a breach by the seller of the liquidated damages provision and the purchase agreement.

Chapter 33 Key Terms

Chapter 34

Arbitration: the independent beast

Learning Objectives

After reading this chapter, you will be able to:

- identify the final and unappealable nature of arbitration awards, and the corresponding risk facing any party who agrees to binding arbitration;
- distinguish the limited circumstances for an erroneous arbitrator's award to be corrected; and
- contrast arbitration and litigation from mediation as the preferable method of dispute resolution.

Key Terms

arbitration
arbitrator
attorney fee provision
mediation

Lost right to correct a decision gone awry

Consider a seller who contacts a brokerage office to list their property for sale. The seller and seller's agent sign a listing agreement containing a provision calling for disputes to be submitted to **binding arbitration** — no judicial oversight permitted.

A buyer is located by a buyer's agent employed by the same broker. The broker and both agents are aware the buyer is financially unstable and may encounter difficulties closing the transaction. However, confirmation of the buyer's creditworthiness and net worth are not made the subject of a *contingency provision* by the buyer's agent who prepares the offer for the buyer. If included, a contingency provision authorizes the seller to cancel the purchase agreement if the seller determines the buyer's credit is unsatisfactory.

The buyer's financial status is not disclosed to the seller when the seller's agent, alone, submits the buyer's offer. The supervising broker fails to catch or correct the oversight.

arbitration
A form of dispute resolution voluntarily agreed to in contracts authorizing a third-party arbitrator to issue a binding award which cannot be reviewed and corrected by a court of law.

The seller accepts the purchase agreement offer which provides for payment of a fee to the broker. Each agent is to receive a share of any fee their broker receives on the sale based on formulas agreed to in their separate written employment agreements with the broker.

Later, the buyer fails to close the transaction due to their financial condition. The seller discovers that the seller's agent, broker and buyer's agent all knew of the buyer's financial condition. The seller makes a demand on the broker and both agents for the seller's losses on the failed transaction, claiming the buyer's financial condition was a *material fact* the agents and broker knew about and failed to disclose.

Binding arbitration as a loose noose

arbitrator
A neutral third-party appointed to hear a dispute who is authorized to make a final decision awarding judgment in favor of one of the parties.

Continuing with the previous example, the dispute is submitted to *binding arbitration*. The **arbitrator** awards money losses to the seller based on the professional misconduct of the seller's agent and employing broker for failure to disclose their knowledge of the buyer's unstable financial status — the broker being *vicariously liable* as the employer of the seller's agent who failed to make the disclosure.

Further, the arbitrator issues the seller a money award against the buyer's agent. The arbitrator erroneously rules the buyer's agent and the seller's agent were "partners" and equally liable for the seller's losses since they shared the fee the broker received on the transaction. Thus, the buyer's agent is *improperly* held liable as a business partner of the seller's agent for the seller's money losses resulting from the misconduct of the seller's agent.

The buyer's agent seeks to vacate the portion of the arbitration award holding them liable as a "partner" of the seller's agent, claiming the arbitrator incorrectly applied *partnership law* to a real estate agency and employment relationship controlled by other laws. May a court correct the award against the buyer's agent when an arbitrator wrongfully applies partnership and agency law?

No! An arbitrator's award, based on an erroneous application of law, is not subject to *judicial review*. A judicial review of an arbitrator's award was not included as a condition of an award in the purchase agreement arbitration provision. Thus, the arbitrator acted within their powers granted by the arbitration provision, even though they applied the wrong law and produced an erroneous result.

A court of law confronted with a binding arbitration agreement is unable to review the arbitrator's award for errors of fact or law even if the error is obvious and causes substantial injustice.[1]

1 **Hall** v. **Superior Court** (1993) 18 CA4th 427

The arbitration provision in purchase agreements

Many pre-printed brokerage and purchase agreements, such as those published by the California Association of Realtors (CAR), perfunctorily include a boilerplate **arbitration provision.** The *arbitration provision* included in a purchase agreement, listing or lease agreement *forms a separate contract* between the parties who initial the provision and remains enforceable despite any defects in the underlying agreement containing the provision.

Thus, the arbitration provision in a real estate purchase agreement or listing:

- forms a separate arbitration agreement between the parties who agree to be bound by the provision;[2] and
- defines the arbitrator's powers and the limitations on those powers.

The rights of the person agreeing to arbitration are established by the incorporation in the provision of arbitration statutes, applicable law limitations and discovery policies. Also controlling are the rules adopted by the arbitrator named in the provision, such as the *American Arbitration Association*.

Unless the arbitration provision states an arbitration award is "subject to judicial review," the award resulting from arbitration brought under the clause is *binding and final*, with limited exceptions discussed below.

Without *judicial review* of an award in an arbitration action, the parties have no assurance the award will be either fair or correct — it is *arbitrary* by name.

*Editor's note — **RPI** purchase agreements and addenda do not contain either an arbitration provision or an attorney fee provision as a matter of policy to reduce the risk of litigation to brokers and agents by making litigation less economically feasible for sellers and buyers — and their attorneys.*

Limited grounds for correction

Any defect in an arbitrator's award resulting from an error of fact or law, no matter how flagrant, is neither reviewable nor correctable, unless:

- the arbitrator exceeded their authorized powers;
- the arbitrator acted with fraud or corruption;
- the arbitrator failed to disclose grounds for their disqualification of a dispute;
- the award was procured by corruption, fraud or other misconduct; or
- the refusal of the arbitrators to postpone the hearing substantially prejudiced the rights of the party.[3]

An arbitrator, unlike a judge in a court of law, is not bound by the rules of law controlling conduct when arbitrating a dispute. Even when the arbitrator agrees to follow applicable California law, their *erroneous award*,

2 Calif. Code of Civil Procedure §1297.71; **Prima Paint Corporation** v. **Flood & Conklin Mfg. Co.** (1967) 388 US 395

3 CCP §1286.2

unlike an award of a court, cannot be corrected by any judicial review.

The arbitrator's award is final and binding on all parties, unless:

- the parties have agreed the arbitrator's award is subject to "judicial review"; or
- the arbitrator exceeded their powers set by the arbitration provision.

Otherwise, no judicial oversight exists — by petition or appeal — to correct an arbitrator's *erroneous award*.

The capricious arbitrator's award

Consider a buyer and seller of real estate who enter into a purchase agreement containing an arbitration provision. They both initial the provision on the request of their agents.

Prior to closing, the seller discovers the property has significantly greater value than the price the buyer has agreed to pay in the purchase agreement, a condition brought about by a sharply rising real estate market. Motivated by their belief the property's value will continue to rise to price levels other buyers will be willing to pay, the seller refuses to close the sale.

The buyer files a "demand for arbitration" with the arbitrator, claiming the seller breached the purchase agreement. The buyer no longer wants the property and does not seek their alternative remedy of *specific performance* of the purchase agreement. The buyer seeks only to recover their *money losses* amounting to the difference between the purchase price they agreed to pay and the increased value of the property on the date of the seller's breach.

Prior to completion of the arbitration hearings, the value of the property drops significantly due to a cyclical local economic downturn. The arbitrator is aware the property's current value has fallen below the sales price agreed to in the purchase agreement, as well as below the increased value at the time of the seller's breach.

Not the requested award

Continuing our previous example, the arbitrator then issues an award in favor of the buyer. However, the award is not for the money losses the buyer asked for and was entitled to. Instead, the arbitrator's award grants the buyer the *right to purchase* the property for a price equal to its current fair market value, a remedy not available under law and not agreed to by the buyer or seller.

The buyer petitions the court to vacate the arbitration award and remand the case for a money award as requested in the arbitration. The buyer claims the arbitrator exceeded their powers by awarding a result that was neither contemplated by the law controlling the purchase agreement nor sought by the parties.

Did the arbitrator exceed their powers, act corruptly or prejudice the rights of the parties by awarding an equitable remedy (specific performance) which was in absolute conflict with the purchase agreement and beyond any expectations of either the buyer or the seller under applicable law?

No! The arbitrator was not corrupt and did not exceed their powers by awarding the buyer the right to purchase the property at its current market value. The erroneous award was drawn from the arbitrator's (mis)interpretation of the purchase agreement and the law.

Here, the remedy awarded a buyer by an arbitrator in binding arbitration is not reviewable by a court of law as long as the remedy has some remotely conceivable relationship to the contract in dispute.[4]

Commercial uncertainty in market instability

When individuals enter into a purchase agreement, each person has expectations about their and the other person's performance as defined by the terms of the agreement and set by existing law, also known as *certainty of contract*. Without certainty in the real estate market, contracting to buy and sell becomes a commercial uncertainty making the market less stable.

Yet, by agreeing in the purchase agreement to binding arbitration, not only is a person forced to accept an arbitrator's incorrect application of law, they are forced to proceed with arbitration and accept an award that is *impossible to predict*.

Arbitrator's powers exceeded

Although an arbitrator is not bound to follow the law when issuing an award, an arbitrator *exceeds their powers* when they attempt to also *enforce* their award. Enforcement of an award is conduct reserved for a court of law after the award has been reduced to a judgment by the court.[5]

An arbitrator also exceeds their powers when they impose fines on a party to arbitration for failure to comply with the arbitration award. An arbitrator does not have the power to impose *economic sanctions*, such as penalties and fines.

However, if an arbitration agreement authorizes the arbitrator to appoint a receiver or impose fines, the arbitrator then has the power to do so, despite the general prohibition barring arbitrators from enforcing their awards.[6]

Attorney's fees as a power

Now consider a buyer and seller who enter into a purchase agreement containing both an arbitration provision, which they all initial, and an **attorney fee provision**. The *attorney fee provision* entitles the party who prevails in an action to be awarded attorney fees.

The buyer terminates the purchase agreement and seeks to recover all their transactional costs, claiming the seller breached the agreement. As agreed, the dispute is submitted to binding arbitration. The arbitrator rules in favor of the seller, but denies the seller's request for attorney fees as called for under the attorney fee provision.

attorney fee provision
A provision in an agreement permitting the prevailing party to a dispute to receive attorney fees when litigation arises due to the agreement. [See **RPI** Form 552 §23.2]

4 **Advanced Micro Devices, Inc.** v. **Intel Corporation** (1994) 9 C4th 362
5 **Marsch** v. **Williams** (1994) 23 CA4th 238
6 **Mastrobuono** v. **Shearson Lehman Hutton, Inc.** (1995) 514 US 52

The seller seeks a correction of the arbitration award in a court of law, claiming the arbitrator exceeded their powers by denying an award of attorney fees as agreed in the purchase agreement.

Here, the arbitrator exceeded their powers by failing to award attorney fees. The seller, as the prevailing party, was entitled to an award of attorney fees by a provision in the purchase agreement which was the subject of the arbitration. If the agreement underlying the dispute contains an attorney fee provision, the arbitrator is to award attorney fees to the prevailing party.[7]

However, the attorney fee dilemma has a flip side. Not only will the arbitrator award attorney fees to the winner if the recovery of fees is called for in the purchase agreement, the arbitrator also determines the amount of attorney fees to be awarded — an amount which is not subject to court review.[8]

The myth surrounding arbitration

The real estate market has become flooded with agents and brokers inculcated to reassure their buyers and sellers that initialing the *arbitration provision* is "standard practice." When guidance is given to clients by their agents, it is that arbitration bears multiple benefits with no comment on the risks. This advice is incorrect.

Most homebuyers and misguided real estate agents know little about arbitration beyond the pretext it is less costly and more efficient than litigation. The myth of arbitration's benefits is so ingrained by repetition over time it has become an unquestioned real estate mantra — the "standard" problem.

Most agents do not have sufficient knowledge or awareness to develop an opinion on arbitration, nor do most buyers and sellers know enough to inquire about it. Thus, arbitration's virtues are passed down as custom, while harmful widespread ignorance of its risks persists among agents and most sweatshop brokers.

Mediation buttressed by judicial certainty

mediation
An informal, non-binding dispute resolution voluntarily agreed to in which a third-party mediator works to bring the disputing parties to their own decision to resolve their dispute.

Arbitration was born out of a genuine desire to save on court costs, expedite the dispute resolution process and improve the efficiency of the real estate marketplace. In practice, however, arbitration often results in absurd legal consequences, in direct conflict with the reasons and practical purposes for its inception. There is a very simple remedy — the soft, more effective medicine of **mediation**.

Mediation is an informal, confidential, non-binding legal process. When agreed to, the buyer and seller are compelled to use it in good faith. Designed to help the parties reach an accord, mediation puts disputes to rest without litigation, while still allowing for judicial intervention if a resolution is not found.

Rather than requiring parties to a purchase agreement to actively initial away their rights to a fair and reviewable judicial determination, mediation passively allows for a mutually acceptable termination of a dispute.

7 **DiMarco** v. **Chaney** (1995) 31 CA4th 1809
8 DiMarco, *supr*

In the process, a neutral third-party — the mediator — acts as an avuncular facilitator. The mediator encourages the disputing parties to arrive at their own decision. They do this by fostering an environment of discussions, asking questions while listening for a commonality of thoughts needed for settlement and resolution. Mediators are trained to help craft a conclusion and end disputes.

Mediation works

While a mediation agreement requires participation, either party can withdraw from the process. In addition to these benefits, the use of mediation also provides a solution to a dispute without adding and falling subject to the backlog of cases burdening the legal system.

Most importantly, mediation works. The Los Angeles Superior court system reports that 63% of cases ordered into mediation are resolved. Nationwide, the mediation success rate ranges between 60%-90%.[9]

Arbitration, like mediation, is a confidential process structured as an alternative to litigating judicially. However, the two parties in a dispute do not come to their own conclusions in arbitration as they do in mediation — the neutral third party appointed to hear the case as the arbitrator makes a final decision awarding judgment in favor of one of the parties. This decision is binding under arbitration provisions when initialed in purchase agreements, and the arbitrator's award may not be reviewed or corrected by a court of law.

Conversely, mediation does not result in a final award that is legally erroneous and uncorrectable by a court of law.

The reality of arbitration

The reality of arbitration provisions is that they do not belong in real estate purchase agreements. These provisions are not included in trust deeds, nor in rental or lease agreements as all remedies in landlord-tenant law are judicial. They are omitted for good reason: it is rules of law, not an "arbitrary" arbitrator, which control for fair results.

Arbitration provisions lead to:

- frequent misapplication and misinterpretation of the law;
- erroneous awards;
- a bar to discovery in preparation for hearings;
- waiver of the right to judicial review; and
- a lack of legal precedent for future application to conduct of buyers, sellers, brokers and agents.

Many agents, due to an unfounded fear they may be engaging in the *unauthorized practice of law* or *killing the deal*, refuse to educate their client on known adverse ramifications of initialing the arbitration provision.

However, explaining the consequences of an arbitration provision a broker and their agents request their clients to initial is not engaging in

9 Final Report of Colorado Governor's Task Force on Civil Justice Reform, Exhibit 7

the unauthorized practice of law. It is their duty as fiduciaries to explain transaction documentation to the best of their knowledge, nothing less and nothing more. This counseling is sufficient to alert the client to the need for possible further inquiry.

Alternatives to the arbitration provision

The purchase agreement published by CAR includes an arbitration provision, exposing a broker's client who initials it to the risks of arbitration. However, readily available alternatives exist, such as:

- using a purchase agreement form that does not include an arbitration provision; or
- counseling clients they are not required to initial the provision to enter into a binding agreement or to close the deal — even if the other party to the purchase agreement has initialed it.

The first solution is simple and feasible. Many real estate forms superior to those produced by the trade unions do not include an arbitration provision.

*Editor's note — **RPI** has been publishing California real estate purchase agreements free of the provision since 1978.*

If some brokers stalwartly refuse to change their forms provider, or an agent's broker refuses to permit change, the agent has the ability to:

- inform the client of the consequences involved in agreeing to binding arbitration;
- advise them they are not required to initial the provision to form a binding contract – even if the other party initials the provisions and their client does not;
- verify that a mediation provision is included in the purchase agreement; and
- make sure an attorney fees provision is omitted or deleted, to discourage litigation.

To do otherwise, a broker and their agents act at their peril for discouraging mutual resolution of a future dispute and failing to mitigate their own risk of becoming involved in arbitration or litigation.

Avoiding arbitration as a licensee

Consider a broker or agent who becomes a member of a local trade association. As part of the membership agreement, the licensee agrees to binding arbitration for disputes arising between them and other association members.

The arbitration panel that hears and decides disputes between members is composed of other members of the local association who have little or no legal training.

These local arbitration panels frequently base their decisions on moral or social beliefs and local customs they have personally adopted, rather than on controlling legal principles. Preference and bias towards a particular member

of the association is more likely since the members of the arbitration panel are acquainted with or know about the members involved in the dispute. Yet, these panels are said to consist of ***"neutral"*** arbitrators.

The panels are also very much aware the decisions they render are not appealable or reversible. Their award is final and binding.

Relinquished rights to a court trial

The primary problem with arbitration proceedings heard by a local association's arbitration panel is the feeling held by most brokers and agents compelled to arbitrate that they are being railroaded through a process that disregards their rights, whether or not they are actually violated.

Further, by becoming a member (rather than a paid nonmember) of a local trade association, brokers and agents are forced to relinquish their rights to a court trial and an appeal to correct an erroneous decision rendered in disputes with other members.

However, brokers and agents employed by a broker who is an association member can avoid the complications imposed on them by membership. To do so, and still comply with their broker's desire to satisfy the local trade association's annual monetary demands arising out of their association with the broker, they can pay the same amount in "nonmember dues" and become "paid nonmembers."[10]

10 **Marin County Board of Realtors, Inc**. v. **Palsson** (1976) 16 C3d 920

Chapter 34 Summary

Arbitration is a form of dispute resolution voluntarily agreed to in contracts authorizing a third-party arbitrator to issue a binding award which cannot be reviewed and corrected by a court of law. Arbitration was born out of a genuine desire to save on court costs, expedite the dispute resolution process and generally improve the efficiency of the real estate marketplace. However, in practice, arbitration often results in absurd legal consequences that are in direct conflict with the reasons and practical purposes for its inception.

An arbitrator's award is final and binding on all parties who agreed to arbitrate, unless:

- the parties have agreed the arbitrator's award is subject to "judicial review"; or
- the arbitrator exceeded their powers set by the arbitration provision.

Arbitrators are not required to be trained in law. A final award they issue is binding and may not be reviewed by a court to confirm it applies current laws controlling the subject of the dispute. Thus, arbitration provisions often lead to:

- frequent misapplication and misinterpretation of the law;
- erroneous awards;
- a bar to discovery in preparation for hearings;
- waiver of the right to judicial review; and
- a lack of legal precedent for future application to conduct of buyers, sellers, brokers and agents.

Alternatively, mediation allows for a mutually acceptable termination of a dispute in which a mediator guides the disputing parties to arrive at their own decision. Unlike arbitration, mediation settles disputes without litigation, while still allowing for judicial intervention if a resolution is not found.

To avoid exposing clients to the risk of arbitration, prudent brokers and agents may:

- use a purchase agreement form that does not include an arbitration provision; or
- counsel clients they are not required to initial a boilerplate arbitration provision in order to enter into a binding agreement or to close the deal.

Chapter 34 Key Terms

Chapter 35

An income property's operating data

Learning Objectives

After reading this chapter, you will be able to:

- determine an income property's fair market value based on the income and expenses it experiences;
- prepare, analyze and interpret an Annual Property Operating Data sheet (APOD) on an income property;
- make forecasts about the potential income and expenses a buyer is likely to experience on acquiring an income property; and
- conduct a diligent investigation to verify the data contained in an APOD to best advise your buyer on an income property acquisition.

Key Terms

Annual Property Operating Data sheet (APOD)
general duty
net operating income (NOI)
income approach

Verifiable fundamentals induce viable offers

An income property's operating data is the glue attaching the commencement to the conclusion of a transaction. If the data is deficient or defective in its content, the adhesiveness of the data is lost. The transaction will not close without a price adjustment.

Operating data from an income property is gathered and entered on an **Annual Property Operating Data sheet (APOD)** by the seller and seller's agent. The *APOD* provides information about the property's fundamentals, and is handed to prospective buyers or their agents.

By design, the APOD is *intended to induce* prospective buyers to rely on its content to decide just what price to offer to buy the property. Thus, with the presentation of an APOD to a prospective buyer or their agent, negotiations have begun.

Annual Property Operating Data sheet (APOD)
A worksheet used when gathering income and expenses on the operation of an income producing property, to analyze its suitability for investment. [See **RPI** Form 352]

The APOD introduces and confirms

If negotiations produce a match, a prospective buyer enters into a purchase agreement with the seller. The conclusive act by the buyer and the buyer's agent is the completion of their due diligence investigation to verify the accuracy and future relevance of the income data contained in the APOD.

To verify the data, the buyer's agent reviews the seller's records for operating expenses, rent rolls, leases and tenant estoppel certificates. If the estoppel certificates are substantially the same as the data contained in the APOD and the leases, and the expenses are verified, the transaction will most likely close.

Thus, on close of the transaction, the income and expenses experienced by the property and presented on an APOD by the seller's agent have come full circle. The buyer's receipt of the APOD on *introduction* to the property is thus cemented to the closing of the transaction by the *confirmation* of the APOD figures.

A transparent start equals a strong finish

The price an investor pays for income producing real estate is set by a property evaluation analysis of data based on different appraisal techniques, one of which is the **income approach**. When another evaluation approach sets a value different than that set by the income approach, the lesser of the values is likely to greatly influence the investor's decision on pricing.

income approach
The use of a property's rental income to set its value.

This chapter is concerned primarily with the *income approach to valuation* since income is initially used by investors to determine a property's *fair market value (FMV)* and the ability of the rents to service debt. Initially, comparable sales or depreciated replacement cost approaches are of secondary concern.

Rental income and operating expenses produce a property's **net operating income (NOI)**. In turn, the property's *NOI* represents the annual return the property delivers to the owner, which is accounted for as:

net operating income (NOI)
The net revenue generated by an investment property. It is calculated as the sum of a property's gross operating income less the property's total expected operating expenses.[See RPI Form 352 §4]

- a **return of** the owner's original capital investment, called *depreciation*, (evidenced in part by the principal reduction on purchase-assist mortgages); and
- a **return on** the owner's capital investment, called a *yield*, (including the portion of the NOI used to service interest payments on the purchase-assist mortgages).

Since the NOI represents the investor's annual return on all capital invested, the information and data entered in an APOD are the *fundamentals* upon which the market value of an income property is initially judged. Thus, the APOD prepared by the seller's agent has to contain accurate representations of either:

- *current operations*, as experienced by the seller; or
- an *opinion honestly held* by the agent about future income and expenses which a buyer will likely experience as the owner of the property.

Reliance on the APOD

As with any purchase of income property, a prospective buyer is acquiring a *future flow* of income (the property's NOI) for which they are willing to pay a price today. This price is the *discounted, present worth* of the property's NOI over the coming years. Further, this is the maximum price, but not necessarily the lowest price the prospective buyer will agree to pay for the property.

With the seller's agent's use of an APOD, the prospective buyer is *induced to rely* on the APOD figures to evaluate the property, enter into negotiations and sign a purchase offer. If the figures hold up under an investigation, as they must to avoid deceit, the buyer acquires ownership of the property.

For the seller's agent to avoid deceitful and dishonest activities in the inducement, the figures entered in an APOD need to have some close relationship to the income and expenses the property actually does or is likely to produce.

The only known *sources of data* for the APOD figures which the seller's agent may draw on are the owner's actual operating records of the property and the operations of comparable properties. Both are readily available to agents on inquiry. Without these bases for the data presented, the data is either a forecast opinion or a fabrication by the individual who prepared the APOD.

Editor's note — The data contained in the APOD referencing the NOI, spendable income and tax consequences are also included with more extensive analysis and documentation in ***RPI's Income Property Brokerage (IPB)*** *suite of forms.*

The need for forecasts

Sometimes data from comparable properties demonstrates that the listed property's current operations are producing less rental income and greater expenses than experienced by owners of other properties.

The comparison likely justifies the preparation of an APOD using figures which are decidedly not reflective of the property's current operating income and expenses. Instead, the APOD figures represent the seller's agent's opinion about the property's probable future operations based on the income and expenses experienced by both the listed property and comparable properties.

Here, the seller's agent must have a reasonable basis for developing a *rational opinion* about the property's future potential when estimating the anticipated income and expenses. The estimate is the seller's agent's *forecast* of income and expenses which the seller's agent *honestly believes* has a reasonable likelihood of occurring under new ownership.

Thus, two entirely different NOI estimates may logically be presented to a prospective buyer regarding the listed property:

- one based on *current operations* as continuing without a significant change in anticipated income and expenses, properly called a **projection**; and

- the other being an *opinion* of potential income and expenses likely to be experienced in the future, properly called a **forecast**.

The difference in the NOI produced by these two estimates of the property's future annual operations has a profound *financial impact* for the property's value. For example, a $10,000 potential increase in annual NOI over the current NOI experienced by the seller converts, by the financial process of *capitalization of income*, into an increase in value ranging from $80,000 to $120,000.

The value range depends on the rate of return expected in the marketplace at the time of sale. It is in the best interest of the seller that the seller's agent enters on an APOD the best set of figures which the seller's agent honestly believes a buyer is able to achieve.

The APOD as opinion

However, the seller's agent has to be certain the buyer does not rely on the APOD figures as a *warranty* or anything more than the seller's agent's honestly held belief that the NOI estimated has a reasonable likelihood of occurring. Seller's agents need to accompany their optimistic forecasts on APODs with a statement indicating the figures are *opinions* and nothing more. Statements that the data is based on reliable sources will not do the job of disclosing the nature of the data, much less the source.

If the buyer receives positive assurance from the seller's agent that the APOD figures are attainable or the agent holds themselves out to be *specially qualified* in the subject matter, it becomes a *positive statement of truth* upon which a buyer can rely. The buyer may properly presume the APOD is a *guarantee* of what is to occur without their further investigation to confirm whether or not the assurances will occur.[1]

A contingency provision in the purchase agreement calling for the buyer's further approval of the income and expenses is always prudent as it demonstrates that the buyer is not relying on the agent's APOD estimates as a guarantee.

Seller's good-faith assistance

To assist a seller's agent to marshal information about a property's operations and prepare an APOD to determine the property's current NOI, the seller must, *in good faith*, provide the seller's agent with printouts of their monthly, year-to-date and past 12 months income and expense statements. The seller, the property manager or resident manager have or are able to generate this operating information for the seller's agent.

An owner, having employed a seller's agent to market their income property and locate a buyer willing to pay the listed price, owes a duty to the seller's agent to make a good-faith effort to cooperate and assist the agent to meet the objectives of the employment. Otherwise, the seller *wrongfully interferes* with the agent's ability to successfully market the property (and earn a fee). Without accurate operating data, income property cannot be honestly marketed to prospective buyers.

---

1 **In re Jogert, Inc.** (9th Cir. 1991) 950 F2d 1498; **Cohen** v. **S & S Construction Co.** (1983) 151 CA3d 941

In turn, the duty the seller's agent owes their seller is to deliver to their seller the best business advantage *legally achievable*. This duty is tempered by the seller's agent's **general duty** owed to prospective buyers to provide them with accurate, factual information about the integrity of the property. Property information often has the potential to adversely affect the value of the property. Thus, it needs to be delivered to prospective buyers before a purchase agreement is entered into.

general duty
The duty a licensee owes to non-client individuals to act honestly and in good faith with up-front disclosures of known conditions which adversely affect a property's value. [See **RPI** Form 305]

To meet this affirmative disclosure duty owed to prospective buyers, the seller's agent needs to provide prospective buyers or their agents with information *known or readily available* to the seller or seller's agent. These disclosures include information about the operations of the property which *have the potential to affect* the decisions of a reasonably prudent buyer regarding acquisition of the property.

As a result, the seller's agent needs to present known facts to a prospective buyer in a manner which will not mislead or deceive the buyer by omitting factors adversely affecting the property's value. Erroneous data is but one example.

If the seller or their property manager are the source of the information on the property's operations, and 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. However, the actual *source of the data* needs to be identified by disclosure.

The APOD contents

An APOD, prepared by a seller's agent and handed to a prospective buyer, provides operating information on the property, including:

- the **estimated NOI**, for setting the price to be paid and the mortgage amounts which may be serviced by the income generated by the property;
- the **spendable income**, for providing a cash-flow cushion reflected by the amount of the NOI remaining after servicing the mortgage financing (including information on mortgage balances, monthly payments, interest rates and any due dates); and
- the **income tax consequences** the prospective buyer is likely to experience during the first year of ownership due to allowable deductions of interest on trust deed mortgages and IRS depreciation schedules.

In the comment's section of the APOD form, the seller's agent enters local trends and factors *known to the seller's agent* which are not necessarily observable or known to a prospective buyer or the buyer's agent when viewing the property, or discoverable when reviewing the marketing package.

Local trends and factors include currently evolving economic or regulatory conditions which can alter the property's future income or expenses, and thus, impact the prospective buyer's decision to buy or use the property.

Economic impacts include:

- population demographics in the location of the property as decreasing, static or increasing in density and personal income;
- the local population's future effect on the appreciation or depreciation of the property's value;
- whether the quality and location of the property will, in the future, support the APOD's income and expense analysis; and
- the rents and expenses experienced by comparable properties in the area.

Income property expense ratios

Expenses, as a percentage of scheduled income, are calculated on the APOD in the center column. Percentages are obtained by dividing each expense item by the scheduled income (100%). [See Form 352]

The percentage calculated for each operating expense alerts the prospective buyer and their agent to data which varies from a range typically experienced by the type of income property involved.

For example, if the percentage allocated to utility expenses is abnormally high compared to other properties, this cost needs to be evaluated to determine:

- what options are available to bring the utility expenses within the normal percentage range; and
- what effect the expense has on the value of the property, other than reducing the NOI.

Property information which needs to be separately disclosed to a prospective buyer so they are able to determine the property's worth includes recent "spikes" in expense items, such as:

- utilities;
- evictions necessitated by delinquencies;
- security re-evaluations needed due to incidents of crime on the premises;
- loss of a local industry which employs a significant percentage of area tenants;
- assumable or locked-in financing;
- rent control adjustments; and
- mortgage commitments.

Mortgage payments

Mortgage payments entered on the APOD reflect only the principal and interest (PI) payments, separately stated from any impounded (escrowed taxes and insurance premiums (TI)) funds deposited with the lender as part of the totally monthly PITI payment. Impounds, however, are disclosed elsewhere in the APOD.

Form 352

Annual Property Operating Data Sheet (APOD)

Page 1 of 2

ANNUAL PROPERTY OPERATING DATA SHEET
APOD

NOTE: This form is used by an agent when preparing a marketing package for an income property they listed for sale or conducting a due diligence investigation of the property for a buyer, to gather rent and expense data for calculating the property's net operating income (NOI) and estimating its annual reportable income or loss.

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)]	$_____	_____%
	b. Other income	(+)$_____	_____%
2.3	**Gross Operating Income**	$_____	_____%
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	_____	$_____	_____%
3.21	**Total Operating Expense** [Lines 3.1 to 3.20]	(-)$_____	_____%
4.	**NET OPERATING INCOME:** [Lines 2.3 Less 3.21]	$_____	_____%

PAGE 1 OF 2 — FORM 352

Impounds are merely a *reserve* for some of the owner's fixed operating expenses (already figured into the NOI), such as:

- property taxes;
- improvement district bond payments; and
- the hazard insurance premium.

The lender pays these expenses on behalf of the owner using the impounded funds.

Deposits into an impound account are not a mortgage charge or an operating expense. However, the lender's later disbursements from the impound account represents payment of the owner's operating expenses.

Form 352

Annual Property Operating Data Sheet (APOD)

Page 2 of 2

5. SPENDABLE INCOME (annual projection):

5.1 **Net Operating Income** (enter from Section 4) . . . . . $_____ _____%

5.2 Loan		Principal Balance Amount	Monthly Payment	Rate	Due Date
a.	1st	$_____	$_____	_____%	_____
b.	2nd	$_____	$_____	_____%	_____
c.	3rd	$_____	$_____	_____%	_____

5.2 Total Annual Debt Service [Lines 5.2 (a), (b) and (c)] . . . . . (-)$_____ _____%

5.3 **Spendable Income** [Lines 5.1 less 5.3] . . . . . .$_____ _____%

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 **RPI** Form 352-1] ☐ need confidentiality agreement.
b. ☐ Rent control restrictions.
c. ☐ Condition of improvements available: ☐ by owner [See **RPI** Form 304-1, ☐ by inspector.
d. ☐ Environmental report available.
e. ☐ Natural Hazard Disclosure Statement available. [See **RPI** 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) . . . . . $_____

7.2 Deductions from NOI

a. Annual interest expense . . . . . $_____
b. Annual depreciation deduction. . . . . .$_____
c. Total deductions from NOI. . . . . .(-)$_____

7.3 **Reportable Income/Loss** (annual projection). . . . . .$_____

Broker: _____
Address: _____
_____
Phone: _____
Cell: _____
Fax: _____
Email: _____

I have reviewed and approve this information.
Date:_____, 20____
Owner's name: _____

Signature: _____

Signature: _____

The amount of any monthly impound deposit is going to change on transfer of the property's ownership, typically due to an increase in property taxes triggered by reassessment because of the change of ownership. The buyer's agent calculates the increase in impounds and enters the estimated future impound payment on the APOD, not the seller's present impound payment.

Data approved for release

As a service to their seller, a seller's agent is able to prepare the APOD if all the verifiable rents and expenses are made known to the agent by the seller. To effectively market the property, the seller needs to be willing to "lay open" the books on the property to the seller's agent so its operations are sufficiently transparent to *provide verifiable data* for a prospective buyer.

The seller's agent uses this information to prepare the APOD, which reflects:

- the property's **current operations**, which implicitly infers that the figures given are more than likely going to occur during the following year; or
- the property's **potential future operations**, influenced by income and expenses now experienced by comparable properties and trends in rents and operating expenses in the surrounding area.

When the APOD is completed to the satisfaction of the seller's agent and the seller, the seller is asked to *sign a copy* for the seller's agent's file. Thus, the seller acknowledges their approval of the contents of the APOD and consents to the release of the figures. Some sellers, sensitive to persons other than bona fide buyers receiving property information, may require that a **confidentiality agreement** be entered into (and net worth statements presented) by a prospective buyer before release of APOD data and other information. [See **RPI** Form 257]

With a seller-approved APOD in the listing file, the APOD becomes the centerpiece of the seller's agent's marketing (listing) package presented to prospective buyers and buyer's agents.

Duties owed the buyer

A seller's agent owes a *general duty* to a prospective buyer and buyer's agent to gather together readily available information on the property and make it available to them without investigation into its accuracy or consequences on ownership, called **putting the buyer on notice**.

In turn, the *special agency duty* owed the buyer by a buyer's agent is to review the skeletal property information received from the seller and seller's agent and advise the buyer on inquiries or investigations needed to understand and appreciate the ramifications of the disclosures.

In essence, the seller's agent hands off to the buyer's agent the duty to determine which points raised by the APOD figures (and other disclosures) need to be further investigated to produce an accurate picture of the property's earning power.

Need for further investigation

For example, the APOD and rent roll sheets do not always give *critical details* about leases, such as whether or not any leases include:

- *free-rent incentives* for a period of time preceding the commencement period stated in the written lease;
- a *downward gradation* in the amount of rent after a six or eight month occupancy on month-to-month tenancies as an incentive for a tenant to remain in possession; or
- an *option to extend* the lease at a fixed rate which is possibly inconsistent with the prospective buyer's expectations of rental income.

Thus, the terms of occupancy, provisions in the leases, discounts, incentives, options or first-refusal rights to additional space, etc., has to be part of the buyer's inquiry, triggered by the disclosure of the fact that tenants hold leases and rental agreements.

The buyer's agent, on completion of the inquiry into the facts behind the numbers on the seller's agent's APOD, may fill out an APOD form to reflect their own belief about the future operating potential of the property. For the buyer's agent, the APOD prepared as a forecast needs to be presented as the agent's opinion of what is likely to be the performance of the property in the hands of the prospective buyer.

No assurances by the agent equal no guarantees. However, the APOD figures given as an opinion need to represent a belief, honestly held by the buyer's agent that the figures have a fair chance of actually occurring in the future.

Due diligence by the buyer's agent

Once the seller's agent informs the prospective buyer and the buyer's agent about the property's operating facts by delivery of an APOD, issues concerning the rent and expenses need to be investigated and analyzed by the buyer's agent. This *investigation or recommendation* for further inquiry includes:

- a review of any **tenant files**, including lease or rental agreements, application for rent, deposits received, credit report printouts, criminal or other background checks, photocopies of driver's licenses, credit card information for payment of monthly rent and payment history [See **RPI** Form 352-1];
- discovering if any units or spaces in the project have a **chronic vacancy** or turnover history requiring a downward adjustment in the price paid for the property;
- a **confirmation of expenses**, through quotes if necessary, on what amounts the buyer is to be charged — not what the seller has been able to arrange and be charged — for hazard insurance premiums and taxes based on the price to be paid, improvement district assessments, professional management fees and the management's opinion of APOD projections;
- determining the date of the **last rental increase**, the amount of the increase and the seller's rent increase policy employed during the past few years;
- establishing who has been providing **maintenance**, and what charges the new owner is to anticipate (as well as questions on intentionally deferred maintenance) [See **RPI** Form 324];
- a confirmation of the **utilities paid** by the owner and any price fluctuations, past or anticipated;
- a review of any **criminal activity** on the premises as confirmed by the local police department and by inquiry of a few tenants [See **RPI** Form 321];

Due diligence by the buyer's agent, cont'd

- ascertaining the number of **unlawful detainers (UDs)** filed during the past 12 months and why those tenants had to be evicted from the property;
- a review of any **rent control activity**, if the units are locally controlled, and a check with the local agency to determine the property's compliance and the buyer's ability to maintain or attain market rates; and
- a confirmation of any **miscellaneous income** to be received from on-site vending machines, such as laundry room equipment and supplies, food and beverage dispensers and furnishings rented to occupants.

When the buyer's agent is not willing to conduct this due diligence investigation, the agent needs to inform the buyer about the agent's knowledge concerning the data. Further, the buyer's agent needs to advise the buyer on the investigations the agent believes need to be undertaken for the buyer to protect their interest.

Chapter 35 Key Terms

Operating data from an income property is gathered and entered on an Annual Property Operating Data sheet (APOD) by the seller and seller's agent. The APOD provides information about the property's fundamentals, and is handed to prospective buyers or their agents.

The APOD prepared by the seller's agent has to contain accurate representations of the expected net operating income (NOI) by providing either:

- a projection based on current operations as experienced by the seller; or
- a forecast based on the opinion honestly held by the agent about future income and expenses which a buyer will likely experience as the owner of the property.

An APOD, prepared by a seller's agent and handed to a prospective buyer, provides operating information on the property, including:

- the estimated NOI, for setting the price to be paid and the mortgage amounts which may be serviced by the income generated by the property;
- the spendable income, for providing a cash-flow cushion reflected by the amount of the NOI remaining after servicing the mortgage financing (including information on mortgage balances, monthly payments, interest rates and any due dates); and
- the income tax consequences the prospective buyer are likely to experience during the first year of ownership due to allowable deductions of interest on trust deed mortgages and IRS depreciation schedules.

Once the seller's agent delivers the APOD to the prospective buyer and their agent, the special agency duty owed the buyer by a buyer's agent is to review the skeletal property information received from the seller and seller's agent and advise the buyer on inquiries or investigations needed to understand and appreciate the ramifications of the disclosures.

In essence, the seller's agent hands off to the buyer's agent the duty to determine which points raised by the APOD figures (and other disclosures) need to be further investigated to produce an accurate picture of the property's earning power.

Chapter 35 Key Terms

Chapter 36

Income property acquisitions

Learning Objectives

After reading this chapter, you will be able to:

- evaluate an income property for suitability as within a client's investment objectives;
- commence negotiations for the sale of an income property; and
- prepare and submit an offer to purchase income-producing property other than one-to-four residential units.

Key Terms

Annual Property Operating Data sheet (APOD)

purchase agreement

Investigating a property's worth

Consider a buyer's agent at an investment property marketing session who picks up a mini-package on a property listed for sale by another agent. The package contains an **Annual Property Operating Data sheet (APOD)**. On review of the APOD, the property appears to match the income property requirements of the agent's client. [See **RPI** Form 352]

Annual Property Operating Data sheet (APOD) A worksheet used when gathering income and expenses on the operation of an income producing property, to analyze its suitability for investment. [See **RPI** Form 352]

Both the agent and the client drive by the property. The building's exterior appearance is acceptable, and the area surrounding the property looks stable. The property seems properly located for a project of its size and type. It is agreed the agent will gather more information on the property.

The agent obtains a profile on the property from a title company. The title is consistent with information received from the seller's agent regarding trust deeds and vesting.

A property's fundamentals

To begin an analysis of the property, the buyer's agent may contact the seller's agent for more *fundamentals* on the property, asking the seller's agent to produce:

- a *rent roll* spread sheet covering each unit (type, size, tenant, commencement of occupancy, expiration of lease, rent amount and any discount/free rent, payment history, furnishings, etc.) [See **RPI** Form 352-1];
- a two-year *occupancy history* on each unit;
- information regarding *security arrangements* and criminal activity on or around the property during the past year [See **RPI** Form 321];
- a *property manager* or resident manager who is available for an interview;
- information regarding *maintenance procedures* and the repair services used [See **RPI** Form 324];
- a copy of schedule "B" (CC&R exclusions) to the owner's policy of *title insurance*;
- the lender's name and the balance, payments, interest rates and due date on each existing mortgage; and
- any available information relating to the integrity of the property's condition and the nature of the property's location which may adversely affect the property's value. [See **RPI** Form 304-1]

Agent duty to gather information

The prospective buyer's agent asks for all this information knowing the seller and the seller's agent *owe a duty* to prospective buyers and their agents to inform them of all facts about the property that are *known or readily available* to them which may adversely impact the property's market value. Typically, the seller's agent gathers all fundamental property information in advance and has it ready in a complete marketing package.

If the seller's agent has not yet gathered the facts available to them, they are likely to insist the information is unnecessary before a prospective buyer submits an offer.

However, it is best to commence price negotiations only when disclosures of *all readily available* property data and information have been handed over by the seller or the seller's agent. The confirmation of the *veracity of initial property disclosures* is what a due diligence investigation during the escrow period is all about.

The buyer's agent advises the prospective buyer that the seller or the seller's agent might insist the buyer enter into a *confidentiality agreement* before some of the information requested of the seller's agent is released. Thus, the buyer is compelled to identify themselves to the seller and promise not to release the information received to others.

Otherwise, the seller will not release information on the tenants, their leases and property operations — information the buyer needs to determine the property's worth, and set the price and terms before making an offer.

When the information is received and reviewed, if it warrants further investigation into the suitability of the property for acquisition, the buyer's agent and prospective buyer will personally inspect the premises and any vacant units, and thoroughly discuss operations with those who manage the property.

After receiving these initial disclosures and conducting a minimal investigation, the buyer's agent prepares a purchase agreement if the property still appears to be suitable to the prospective buyer.

By submission of the purchase agreement offer, they *commence negotiations* on the price to be paid and the conditions which need to be met so the prospective buyer can complete a due diligence investigation and confirm their initial expectations about the property. Any counteroffer by the seller sorts out the seller's willingness to permit the prospective buyer to corroborate the property's worth.

Analyzing the commercial income property purchase agreement

The **Commercial Income Property Purchase Agreement**, **RPI** Form 159, is used to prepare and submit the buyer's *written offer* to purchase income property, excluding one-to-four unit residential property.

Terms for payment of the price are limited to conventional financing, an assumption of existing mortgages and a carryback note. Sellers also properly use the *purchase agreement* in a counteroffer situation to submit their *fresh offer* to sell the real estate. [See Figure 1]

The purchase agreement offer, if accepted, becomes the binding written contract between the buyer and seller. Its terms need to be complete and clear to prevent misunderstandings so any agreement entered into may be judicially enforced. Thus, Form 159 is a comprehensive "boilerplate" purchase agreement which serves as a *checklist*, presenting the various conventional financing arrangements and conditions a prudent buyer is to consider when making an offer to purchase.

purchase agreement The primary document used as a checklist to negotiate a real estate sales transaction between a buyer and seller. [See **RPI** Form 150-159]

Purchase agreement components

Each section in Form 159 has a separate purpose and need for enforcement. The sections include:

- **Identification**: The date of preparation for referencing the agreement, the name of the buyer, the amount of the good faith deposit, the description of the real estate, an inventory of any personal property included in the transfer and the number of pages contained in the agreement and its addenda are set forth in sections 1 and 2 to establish the facts on which the agreement is negotiated.
- **Price and terms**: All the typical variations for payment of the price by conventional purchase-assist financing or an assumption of

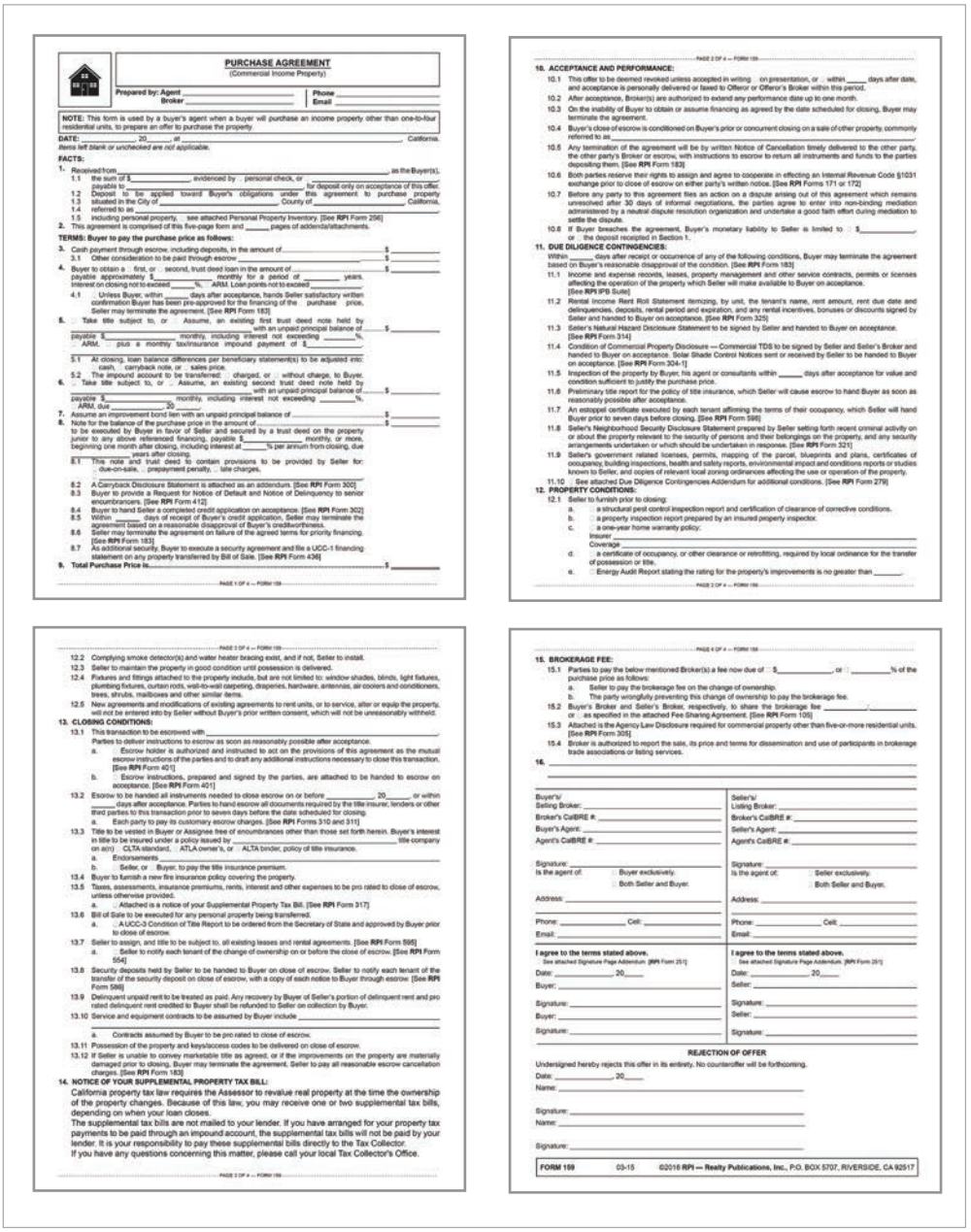
existing financing are set forth in sections 3 through 9 as a checklist of provisions. On making an offer (or counteroffer), the terms for payment and financing of the price are selected by checking boxes and filling blanks in the desired provisions.

- **Acceptance and performance**: Aspects of the formation of a contract, excuses for nonperformance and termination of the agreement are provided in section 10, 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.
- **Due diligence contingencies**: Contingencies for the buyer's due diligence investigations into income and expense records, rental income statements, hazard disclosures, property condition disclosures and other relevant information to be delivered by the seller are set forth in section 11.
- **Property Conditions**: The buyer's confirmation of the physical condition of the property as disclosed prior to acceptance is *confirmed,* as set forth in section 12, by the seller's delivery of reports, warranty policies and certifications not handed to the buyer prior to entry into the purchase agreement.
- **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 mortgage adjustments.
- **Brokerage and agency**: The release of sales data on the transaction to trade associations is authorized, the broker fee is set and the delivery of the agency law disclosure to both buyer and seller is provided for as set forth in section 15, 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.
- **Signatures**: The seller and buyer 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.

Preparing the commercial income property purchase agreement

The following instructions are for the preparation and use of the Commercial Income Property Purchase Agreement, **RPI** Form 159. Form 159 is designed as a checklist of practical provisions so a broker or their agent may prepare an offer for a prospective buyer who seeks to purchase conventionally-financed, California-located income property other than one-to-four units.

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



PURCHASE AGREEMENT
(Commercial Income Property)

Prepared by: Agent _____ Phone _____
Broker _____ Email _____

NOTE: This form is used by a buyer's agent when a buyer will purchase an income property other than one-to-four residential units, to prepare an offer to purchase the property.

DATE: _____, 20____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. Received from _____ as the Buyer(s).
1.1 the sum of $_____ evidenced by ☐ personal check, or ☐ _____ payable to _____ for deposit only on acceptance of this offer.
1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
1.3 situated in the City of _____ County of _____, California,
1.4 referred to as _____
1.5 including personal property, ☐ see attached Personal Property Inventory. [See **RPI** Form 256]
2. This agreement is comprised of this five-page form and _____ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of _____ $ _____
3.1 Other consideration to be paid through escrow _____ $ _____
4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of _____ $ _____
payable approximately $_____ monthly for a period of _____ years,
interest on closing not to exceed _____%, ☐ ARM. Loan points not to exceed _____,
4.1 ☐ Unless Buyer, within _____ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **RPI** Form 183]
5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____ with an unpaid principal balance of _____ $ _____
payable $_____ monthly, including interest not exceeding _____%,
☐ ARM, ☐ plus a monthly tax/insurance impound payment of $_____.
5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.
5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.
6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____ with an unpaid principal balance of _____ $ _____
payable $_____ monthly, including interest not exceeding _____%,
☐ ARM, due _____, 20____.
7. Assume an improvement bond lien with an unpaid principal balance of _____ $ _____
8. Note for the balance of the purchase price in the amount of _____ $ _____
to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____ years after closing.
8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, _____
8.2 A Carryback Disclosure Statement is attached as an addendum. [See **RPI** Form 300]
8.3 Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **RPI** Form 412]
8.4 Buyer to hand Seller a completed credit application on acceptance. [See **RPI** Form 302]
8.5 Within _____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.
8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **RPI** Form 183]
8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **RPI** Form 436]
9. **Total Purchase Price is** _____ $ _____

PAGE 1 OF 4 — FORM 159

10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.
10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.
10.3 On the inability of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.
10.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as _____.
10.5 Any termination of the agreement will be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See **RPI** Form 183]
10.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See **RPI** Forms 171 or 172]
10.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.
10.8 If Buyer breaches the agreement, Buyer's monetary liability to Seller is limited to ☐ $_____, or ☐ the deposit receipted in Section 1.

11. DUE DILIGENCE CONTINGENCIES:

Within _____ days after receipt or occurrence of any of the following conditions, Buyer may terminate the agreement based on Buyer's reasonable disapproval of the condition. [See **RPI** Form 183]
11.1 Income and expense records, leases, property management and other service contracts, permits or licenses affecting the operation of the property which Seller will make available to Buyer on acceptance. [See **RPI IPS** Suite]
11.2 Rental Income Rent Roll Statement itemizing, by unit, the tenant's name, rent amount, rent due date and delinquencies, deposits, rental period and expiration, and any rental incentives, bonuses or discounts signed by Seller and handed to Buyer on acceptance. [See **RPI** Form 325]
11.3 Seller's Natural Hazard Disclosure Statement to be signed by Seller and handed to Buyer on acceptance. [See **RPI** Form 314]
11.4 Condition of Commercial Property Disclosure — Commercial TDS to be signed by Seller and Seller's Broker and handed to Buyer on acceptance. Solar Shade Control Notices sent or received by Seller to be handed to Buyer on acceptance. [See **RPI** Form 304-1]
11.5 Inspection of the property by Buyer, his agent or consultants within _____ days after acceptance for value and condition sufficient to justify the purchase price.
11.6 Preliminary title report for the policy of title insurance, which Seller will cause escrow to hand Buyer as soon as reasonably possible after acceptance.
11.7 An estoppel certificate executed by each tenant affirming the terms of their occupancy, which Seller will hand Buyer prior to seven days before closing. [See **RPI** Form 598]
11.8 Seller's Neighborhood Security Disclosure Statement prepared by Seller setting forth recent criminal activity on or about the property relevant to the security of persons and their belongings on the property, and any security arrangements undertaken or which should be undertaken in response. [See **RPI** Form 321]
11.9 Seller's government related licenses, permits, mapping of the parcel, blueprints and plans, certificates of occupancy, building inspections, health and safety reports, environmental impact and conditions reports or studies known to Seller, and copies of relevant local zoning ordinances affecting the use or operation of the property.
11.10 ☐ See attached Due Diligence Contingencies Addendum for additional conditions. [See **RPI** Form 279]

12. PROPERTY CONDITIONS:

12.1 Seller to furnish prior to closing:
a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.
b. ☐ a property inspection report prepared by an insured property inspector.
c. ☐ a one-year home warranty policy:
Insurer _____
Coverage _____
d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.
e. ☐ Energy Audit Report stating the rating for the property's improvements is no greater than _____.

PAGE 2 OF 4 — FORM 159

12.2 Complying smoke detector(s) and water heater bracing exist, and if not, Seller to install.
12.3 Seller to maintain the property in good condition until possession is delivered.
12.4 Fixtures and fittings attached to the property include, but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.
12.5 New agreements and modifications of existing agreements to rent units, or to service, alter or equip the property, will not be entered into by Seller without Buyer's prior written consent, which will not be unreasonably withheld.

13. CLOSING CONDITIONS:

13.1 This transaction to be escrowed with _____
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.
a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See **RPI** Form 401]
b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See **RPI** Form 401]
13.2 Escrow to be handed all instruments needed to close escrow on or before _____, 20____, or within _____ days after acceptance. Parties to hand escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.
a. ☐ Each party to pay its customary escrow charges. [See **RPI** Forms 310 and 311]
13.3 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): ☐ CLTA standard, ☐ ATLA owner's, or ☐ ALTA binder, policy of title insurance.
a. Endorsements _____
b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.
13.4 Buyer to furnish a new fire insurance policy covering the property.
13.5 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.
a. ☐ Attached is a notice of your Supplemental Property Tax Bill. [See **RPI** Form 317]
13.6 Bill of Sale to be executed for any personal property being transferred.
a. ☐ A UCC-3 Condition of Title Report to be ordered from the Secretary of State and approved by Buyer prior to close of escrow.
13.7 Seller to assign, and title to be subject to, all existing leases and rental agreements. [See **RPI** Form 595]
a. ☐ Seller to notify each tenant of the change of ownership on or before the close of escrow. [See **RPI** Form 554]
13.8 Security deposits held by Seller to be handed to Buyer on close of escrow. Seller to notify each tenant of the transfer of the security deposit on close of escrow, with a copy of each notice to Buyer through escrow. [See **RPI** Form 598]
13.9 Delinquent unpaid rent to be treated as paid. Any recovery by Buyer of Seller's portion of delinquent rent and pro rated delinquent rent credited to Buyer shall be refunded to Seller on collection by Buyer.
13.10 Service and equipment contracts to be assumed by Buyer include _____
a. Contracts assumed by Buyer to be pro rated to close of escrow.
13.11 Possession of the property and keys/access codes to be delivered on close of escrow.
13.12 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See **RPI** Form 183]

14. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.
The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.
If you have any questions concerning this matter, please call your local Tax Collector's Office.

PAGE 3 OF 4 — FORM 159

PAGE 4 OF 4 — FORM 159

15. BROKERAGE FEE:

15.1 Parties to pay the below mentioned Broker(s) a fee now due of ☐ $_____, or ☐ _____% of the purchase price as follows:
a. Seller to pay the brokerage fee on the change of ownership.
b. The party wrongfully preventing this change of ownership to pay the brokerage fee.
15.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee _____, _____ or ☐ as specified in the attached Fee Sharing Agreement. [See **RPI** Form 105]
15.3 Attached is the Agency Law Disclosure required for commercial property other than five-or-more residential units. [See **RPI** Form 305]
15.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

16. _____

Buyer's/ Selling Broker: _____	Seller's/ Listing Broker: _____
Broker's CalBRE #: _____	Broker's CalBRE #: _____
Buyer's Agent: _____	Seller's Agent: _____
Agent's CalBRE #: _____	Agent's CalBRE #: _____
Signature: _____	Signature: _____
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: _____	Address: _____
Phone: _____ Cell: _____	Phone: _____ Cell: _____
Email: _____	Email: _____
I agree to the terms stated above. See attached Signature Page Addendum [RPI Form 251]	**I agree to the terms stated above.** See attached Signature Page Addendum [RPI Form 251]
Date: _____, 20____	Date: _____, 20____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____

REJECTION OF OFFER

Undersigned hereby rejects this offer in its entirety. No counteroffer will be forthcoming.
Date: _____, 20____
Name: _____
Signature: _____
Name: _____
Signature: _____

Figure 1

Form 159

Purchase Agreement — Commercial Income Property

*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 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).

1.2 **Confirm** the deposit is to be applied toward the buyer's obligations.

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 need to be listed as inventory if they are to be acquired by the buyer. [See **RPI** 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.

3.1 *Additional down payment:* **Enter** the description of any other consideration to be paid as part of the price, such as trust deed notes, personal property or real estate equities (an exchange). Enter the dollar amount of its value.

4. *New trust deed mortgage:* **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed mortgage. **Enter** the amount of the principal, the monthly principal and interest (PI) payment, the term of the mortgage and the rate of interest. **Check** the box to indicate whether the interest will be adjustable (ARM). If so, **enter** the index name and any limitations on mortgage origination points.

4.1 *Buyer's mortgage qualification:* Check the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new mortgage and fails to deliver documentation from a lender indicating they have been pre-approved for a mortgage. **Enter** the number of days the buyer has after acceptance to deliver written confirmation of their pre-approval for the mortgage. [See **RPI** Form 183]

5. *First trust deed note:* **Check** the appropriate box to indicate whether the transfer of title is to be "subject-to" an existing mortgage or by an "assumption" of the mortgage if the buyer is to take over an existing first trust deed mortgage. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the mortgage. **Check** the box to indicate whether the interest is adjustable (ARM). If so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment.

Terms for payment of the purchase price, cont'd

5.1 *Mortgage balance adjustments:* **Check** the appropriate box to indicate the financial adjustment desired for mortgage balance differences at the close of escrow.

5.2 *Impound balances:* **Check** the appropriate box to indicate whether the impound account transferred to the buyer will be with or without a charge to the buyer.

6. *Second trust deed note:* **Check** the appropriate box to indicate whether the transfer of title is to be "subject-to" an existing mortgage or by an "assumption" of the mortgage if the buyer is to take over an existing second trust deed mortgage. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the mortgage. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** the due date for payment of a final/balloon payment.
7. *Bond or assessment assumed:* **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos or 1915 improvement bonds) which will remain unpaid and become the responsibility of the buyer on closing.

Editor's note — Improvement bonds are debt obligations of the seller which may be assumed by the buyer 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.*

Seller carrybacks and financing

8. *Seller carryback note:* **Enter** the amount of the carryback note to be executed by the buyer 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.

8.1 *Special carryback provisions:* **Check** the appropriate box to indicate any special provisions to be included in the carryback note or trust deed. **Enter** the name of any other special provision to be included in the carryback note or trust deed, such as impounds, discount options, extension provisions, guarantee arrangements or right of first refusal on the sale or hypothecation of the note.

8.2 *Carryback disclosure:* **Check** the box to indicate a Seller Carryback Disclosure Statement is attached as an addendum. [See **RPI** 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.

8.3 *Notice of Delinquency:* **Check** the box to indicate the buyer is to execute a Request for Notice of Delinquency (NODq) and pay the costs of recording and serving it on senior lenders since they

Seller carrybacks and financing, cont'd

will have priority on title to the trust deed securing the carryback note. [See **RPI** Form 412]

8.4 Buyer creditworthiness: **Requires** the buyer to provide the seller with a completed credit application. [See **RPI** Form 302]

8.5 Approval of creditworthiness: **Enter** the number of days within which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

8.6 Subordination: **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a mortgage with priority on title to the carryback note are exceeded. [See **RPI** Form 183]

8.7 Personal property as security: **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 financing statement to provide additional security for any carryback note. [See **RPI** Form 436]

9. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

Acceptance and performance

10. **Acceptance and performance periods:**

10.1 *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 — Acceptance occurs on the return delivery to the person making the offer (or counteroffer) or to their broker of a copy of the unaltered purchase agreement offer containing the signed acceptance.

10.2 *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.

10.3 *Mortgage contingency:* **Authorizes** the buyer to cancel the transaction at the time scheduled for closing if the financing for payment of the price is not obtainable or assumable.

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

10.5 *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. [See **RPI** Form 183]

10.6 *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. [See **RPI** Forms 171]

10.7 *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.

10.8 *Liability limitations:* **Provides** for a dollar limit on the buyer's liability for the buyer's breach of the agreement. **Check** the first box and **enter** the maximum dollar amount of money losses the seller may recover from the buyer or **check** the second box to indicate the buyer's monetary liability is limited to the good faith deposit tendered with the offer to buy.

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.

Due diligence contingencies

11. *Approval period*: **Enter** the number of days the buyer has to approve or disapprove and cancel this agreement after the buyer's receipt of each item listed below. This section calls for the buyer to complete a due diligence investigation to confirm the representations of the seller and the seller's broker and the pre-contract expectations of the buyer about the property. If the buyer is unable to confirm their expectations, they may waive the requirements or cancel the transaction. [See **RPI** Forms 182 and 183]

11.1 *Operating records:* **Requires** the seller to make income and expense records and supporting documents available to the buyer for inspection as soon as possible after acceptance of the offer. [See **RPI** Income Property Brokerage (IPB) Suite]

11.2 *Rents and deposits:* **Requires** the seller to prepare a detailed rent roll profile on each occupancy and deliver it to the buyer as soon as possible after acceptance. [See **RPI** Form 352-1]

11.3 *Natural Hazard Disclosure Statement (NHD):* **Requires** the seller to prepare and deliver to the buyer a NHD Statement disclosing the seller's knowledge of the hazards listed on the form. [See **RPI** Form 314]

11.4 *Condition of property:* **Requires** the seller to prepare and deliver a statement disclosing the physical condition of the property as known to the seller. [See **RPI** Form 304-1]

11.5 *Valuation inspection:* **Enter** the number of days after acceptance in which the buyer is to investigate the market value of the property to confirm its value justifies the price the buyer has agreed to pay.

11.6 *Title report:* **Requires** the seller to deliver a preliminary title report to the buyer for review to confirm the condition of title allows the buyer to use the property as they intended.

Due diligence contingencies, cont'd

11.7 *Tenant Estoppel Certificate:* **Requires** the seller to produce Tenant Estoppel Certificates prior to seven days before the date scheduled for closing to confirm the tenants' acquiescence to the terms stated in the certificate. [See **RPI** Form 598]

11.8 *Tenant security:* **Requires** the seller to prepare and deliver a statement disclosing criminal activity affecting individuals on the property and any crime prevention undertaken or which should be undertaken. [See **RPI** Form 321]

11.9 *Due diligence contingencies:* **Check** the box to indicate the due diligence contingencies addendum for additional conditions is attached. [See **RPI** Form 279]

Condition and property

12. **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. *Energy Audit Report:* **Check** the box and **enter** the rating of the property's improvements.

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

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

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

12.4 *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 at § 1.

12.5 *Leasing and lease modifications:* **Requires** the seller to obtain the buyer's consent (which will not be unreasonably withheld) to any new tenancies or modifications of existing tenancies

Condition and property, cont'd

entered into during the escrow period.

13. **Closing conditions:**

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

a. *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. [See **RPI** Form 401]

b. *Escrow instructions*: **Check** the box to indicate escrow instructions have been prepared and are attached to this purchase agreement. **Attach** the prepared escrow instructions to the purchase agreement and **obtain** the signatures of the parties. [See **RPI** Form 401]

13.2 *Closing date:* **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. [See **RPI** Forms 310 and 311]

13.3 *Title insurance*: **Provides** for the title to be vested in the name of the buyer 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.

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

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

13.4 *Fire insurance:* **Requires** the buyer to provide a new policy of hazard insurance.

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

a. *Supplemental property tax:* **Check** the box to indicate a notice of supplemental property tax bill has been prepared and attached. [See **RPI** Form 317]

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

Condition and property, cont'd

a. *Personal property report*: **Check** the box to indicate escrow is to order a UCC-3 from the Secretary of State on any personal property located on the real estate which is to be transferred by bill of sale to the buyer.

13.7 *Assignment of leases:* **Requires** the seller to assign all leases and rental agreements to the buyer on closing. [See **RPI** Form 595]

a. *Ownership notice:* **Requires** the seller to notify each tenant of the change of ownership. [See **RPI** Form 554]

13.8 *Tenant security deposits:* **Requires** the seller to credit or pay the buyer on the close of escrow for security deposits held by the seller under the existing occupancies. **Requires** the seller to notify each tenant of the transfer of the security deposit. [See **RPI** Form 586]

Editor's note — Proper notice to the tenant regarding the security deposit transfer to the buyer eliminates all future liability the seller may have had due to the seller's original receipt of the deposits.

13.9 *Rent due and unpaid at closing:* **Treats** delinquent unpaid rent as paid for purposes of prorations. The buyer is credited for their share of paid and unpaid rents for the month of the closing. On any later recovery by the buyer of delinquent prorated rent, the buyer is to forward the entire amount received to the seller.

13.10 *Service contracts:* **Enter** the name of the providers of services under contracts the buyer is to assume.

a. *Prorations*: **Authorizes** the proration of amounts prepaid or unpaid on the service contracts.

13.11 *Buyer's possession:* **Requires** the seller to deliver possession of the property to the buyer on the close of escrow.

13.12 *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 buyer may terminate the agreement if the seller is unable to provide a marketable title or should the property improvements suffer major damage.

14. *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.

Structuring the broker fee

15. **Broker fee:**

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

a. *Seller paid:* **Provides** that the seller will pay the broker fee on the change of ownership.

b. *Wrongful prevention:* **Provides** that the party wrongfully preventing the change of ownership will pay the broker fee.

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

15.2 *Fee sharing:* **Enter** the percentage share of the fee each broker is to receive or **check** the box if a separate Fee Sharing Agreement is attached. [See **RPI** Form 105]

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

15.3 *Agency law disclosures:* **Check** the box to indicate a copy of the Agency Law Disclosure addendum for all parties to sign is attached. The disclosure is mandated to be acknowledged by the buyer with the offer and acknowledged by the seller on acceptance as a prerequisite to the buyer's broker enforcing collection of the fee earned on all property transactions other than multi-family parcels with more than four units. [See Form 305 accompanying Chapter 2]

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

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

Agency confirmation

Buyer's broker identification: **Enter** the name of the buyer's broker and their California Bureau of Real Estate (CalBRE) license number. **Enter** the name of any buyer's agent and their CalBRE license number. **Obtain** the signature of the buyer's broker or 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 buyer's broker's address, telephone and fax numbers, and email address.

Seller's broker identification: **Enter** the name of the seller's broker and their CalBRE license number. **Enter** the name of any listing agent and their CalBRE license. **Obtain** the signature of the seller's broker or the listing 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 seller's broker's address, telephone and fax numbers, and email address.

Signatures

Buyer's signature: If *additional* buyers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement,

and **enter** their names and **obtain** their signatures until all buyers are individually named and have signed. **Enter** the date the buyer signs the purchase agreement and the buyer's name. **Obtain** the buyer's signature.

Seller's signature: If *additional* sellers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all sellers are individually named and have signed. **Enter** the date the seller signs the purchase agreement and the seller's name. **Obtain** the seller's signature.

Rejection of offer

If the offer contained in the purchase agreement is rejected, and the rejection will not result in a counteroffer, enter the date of the rejection and the names of the party rejecting the offer. Obtain the signatures of the party rejecting the offer.

Observations

As a policy of the publisher to provide users of **RPI** forms with maximum loss reduction protection, this purchase agreement does not contain clauses which tend to increase the risk of litigation or are generally felt to work against the best interests of the buyer, seller and broker. Excluded provisions include:

- an *attorney fee provision*, which tends to **promote litigation** and inhibit normal contracting;
- a *time-essence clause*, since future performance (closing) 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 [See Chapter 30];
- an *arbitration provision*, since arbitration decisions are **final and unappealable**, without any assurance the arbitrator's award will be fair or correct [See Chapter 34]; and
- a *liquidated damages provision*, since they **create wrongful** expectations of windfall profits for sellers and are nearly always forfeitures and unenforceable. [See Chapter 33]

Chapter 36 Summary

An agent seeking an income property for a client first reviews an Annual Property Operating Data sheet (APOD) to assess the property's suitability to the client. If the property meets the buyer's requirements, the agent requests more information about the property, including:

- a rent roll spread sheet;
- an occupancy history of each unit;
- information on security arrangements and criminal activity;
- an interview with a property manager;
- information on maintenance and repair services;
- CC&R exclusions to the title insurance policy; and
- any other material facts about the property's condition or location which may affect its value.

Price negotiations are best to commenced only when disclosures of all readily available property data and information have been handed over by the seller or the seller's agent.

After receiving the disclosures and conducting a minimal investigation, the buyer's agent prepares a purchase offer agreement. The seller and prospective buyer establish conditions to be met so the prospective buyer can complete a due diligence investigation and confirm their initial expectations about the property.

The income property purchase agreement becomes the binding written contract between the buyer and seller. A comprehensive income property purchase agreement includes:

- identification of the buyer, seller and property;
- the price and financing terms of the sale;
- agreements setting forth the terms of acceptance and performance of the contract, including deadlines and cancellation provisions;
- due diligence contingencies for the buyer's investigation;
- the buyer's confirmation of the property conditions as disclosed;
- closing conditions and procedures;
- brokerage and agency provisions, such as the amount and payment of the broker fee and confirmations of agency; and
- the binding signatures.

Chapter 36 Key Terms

Chapter 37

Tax aspects advice

Learning Objectives

After reading this chapter, you will be able to:

- develop better clientele and capitalize on your competitive advantage of offering advice to clients on the tax consequences of a real estate transaction;
- advise clients when they need third-party tax counsel and a contingency provision for further approval of a transaction's tax consequences;
- avoid liability exposure for the tax information you give; and
- understand the mortgage interest deduction (MID).

Key Terms

§1031 cooperation provision
§1031 transaction
Agency Law Disclosure
carryback financing
itemized deductions
mortgage interest deduction (MID)
principal residence
qualified interest
second home

Analyzing a transaction's tax aspects

Consider an owner of an income-producing parcel of improved real estate who intends to hire a brokerage office to market a property for sale and locate a buyer. The owner interviews a few brokers and sales agents to determine who they will employ.

The owner's primary concern is to hire an agent who is most likely to produce a prospective buyer who will purchase the property. Thus, the owner's interviews include an inquiry into:

- the **contents of the listing package** the agent will prepare to market the property;
- the **scope of the advertising** the agent will provide to locate prospective buyers; and
- the **professional relationship** the agent has with other brokers and agents who represent buyers.

One agent inquires about the owner's **intended use of the proceeds** from the sale. The owner indicates they want to reinvest the funds in developable land, to hold for profit on a later resale to a subdivider or builder.

On further inquiry, the owner provides the agent with:

- *data on the price* paid for the property;
- the *debt* now encumbering the property; and
- the depreciated *cost basis* remaining in the property.

These three key pieces of data are needed for an agent to assist the owner in *tax planning* for a sale.

Initial opinion of tax liability

The agent does some quick math (sales price minus basis equals profit) to approximate the amount of profit the owner will realize on a sale. The agent immediately determines the owner would pay profit taxes at **recapture** (25%) and **long-term** (15%) rates that will equal nearly one fifth of the net proceeds from a sale (plus one twelfth for state taxes). The owner is informed of the agent's initial opinion about the owner's tax liability on a sale.

The agent then informs the owner they can *avoid reporting the profit* and paying income taxes on the sale by buying the land the owner wants to acquire now. Thus, the sale of the income property and the purchase of land can be linked together to bring about a *continuing investment* of the owner's equity in real estate.

The agent also informs the owner that the purchase agreements entered into for the sale of the income property and the purchase of the land are to contain *contingency provisions* conditioning the closing of the sale on the owner's purchase of other property.

Disclosure of known consequences

To avoid misleading the owner about the extent of the agent's experience handling §1031 reinvestment plans for clients, the agent informs the owner they have not personally handled a **§1031 transaction**. However, the agent lets the owner know they have taken courses on §1031 transactions and discussed §1031 funding procedures with brokers and escrow officers who have experience handling §1031 reinvestment arrangements.

The agent tells the owner they believe they can properly market the property and locate suitable land for the owner's reinvestment, as well as follow up on the steps needed for §1031 tax avoidance if the property is listed with the agent's broker.

Conversely, a second agent contacted by the owner is reticent about becoming involved in a review of the tax aspects of selling property.

§1031 transaction
A sales transaction in which sales proceeds are reinvested by the acquisition of a replacement like-kind property, the profits on the sale deferred until the investment is cashed out.[See **RPI** Form 354 and 355]

The second agent hands the owner a *written statement* attached to a proposed listing agreement advising the owner that the agent:

- has disclosed the extent of their *knowledge* of the tax consequences on the sale of real estate;
- is unable to give *further tax advice* on the rules and procedures involved in a §1031 transaction; and
- has advised the owner to *seek the advice* of their accountant or tax attorney on how to properly avoid the tax on profit from the sale and purchase of real estate.

Did both agents comply with their agency duty to make proper disclosures to the owner about their knowledge and willingness to provide tax advice?

Yes! Both agents met the *agency duty* undertaken when soliciting employment since each agent:

- determined how the tax consequences of the sale may affect the owner's handling of the sales transaction, called a **material fact**;
- disclosed the extent of their knowledge regarding the possible tax consequences of the sale; and
- advised on the need for a professional to further investigate and advise on the §1031 tax aspects.

The question then remains: Is a broker employed by a seller of real estate required to give tax advice to their seller?

The answer lies in the *type of real estate* involved and the client's intended use of the sales proceeds.

An affirmative duty to advise

Consider a seller's agent who determines that information about the tax aspects of a sale is *material* to a sales transaction entered into by a client since tax information can affect the client's handling of the transaction. Accordingly, the agent has a duty owed to the client to disclose the extent of the agent's knowledge on the transaction's tax aspects, called an **agency duty** or **fiduciary duty**.

Further, a concerned seller's agent goes beyond disclosure of mere tax information and assists their client in structuring the sales arrangement to achieve the best possible tax consequences available.

However, a *statutory exception* to the disclosure duties exists: on a one-to-four unit residential dwelling, a seller's agent has *no duty to disclose* their knowledge of possible tax consequences. Even if the tax consequences are known by the agent to affect the client's decision on how to handle the sale of the property, the seller's agent has no duty to disclose, unless the topic becomes the subject of the client's inquiry.[1]

1 Calif. Civil Code §2079.16

Advice disclosure

Consider a seller of a one-to-four unit residential property who enters into a client-agent relationship with a broker, employing the broker (and the broker's agents) to sell the property under a listing agreement.

The listing agreement form used by the broker contains a boilerplate clause stating a real estate licensee is a person qualified to advise on real estate, a statement that is consistent with the training of brokers and agents. However, the clause reflecting out-dated training further states that if the seller desires legal or tax advice, the seller is to consult an appropriate professional — saying nothing about the broker's or agent's ability to do so.[2]

Agency Law Disclosure
Restatement of agency codes and cases which establish the conduct of real estate licensees. It is delivered to all parties in targeted sales and leasing transactions. [See **RPI** Form 305]

The broker also hands the seller a statutorily mandated **Agency Law Disclosure** form that states: "A real estate agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional." Here, the competent professional may just be the broker and agent involved.

Neither "disclaimer" requires the broker and their agents to provide tax advice or obligates the seller to employ another professional to advise on the tax aspects of the transaction before closing escrow, thus leaving the client a bit rudderless.[3]

The broker then locates a buyer who enters into a purchase agreement with the seller to buy the property. The purchase agreement, like the listing agreement, states the seller is to consult their attorney or accountant for tax advice.

Constructive receipt of sales proceeds

Prior to closing the sale of the seller's property, the broker also negotiates the seller's purchase of another one-to-four unit residential property, which involves the broker's preparation of a purchase agreement.

Before the separate escrows close on the sale and purchase transactions, the seller asks the broker about the number of days they have after the sale closes to purchase the replacement property and avoid paying profit tax on the sale. The seller has never been involved in a §1031 reinvestment.

The broker informs the seller they are not sure of the number of days and orally advises the seller to consult a tax accountant. The seller does not do so since no *contingency provision* for further-approval of the tax consequences was in the purchase agreement.

Ultimately, the seller is taxed on the profit from the sale, but not because of the time constraints on the closing of escrow which the seller inquired about. The profit is taxed because the seller failed to avoid actual and constructive receipt of the sales proceeds. To avoid receipt, the seller needed to either:

- *directly transfer* the sales proceeds from the sales escrow to the purchase escrow; or

2 CC §2079.16
3 CC §2079.16

- *impound* the sales proceeds with a third-party trustee until the proceeds are needed to fund the purchase escrow for the replacement property.

Tax advice liability exception

Continuing with the above example, the seller then seeks to recover losses from the broker due to adverse tax consequences incurred on the reinvestment. The seller claims the broker breached the agency duty owed to the seller by failing to disclose that the structure of the seller's transfer of net sales proceeds from the sales escrow to the purchase escrow for the replacement property might result in *adverse tax consequences* due to the seller's actual receipt of the reinvestment funds.

The broker claims they have *no duty to advise* the seller on the tax consequences of the one-to-four unit sale since the listing agreement, the *Agency Law Disclosure* and the purchase agreement all clearly stated:

- the broker did not advise on tax matters; and
- the seller is to look to other professionals for tax advice.

Did the seller's broker (or agents) have a duty to advise the seller on the tax consequences of the sale as known to the broker (or agents)?

No! On the sale of one-to-four unit residential property, sellers (and buyers) are expected, as a matter of public policy, to obtain tax advice from competent professionals other than the residential real estate brokerage office handling the transaction.[4]

A broker has no duty to voluntarily disclose any tax aspects surrounding the sale of a one-to-four unit residential property, even if the *information is known* to the broker or the sales agent. However, the listing agreement needs to specify the broker and broker's agents *do not undertake the duty* to advise the seller on the tax aspects of the transactions. Further, on a direct inquiry from the seller (or buyer), the agent must *respond honestly* and to the best of their knowledge.[5]

The Agency Law Disclosure addendum attached to listing agreements and purchase agreements *eliminates the duty* of a broker and their agents to disclose their knowledge about the tax aspects of a sale when a one-to-four unit residential property is involved.

carryback financing
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing, also known as an installment sale, credit sale or seller financing.

The irony of mandated disclosures

The tax consequences of sales transactions involving the subsequent purchase of replacement property are as material to a seller as the structuring of **carryback financing**. *Carryback financing* arrangements require an agent to make extensive mandated disclosures regarding documentation of the carryback and the rights of the carryback seller. However, carryback arrangements are less frequently encountered during boom times than §1031 reinvestment opportunities.

4 CC §2079.16

5 **Carleton** v. **Tortosa** (1993) 14 CA4th 745

Further, the financial damage of profit taxes avoidable in a §1031 transaction often exceeds the risk of loss on an improperly structured carryback note and trust deed transaction. Unlike the agency duty of a broker (and their agents) in §1031 transactions, the agency duty a broker (and their agents) owes to their carryback seller includes full disclosure of information necessary for the seller to make an informed decision about the *financial suitability* of a carryback sale before the seller enters into the transaction.[6]

Avoiding misleading disclaimers

The boilerplate statement included in some listing agreements and purchase agreements used by unionized real estate brokers and their agents incorrectly implies that they are not qualified to give tax advice.

If a broker or agent is not fully qualified to handle the sale and purchase aspects of a §1031 transaction, they are at least aware of its beneficial tax aspects available to a seller of property. Further, real estate brokers and their agents with tax knowledge are *duty-bound to advise their client* about their knowledge concerning the tax consequences of the real estate transaction their client is about to enter into — unless a one-to-four unit residential property is involved.

A savvy broker or agent *capitalizes* on the tax knowledge they have spent time acquiring by advising clients on the tax results of their real estate transactions, regardless of the type of property involved. However, the broker or agent who advises a client on a transaction's tax consequences has a duty to not mislead the client by intentional or negligent misapplication of the tax rules.[7]

To avoid misleading the client**,** the broker or agent is advised to disclose to the client:

- their full extent of tax knowledge regarding the transaction;
- how they acquired this tax knowledge; and
- whether the broker or agent intends to further investigate the matter or whether the client should seek further advice from other professionals.

Shifting reliance

Brokers and agents who provide tax advice are best served by involving the client's other advisors in the final decision, such as their attorney or tax accountant. Input from others who know the client help the broker eliminate future claims arising from adverse tax consequences said to be due to the *client's reliance* on the agent's opinion.

The most practical (and effective) method for shifting reliance to others or to the client when the broker provides their opinion on a transaction's tax consequences, is to insert a *further-approval contingency provision* in the purchase offer or counteroffer.

---

6 **Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860

7 **Ziswasser** v. **Cole & Cowan, Inc.** (1985) 164 CA3d 417

The *contingency provision* requires the client to initiate the investigation by obtaining additional tax advice and further approval of the transaction's tax consequences from an attorney or accountant before allowing escrow to close.

An oral or written warning, or *general advice* to further investigate as in a disclaimer statement, is insufficient. Advisory statements do not require the client to act. Worse, they do not explain why the broker or agent providing the advisory statements believes the client needs to act to protect themselves. A further-approval contingency provision makes the advice an *opinion*, to be confirmed by the client before closing.[8]

Tax advisor's further approval

In an exchange agreement (or purchase agreement), a further approval contingency regarding the transaction's tax consequences allows a client to confirm the transaction qualifies for §1031 tax-exempt status as represented by the agent. If the tax status cannot be confirmed, the client may terminate the transaction by delivery of a notice of cancellation. [See **RPI** Form 171 §5.2j]

In other words, the client is *not relying* on the agent's opinion if they decide to enter into an exchange agreement with the intent to close escrow only after further confirmation of the tax consequences.

However, a purchase agreement or exchange agreement that contains a written contingency provision calling for a third party's approval of some aspect of the transaction also contains an unwritten *implied covenant provision*. Under the implied covenant provision, before a client can cancel a transaction, they are required to "act in good faith and with fairness" in efforts to obtain a third party's approval, such as submitting data on the transaction for confirmation from an attorney or accountant.

Thus, the *implied covenant provision* compels the client to actually submit documentation on the transaction to the third party tax advisor, and to do so within the time period called for after the date of acceptance.

Here, the client's agent usually steps into the chain of events by contacting the third party and providing the paperwork sought to review the transaction for its §1031 tax-exempt status. On review, the agent may make procedural changes needed to meet the client's objectives and satisfy the objections of the third party advisor.

Since fair dealing and reason are implied in every agreement and applied to the conduct of all parties, a termination of the exchange agreement due to the disapproval of an activity or occurrence subject to a contingency provision must be based on a *justifiable reason*.

On a potential disapproval and possible termination due to reasons expressed by the client or their advisor, the agent might be able to cure the defect that

8 **Field** v. **Century 21 Klowden-Forness Realty** (1998) 63 CA4th 18

gave rise to the reason for disapproval or demonstrate that the third party's concern is unfounded, i.e., if their concern is, in fact or in law, an erroneous conclusion.[9]

Tax aspects: a material fact

All real estate in the hands of a seller is classified as either a principal residence, like-kind (§1031) property or dealer property.

When representing sellers of real estate that, on a sale, qualify for the §1031 profit reporting exemption, an agent is to use a purchase agreement containing a §1031 cooperation provision. [See **RPI** Form 159 §10.6]

§1031 cooperation provision
A statement in purchase agreements putting the seller and buyer on notice they are able to avoid profit reporting on the transaction and provides cooperation when a §1031 exemption is intended on the sale or purchase of a property.

A **§1031 cooperation provision** puts the seller on notice they are able to avoid profit reporting on the sale and have bargained for the buyer's cooperation if the seller decides to act to qualify their profit for a §1031 exemption. It is not an advisory disclaimer by which a broker or agent attempts to relieve themselves of their responsibility to give tax advice.

Again, an agent who is not knowledgeable about the handling required for a §1031 reinvestment can initially avoid a discussion of tax aspects by including the §1031 cooperation provision in the purchase agreement. The §1031 cooperation provision conveys to the seller the seller's need to consider, plan for and inquire about the tax consequences of the sale.

Knowledge of basic tax aspects

Technical questions by a seller that go beyond their agent's knowledge or expertise require a truthful response from the agent, including:

- **disclosing** the extent of their *knowledge* to the seller and advising the seller to seek further advice they may want from another qualified source;
- **associating** with a more knowledgeable broker, a tax attorney or accountant who provides the seller with the advice; or
- **learning** how to handle §1031 reinvestments and giving the advice themselves.

Escrow officers are of great assistance to an agent who is aware they have a potential §1031 transaction. Many escrow officers and transaction agents advertise their expertise in handling §1031 tax- deferred reinvestments to broadcast their competitive advantage over other escrow officers and agents.

Ideally, brokers and agents handling the sale of real estate used in the seller's business or held for investment (both are like-kind property) will, as a matter of basic competency, possess an understanding of several fundamental tax concepts, such as:

- the principal residence owner-occupant's individual $250,000 profit exclusion on a sale;
- the separate income and profit categories for different types of real estate;

9 **Brown** v. **Critchfield** (1980) 100 CA3d 858

- the §1031 profit reporting exemption;
- interest deductions on mortgages;
- depreciation schedules and cost recovery deductions;
- the $25,000 deduction and real-estate-related business adjustments for rental property losses;
- the tracking of rental income/losses separately for each property;
- profit and loss spillover on the sale of a rental property;
- standard and alternative reporting and their tax bracket rates; and
- installment sales with deferred profit reporting.

These tax aspects are basic to the sale or ownership of real estate commonly listed and sold by agents. When applicable, they have significant financial impact on sellers and buyers of real estate. Any agent with a working knowledge of the tax aspects of real estate can and is advised to consider offering a wider range of services — including tax advice — when competing to represent buyers and sellers.

Additionally, giving a seller tax advice concerning a §1031 reinvestment plan when the seller follows the advice always leads to a second fee for negotiating the purchase of the replacement property and coordinating the transfer of funds.

The mortgage interest deduction

A tax rule relevant to some homeowners is the special home **mortgage interest deduction (MID)**, an exception for income tax reporting which allows interest accrued and paid on a mortgage to be deductible from (adjusted gross) income as an itemized expense reducing the taxable income. A mortgage qualifies if it:

- funded the purchase price or paid for the cost of improvements for the owner's principal residence or second home; and
- is secured by either the owner's principal residence or second home.[10]

mortgage interest deduction (MID) An itemized deduction for income tax reporting allowing homeowners to deduct interest and related charges they pay on a mortgage encumbering their primary or second homes.

Without the special exemption of the home *MID* rule, interest paid on a mortgage which funds the purchase or improvement of a principal residence or second home is not deductible. When a mortgage does not fund the purchase or improvement of a principal residence, it funds either a *personal expense* on which interest is not deductible or the acquisition of an investment or business property in which case interest is deductible or expensed.

Also, interest accrued and paid on **home equity mortgages** secured by the property owner's principal residence or second home is tax deductible under the home MID exemption rules, regardless of whether or not the mortgage's net proceeds were used for personal or investment/business purposes.

10 Internal Revenue Code §163(h)

The MID as an itemized deduction

itemized deductions
Deductions taken by a taxpayer for allowable personal expenditures which, to the extent allowed, are subtracted from adjusted gross income (AGI) to set the taxable income for determining the income tax due, called Schedule A.

The MIDs for the first and second home reduce the property owner's taxable income as an **itemized deduction** from the owner's adjusted gross income under both the standard income tax (SIT) and the alternative minimum tax (AMT) reporting rules. In contrast, the real estate *property tax deduction* on the first and second homes, another exemption from disallowance of personal deductions, only reduces the owner's SIT, not their AMT.

Thus, homeowners with significant income from personal income and business or investment assets do not get much if any benefit from the homeowner's property tax deduction.

Two *categories of mortgages* exist to control the deduction of interest paid on any mortgage secured by the principal residence or second home. These include:

- interest on the balance of a purchase or improvement mortgage up to a combined principal amount of $1,000,000; and
- interest on all other mortgage amounts up to an additional $100,000 in principal, called *home equity mortgages.*[11]

Thus, interest paid on first and second home mortgages up to a balance of $1,100,000 can be deducted from income under the interest deduction exemption from disallowed personal expenses rules.

Qualifying the principal residence and second home

principal residence
The residential property where the homeowner resides a majority of the year.

second home
An individual's alternative residence where they do not reside a majority of the year.

To qualify for a home MID, mortgages need to be secured by the **principal residence** or **second home**.

A *principal residence* is defined as an individual's home if:

- the homeowner's immediate family resides in it a majority of the year;
- the home is located close to the homeowner's place of employment and banks which handle the homeowner's accounts; and
- the home's address is used for tax returns.[12]

A *second home* is any residence selected by the owner from year to year, including mobile homes, recreational vehicles and boats.

When the second home is *rented out* for portions of the year, the interest qualifies for the home MID if the owner occupies the property for the greater of:

- more than 14 days; or
- 10% of the number of days the residence is rented.[13]

If the owner *does not rent* out their second home at any time during the year, the property qualifies for the home MID whether or not the owner occupies it.[14]

11 IRC §163(h)(3)
12 IRC §§163(h)(4)(A)(i)(I), 121
13 IRC §280A(d)(1)
14 IRC §163(h)(4)(A)(iii)

The rental income on the second home is *investment/portfolio income* if the home qualifies for the interest deduction due to the owner's days in occupancy exceeding the 14-day/10% rule.

When the second home is rented and the owner's family occupied the property for more than 14 days or 10% of the days rented (thus qualifying the home for the MID), the owner is not allowed to treat the property as an investment. Since the property is not an investment, the owner cannot depreciate the home.[15]

A second home, when purchased for personal use and held for a profit on resale, also qualifies as investment (like-kind) property for exemption from profit taxes under IRC §1031.[16]

Taking the deductions

Interest deductions on home mortgages are only allowed for interest which has *accrued and been paid*, called **qualified interest**.[17]

qualified interest Interest on a mortgage which has accrued and been paid and is an allowable interest deduction for ownership of a first and second home.

Interest on first and second home mortgages is deducted from an owner's *adjusted gross income (AGI)* as an *itemized deduction*. Further, limitations restrict the amount of deductions the homeowner can claim.

Unlike deductions, business, rental or investment interest paid on a mortgage is an *adjustment* that reduces the AGI. Thus, the two types of home mortgage interest deductions directly reduce the amount of the owner's taxable income (if the interest deductible is not limited by ceilings on the homeowner's itemized deductions).

The inability to reduce the owner's AGI by use of the home mortgage interest makes a substantial difference for high-income earners. The higher an owner's AGI, the lesser the amounts allowed for rental loss deductions, the *itemized deduction phaseout* (starting at an AGI of $258,250 for individuals in 2015), and any tax credits held by the owner.[18]

Consider a homeowner who wants to generate funds to use as a down payment to purchase business, rental or investment real estate. Their only substantial asset is the $300,000 equity in their home.

If the owner further encumbers the home with a home equity mortgage or refinances the existing mortgage to net $200,000 in mortgage proceeds, they will be paying interest which is only partially deductible. The non-purchase/improvement mortgage amount exceeds the $100,000 home equity mortgage cap.

The interest the owner pays on the portion of home equity mortgage balance in excess of the $100,000 mortgage cap is not deductible under the home MID rules. All or part of the interest may be a deduction or expense of the investment or business the mortgage funded.

15 IRC §§163(h)(4)(A)(i)(II); 280A(d)(1)
16 IRC §1031; IRS Private Letter Ruling 8103117
17 IRC §163(h)(3)(A)
18 IRC §163(a), (h)(2)(A)

Chapter 37 Key Terms

Ideally, agents will, as a matter of basic competency, possess an understanding of certain fundamental tax concepts which are basic to the sale or ownership of real estate that they will most frequently be listing and selling.

In certain real estate transactions, a broker stands to earn an additional fee for assisting a seller in locating and acquiring a like-kind replacement property for the property being sold. This exempts the client from reporting the sale proceeds as income and thus having those proceeds taxed, known as a §1031 transaction or §1031 reinvestment plan.

If an agent determines information about the tax aspects of a sale might affect the client's handling of the transaction, the tax aspects become material to the transaction and the agent is duty-bound to disclose the extent of their knowledge on the transaction's tax implications. However, on a one-to-four unit residential property transaction, the agent has no duty to disclose tax information unless the client makes a direct inquiry on the matter.

A broker or agent who chooses to voluntarily counsel a client on such matters needs to be careful to avoid misleading their client by intentional or negligent misapplication of the tax rules, and may advise their client to seek advice from a qualified third-party advisor. The most practical (and effective) method for shifting reliance to others or to the client is to insert a further-approval contingency in the purchase offer or counteroffer.

A tax rule relevant to homeowners is the special home mortgage interest deduction (MID), which allows interest accrued and paid on a mortgage to be deductible from adjusted gross income as an itemized expense.

To qualify for a home MID, mortgages need to be secured by a principal residence or second home.

Interest deductions on home mortgages are only allowed for interest which has accrued and been paid, called qualified interest.

Chapter 37 Key Terms

Glossary

#

§1031 cooperation provision 408
A statement in purchase agreements putting the seller and buyer on notice they are able to avoid profit reporting on the transaction and provides cooperation when a §1031 exemption is intended on the sale or purchase of a property.

§1031 transaction 403
A sales transaction in which sales proceeds are reinvested by the acquisition of a replacement like-kind property, the profits on the sale deferred until the investment is cashed out. [See **RPI** Form 354 and 355]

A

abstract of title 31
A representation issued by a title company as a guarantee to the named person, not an insurance policy, listing all recorded conveyances and encumbrances affecting title to the described real estate.

advance cost sheet 31
An itemization of the costs incurred to properly market a property for sale which are to be paid by the owner. [See **RPI** Form 107]

advance costs 41
Deposits handed to a broker to cover out-of-pocket costs incurred on behalf of the depositor while performing brokerage services.

affiliated business arrangement (ABA) 24, 46
A business arrangement in which a broker may lawfully profit from referring a client to a service provider the broker owns; requires the broker to make a disclosure of their ownership interest to the client. [See **RPI** Form 205 and 519]

affirmative fraud 96
Intentionally and knowingly misrepresenting information to someone.

Agency Law Disclosure 10, 404
Restatement of agency codes and cases which establish the conduct of real estate licensees. It is delivered to all parties in targeted sales and leasing transactions. [See **RPI** Form 305]

Alquist-Priolo Maps 135
Maps which identify earthquake fault areas available from the State Mining and Geology Board and the city or county planning department.

Annual Property Operating Data sheet (APOD) 63, 373, 385
A worksheet used when gathering income and expenses on the operation of an income producing property, to analyze its suitability for investment. [See **RPI** Form 352]

arbitration..... 363
A form of dispute resolution voluntarily agreed to in contracts authorizing a third-party arbitrator to issue a binding award which cannot be reviewed and corrected by a court of law.

arbitrator 364
A neutral third-party appointed to hear a dispute who is authorized to make a final decision awarding judgment in favor of one of the parties.

attorney fee provision **367**
A provision in an agreement permitting the prevailing party to a dispute to receive attorney fees when litigation arises due to the agreement. [See **RPI** Form 552 §23.2]

authorization-to-extend provision **319**
A purchase agreement provision granting authority to extend performance dates before the transaction may be cancelled.

B

best effort obligation **60**
Obligations under an open listing requiring the agent to take reasonable steps to achieve the objective of the client but requiring no affirmative action until a match is located at which point due diligence is required.

bilateral rescission **308**
An agreement by a buyer and a seller mutually agreeing to terminate their purchase agreement.

bona fide purchaser (BFP) **331**
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.

buyer's cost sheet. **211**
A worksheet used when estimating the total expenditures for acquiring a property and the amount of funds needed to close, including the source of the funds. [See **RPI** Form 311]

C

California Home Energy Rating System **111**
California state system used to create a standard rating for energy efficiency and certify professional raters.

carcinogen **158**
A substance which causes cancer in human beings.

carryback financing **213, 405**
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing, also known as an installment sale, credit sale or seller financing.

certificate of clearance **140**
A document certifying a property has been cleared of all infestations and all repairs necessary to prevent infestations have been completed.

chain of title. **250**
A history of conveyances and encumbrances affecting the title from the time the original patent was granted, or as far back as records are available, used to determine how title came to be vested in the current owner.

community property **251**
All property acquired by husband or wife during a marriage when not acquired as the separate property of either spouse.

condition concurrent **293, 319**
A provision in an agreement calling for the performance of an activity by a buyer or seller without concern for the performance of the other person.

condition precedent **293, 319**
A provision in an agreement calling for the occurrence of an event or performance of an act by another person before the buyer or seller is required to further perform.

conflict of interest **19, 23**
When a broker or agent has a positive or negative bias toward a party in a transaction which is incompatible with the duties owed to their client. [See **RPI** Form 527]

consideration **286**
Anything given or promised by a party to induce another to enter into a contract. It may be a benefit conferred upon one party or a detriment suffered by the other.

constructive notice **287**
To be charged with the knowledge of conditions existing on the property by recorded documents or an occupancy of the property at the time of a transaction.

conveyance **249**
A transfer of an interest in title to property from one person to another, such as is effected by a deed or a trust deed.

cooperating broker **44**
A broker or their agent acting as a subagent of the seller's broker with specific affirmative duties of care owed the seller, but not the buyer.

counteroffer **269**
An alternative response to an offer received consisting of terms different from those of the offer rejected. [See **RPI** Form 180]

covenants, conditions and restrictions (CC&Rs) **53**
Recorded restrictions against the title to real estate prohibiting or limiting specified uses of the property.

D

date-down search **266**
A further search of the public records performed by a title insurer after preparing a preliminary title report and immediately prior to issuance of a policy of title insurance.

defacing **275**
When a document is modified on its face, usually by striking copy and interlineation, after it is signed by one or both parties.

double-end **12**
When the seller's agent receives the entire fee in the real estate transaction, there being no buyer's agent for fee splitting.

dual agency **10, 27**
The agency relationship that results when a broker represents both the buyer and the seller in a real estate transaction. [See **RPI** Form 117]

dual agent **12, 19**
A broker who represents both parties in a real estate transaction. [See **RPI** Form 117]

due diligence **59**
The concerted and continuing efforts of an agent employed to meet the objectives of their client, the agent's promise given in exchange for the client's promise to pay a fee.

E

encumbrance **266**
A claim or lien on title to a parcel of real estate, such as property taxes, assessment bonds, trust deeds, easements and covenants, conditions and restrictions (CC&Rs).

energy audit **111**
An inspection which pinpoints a home's energy-efficient improvements and features in need of energy-efficient improvements.

environmental hazards **153**
Noxious or annoying man-made conditions which are injurious to health or interfere with an individual's sensitivities.

equity **195**
The interest or value an owner has in real estate over and above the liens against it.

estimate **98**
Prediction of future amounts which have not yet actually occurred.

event-occurrence contingency provision **292**
A purchase agreement provision requiring an event or activity to take place which is not subject to the approval of the buyer or seller. [See **RPI** Form 150 §11.1]

extraordinary expense **171**
An emergency situation lifting the limits placed on the amount an HOA may charge for regular and special assessments.

F

fact **88**
An existing condition which is presently known or readily knowable by the agent.

fiduciary duty **70, 93**
That duty owed by an agent to act in the highest good faith toward the principal and not to obtain any advantage over their principal by the slightest misrepresentation, concealment, duress or undue influence.

forecast **99**
Analysis of anticipated changes in circumstances influencing the future income, expenses and use of a property.

forfeiture **358**
Loss of money, rights or anything of value due to failure to perform, a remedy abhorred by the courts.

further-approval contingency provision **292, 306**
A provision in an agreement calling for the further approval of an event or activity as a condition precedent to the further performance or cancellation of the transaction by the persons benefiting from the provision. [See **RPI** Form 185 §9 and 279 §2]

G

general damages **334, 345**
Money losses by a buyer or seller due to their expenditures and loss of value directly related to a failed property sales transaction.

general duty **70, 377**
The duty a licensee owes to non-client individuals to act honestly and in good faith with up-front disclosures of known conditions which adversely affect a property's value. [See **RPI** Form 305]

good faith deposit **354**
A money deposit made by a buyer to evidence their good faith intent to buy when making an offer to acquire property. Also known as earnest money. [See **RPI** Form 401 §1.1]

guarantee **88**
An assurance that events and conditions will occur as presented by the agent.

H

hazardous waste **160**
Any products, materials or substances which are toxic, corrosive, ignitable or reactive.

home inspection report (HIR) **107, 117**
A report prepared by a home inspector disclosing defects in improvements on a property and used by the seller's agent to complete a TDS and assure prospective buyers about a property's condition.

home inspector **108**
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.

homeowners' association (HOA) **170**
An organization made up of owners of units within a common interest development (CID) which manages and operates the project through enforcement of conditions, covenants and restrictions (CC&Rs).

I

implicit rent **349**
The value of the use of a property by the owner.

implied covenant of good faith and fair dealing **340**
A legal presumption that parties to an agreement will deal equitably with one another by abiding by the terms of the agreement and timely performing their obligations.

inaccessible areas **146**
Areas of a structure which cannot be inspected without opening the structure or removing the objects blocking the opening, such as attics or areas without adequate crawl space.

income approach **374**
The use of a property's rental income to set its value.

interlineation **275**
The process of modifying an instrument or document by inserting additional language between the lines to clarify a particular provision, usually adding something that was omitted.

itemized deductions **410**
Deductions taken by a taxpayer for allowable personal expenditures which, to the extent allowed, are subtracted from adjusted gross income (AGI) to set the taxable income for determining the income tax due, called Schedule A.

K

kickback **50**
A fee improperly paid to a transaction agent (TA) who renders no service beyond the act of referring when the TA is already providing another service in the transaction for a fee.

L

lead-based paint **163**
Any surface coating containing at least 1.0 milligram per square centimeter of lead, or 0.5% lead by weight. [See **RPI** Form 313]

lead-based paint hazard **165**
Any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects. [See **RPI** Form 313]

liquidated damages provision **353**
A provision stating the maximum money losses a buyer owes a seller in the event the seller incurs losses on a buyer's breach.

listing agreement **18, 215**
An employment agreement used by brokers and agents when a client retains a broker to render real estate transactional services as the agent of the client. [See **RPI** Form 102 and 103]

loan-to-value ratio (LTV) **212**
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value.

M

marketing package **32, 63, 80**
A property information package handed to prospective buyers containing disclosures compiled on the listed property by the seller's agent.

material defect **114, 119**
Information about a property which might affect the price and terms a prudent buyer is willing to pay for a property.

material fact **60, 71, 192, 196**
A fact that, if known, might cause a prudent buyer or seller of real estate to make a different decision regarding what price to offer or demand for a property or whether to remain in a contract or cancel it.

mediation **368**
An informal, non-binding dispute resolution voluntarily agreed to in which a third-party mediator works to bring the disputing parties to their own decision to resolve their dispute.

Mello-Roos **180**
The Mello-Roos Community Facilities Act of 1982 authorizes the formation of community facilities districts; the issuance of bonds, and the levying of special taxes thereunder to finance designated public facilities and services.

mortgage interest deduction (MID) **409**
An itemized deduction for income tax reporting allowing homeowners to deduct interest and related charges they pay on a mortgage encumbering their primary or second homes.

multiple listing service (MLS) **10, 18, 80**
An association of real estate agents pooling and publishing the availability of their listing properties.

N

Natural Hazard Disclosure Statement (NHD) **63, 126**
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 **RPI** Form 314]

natural hazards **125**
Risks to life and property which exist in nature due to a property's location.

negative fraud **96**
Deceitfully withholding or failing to disclose information to someone.

net listing **27**
A type of listing in which the agent's fee is set as all sums received exceeding a net price established by the owner.

net operating income (NOI) **374**
The net revenue generated by an investment property. It is calculated as the sum of a property's gross operating income less the property's total expected operating expenses. [See **RPI** Form 352 §4]

net operating income (NOI) (employment) **6**
The net revenue generated by an agent's employment, calculated by subtracting business operating costs from the expected income from fees generated from sales, leasing or financing transactions.

net sales proceeds **195, 344**
The seller's receipts on closing a sale of their property after all costs of the sale have been deducted from the gross proceeds.

Notice of Cancellation **317**
A notice from either the buyer or seller given to the other party cancelling the transaction. [See **RPI** Form 181]

O

off-site improvements **179**
Improvements not located on the lots being sold which add value to the development, such as access roads, street lighting and sidewalks.

operating expenses **213**
The total annual cost incurred to maintain and operate a property for one year. [See **RPI** Form 352 §3.21]

opinion **88**
A statement by an agent concerning an event or condition which has not yet occurred based on readily available facts.

option money **281**
Consideration given by a buyer to a seller for granting the buyer an option to purchase the property.

option period **281**
The time period during which an optionee/buyer may exercise their right to buy under an option agreement. [See **RPI** Form 161 §4]

option to buy **280**
An agreement granting an irrevocable right to buy property within a specific time period. [See **RPI** Form 161]

ownership **251**
The right of one or more persons to possess and use property to the exclusion of all others. A collection of rights to the use and enjoyment of property.

P

Pest Control Certification **144**
A certificate of clearance by the Structural Pest Control company indicating the property is free of pest infestation or infection in the visible and accessible areas, commonly called a termite clearance.

preliminary title report (prelim) **72, 265**
A report constituting a revocable offer by a title insurer to issue a policy of title insurance, used by a buyer and escrow for an initial review of the vesting and encumbrances recorded and affecting title to a property.

price adjustment provision **122**
A provision contained in a purchase agreement calling for an adjustment in the price paid for a property to cover the costs necessary to bring the property into the condition as disclosed at the time of acceptance.

price fixing **13**
An arrangement among providers of the same service to sell their services only at a predetermined price.

price-to-value difference **335, 346**
The difference between the price agreed to in a purchase agreement and the value of the property on the date the agreement is breached.

principal residence **410**
The residential property where the homeowner resides a majority of the year.

pro forma operating budget **172**
A budget which discloses the amount of assessments collected by an HOA, its cash reserves and whether special assessments are anticipated to occur.

projection **99**
An opinion about an income property's future performance based on its performance during the preceding 12-month period, adjusted for presently known trends.

property profile **63**
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

purchase agreement **229**
The primary document used as a checklist to negotiate a real estate sales transaction between a buyer and seller. [See **RPI** Form 150-159]

purchase-assist funding **210**
The use of proceeds from a mortgage to fund the price paid by the borrower to acquire real estate.

Q

qualified interest **411**
Interest on a mortgage which has accrued and been paid and is an allowable interest deduction for ownership of a first and second home.

R

Real Estate Settlement Procedures Act (RESPA) **46**
A federal law governing the behavior of service providers on a federally related mortgage which prohibits them from giving or receiving unlawful kickbacks.

referral fee..... **46**
A fee paid by one service provider to another for referring a client to them. Prohibited by the Real Estate Settlement Procedures Act (RESPA) when consumer financing funds the purchase of one-to-four unit residential property.

regular assessments..... **171**
Recurring HOA assessments which fund the operating budget to pay for the cost of maintaining the common areas.

restoration **127, 308**
The return of funds and documents on a rescission of a purchase agreement or transaction sufficient to place all the parties in the position they held before entering into the agreement or closing the transaction.

restraint on alienation..... **55**
A limit placed on a property owner's ability to sell, lease for a period exceeding three years or further encumber a property, as permitted by federal mortgage policy.

right of first refusal..... **334**
A pre-emptive right held by another person to buy a property if the owner decides to sell. [See **RPI** Form 579]

S

safety conditions **101**
Property conditions which do not meet current building codes and might affect property value.

sales goal.....**4**
The amount of after-tax income agents and brokers intend to earn as a result of their real estate licensing activities.

second home **410**
An individual's alternative residence where they do not reside a majority of the year.

seller's net sheet..... **64, 196, 355**
A document prepared by a seller's agent to disclose the financial consequences of a sale when setting the listing price and on acceptance of a buyer's price in a purchase offer. [See **RPI** Form 310]

seller-may-cancel provision **319**
A purchase agreement provision authorizing the seller to cancel if a specified condition or event does not occur, whether or not the agreement contains a time-essence provision.

separated report..... **143**
A report issued by a structural pest control company which is divided into Section I items, noting active infestations, and Section II items, noting adverse conditions which may lead to an infestation.

severalty ownership **251**
Ownership by one person.

special assessments **172**
A lien against real estate by a public authority to pay the cost of public improvements, such as street lights, sidewalks and street improvements. In a common interest subdivision, an additional charge levied by the association for unanticipated repairs.

special damages **337, 345**
Money losses not incurred directly from another's breach of a real estate agreement, but which are naturally incurred as a result of the breach. Also known as consequential damages.

specific performance action **347**
An action to compel performance of an agreement, such as a purchase agreement or assignment of rents.

stepped-up basis **262**
The readjustment of an appreciated asset's cost basis to fair market value for future tax purposes when transferred by inheritance.

Structural Pest Control report (SPC) **139**
A report disclosing any active infestations, damage from infestations or conditions which may lead to infestations.

subagent **9, 17, 44**
An individual who has been delegated agency duties by the primary agent of the client, not the client themselves.

supra-competitive **15**
A market condition where prices are unfairly set by collusion, preventing others from entering the market and hurting consumers.

T

termination **127**
The cancellation of a transaction before escrow has closed or a lease has ended.

time-essence provision **315**
A purchase agreement provision declaring that dates for performance of any activity or occurrence of an event are to be strictly enforced as essential to the continuation of the transaction.

title conditions **72**
Encumbrances such as liens, conditions, covenants and restrictions and easements which affect title to property.

Transfer Disclosure Statement (TDS) **70, 191**
A mandatory disclosure prepared by a seller 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 **RPI** Form 304]

trust funds **40**
Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.

U

unilateral cancellation **307**
A situation under a purchase agreement when one party acting alone terminates the agreement, eliminating the requirement for the buyer and seller to perform on the terms stated.

V

vesting **250**
A method of holding title to real estate, including tenancy in common, joint tenancy, community property and community property with the right of survivorship.

visual inspection..... **101**
An inspection of a listed property performed by the seller's agent and undertaken to observe defects to be noted on a condition of property disclosure, called the Transfer Disclosure Statement (TDS).