Real Estate Principles

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Chapter 1

Real estate licensing and endorsement

Learning Objectives

After reading this chapter, you will be able to:

- understand the function of the Department of Real Estate (DRE) to oversee, regulate, administer and enforce the real estate law as practiced by licensees;
- identify the activities requiring a real estate license;
- determine the eligibility and education requirements for broker and agent licensing and renewal;
- understand the function of the Real Estate Recovery Fund; and
- comprehend when a mortgage loan originator (MLO) license endorsement is required of licensees who originate mortgages.

Key Terms

bulk sale

business opportunity

Department of Real Estate (DRE)

designated officer (DO)

fictitious business name

mobilehome

mortgage loan originator (MLO)

principal

Real Estate Recovery Fund

DRE oversight

Real estate law is codified to protect the public in real estate transactions when a real estate licensee or subdivision is involved.[1]

The California Legislature created the **Department of Real Estate (DRE)** to oversee, regulate, administer and enforce the real estate law. The *DRE* was formally known as the **California Bureau of Real Estate (CalBRE)** prior to July 2018.

1 Calif. Business and Professions Code §§10000 et seq.

Real Estate Commissioner

The chief officer of the DRE is the **Real Estate Commissioner**. The *Real Estate Commissioner's* principal responsibility is to enforce all the real estate laws pertaining to real estate licensing and the Subdivided Lands Act.[1]

Department of Real Estate (DRE)
A government entity which oversees, regulates, administers and enforces California real estate law as practiced by licensees.

The Commissioner ensures that real estate licensees and members of the public dealing with licensees receive maximum protection.[2]

As a means of enforcing licensing and subdivision laws, the Commissioner issues regulations addressing conduct of persons falling within the real estate law activities. The regulations are part of the California Code of Regulations known as **Title 10**.

Activities requiring a real estate license

To engage in the business of real estate as a real estate **broker or agent**, a person first obtains a real estate license issued by the DRE.[3]

A *real estate broker* is a person who, for compensation or in expectation of compensation, engages in:

- negotiating the sale, purchase or exchange of real estate, leases or business opportunities;
- soliciting listings, buyers or sellers;
- leasing or renting, or offering to lease or rent, property on behalf of an owner or tenant;
- collecting rent from real estate or business opportunities;
- assisting in the purchase or lease of property owned by the state or federal government;
- negotiating real property sales contracts or mortgages to be secured directly or collaterally by real estate or business opportunities on behalf of lenders or borrowers; and
- negotiating the sale or purchase of a mobilehome.[4]

real estate agent
A person who, for compensation or in expectation of compensation, is employed by a licensed broker to do one or more of the acts of a licensed broker.

A **real estate agent** is an individual who, for compensation or in expectation of compensation, is employed by a licensed broker to do one or more of the acts of a licensed broker.[5]

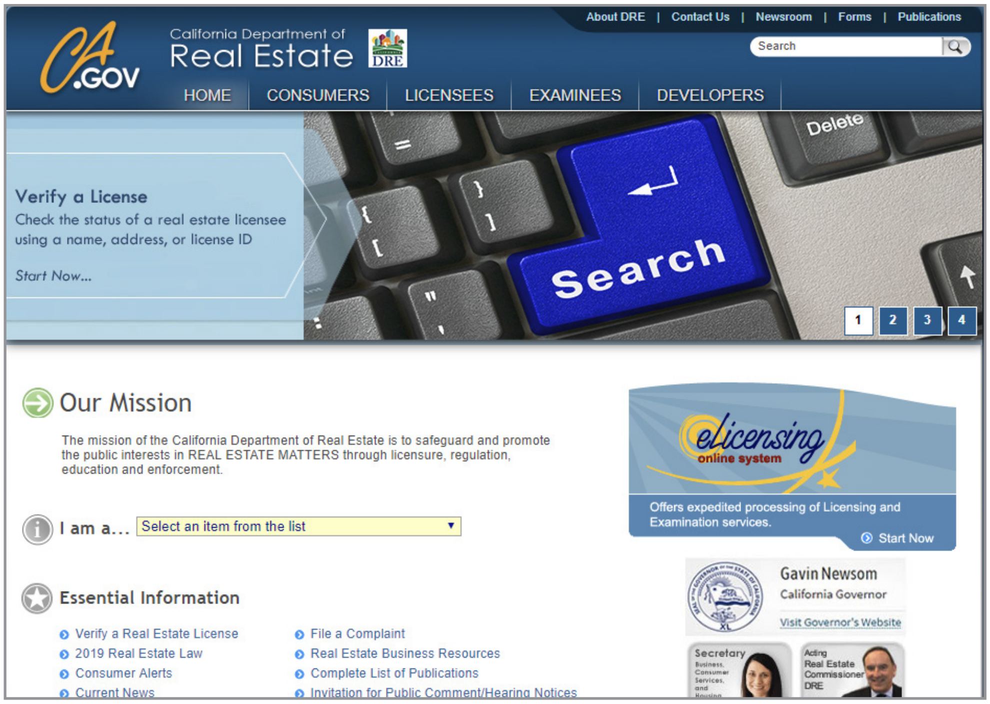
Real estate agents are legally classified as *agents of the agent*, since they need to be employed by a real estate broker to render real estate-related services to the public. Agents render all services on behalf of the broker that employs them.

Delegated supervision, not agency

A sales agent employed by a broker is the agent of the broker, not a client. In turn, the broker is the agent of the client.

1 Bus & P C §§10050; 10051
2 Bus & P C §10050
3 Bus & P C §10130
4 Bus & P C §10131
5 Bus & P C §10132

Department of Real Estate (DRE) website and contact information



www.dre.ca.gov

Sacramento
1651 Exposition Blvd., Sacramento, CA 95815 (877) 373-4542

Fresno
2550 Mariposa Mall, Room 3070, Fresno, CA 93721 (559-445-2273)

Los Angeles
320 West 4th Street, Suite 350, Los Angeles, CA 90013 (213-620-2072)

Oakland
1515 Clay Street, Suite 702, Oakland, CA 94612 (510-622-2552)

San Diego
1350 Front Street, Suite 1063, San Diego, CA 92101 (619-525-4192)

As an agent representing the broker, a real estate sales agent is authorized to prepare listings, sales documents, disclosure sheets, etc., on behalf of the broker. The agent does not do so on their own behalf.

The broker employing agents is required under the DRE's supervisory scheme to **reasonably supervise** sales agents' activities. *Reasonable supervision* includes establishing policies, rules, procedures and statements to review and manage:

- transactions requiring a real estate license;
- documents having a material effect upon the rights or obligations of a party to the transaction;
- the filing, storage and maintenance of documents;
- the handling of trust funds;
- advertisement of services that require a license;
- sales agents' knowledge of anti-discrimination laws; and
- reports of the activities of the sales agents.[6]

Licensing education

To be eligible for a broker or agent license, the applicant needs to:

- be at least 18 years old;[7]
- be honest and truthful;

6 Calif. Department of Real Estate Regulation §2725
7 DRE Regs. §§2720; 2750

- make the application on the proper form prescribed by the DRE;
- complete the mandatory education; and
- pass the qualifying exam.

In addition, all applicants need to be fingerprinted. Fingerprints are not required if the applicant is currently licensed by the DRE or holds a real estate license that expired less than two years ago.

All statutory course requirements for both the agent and the broker license may be waived if the applicant is a member of the state bar.[1]

The individual broker license

Every real estate broker maintains a definite place of business which serves as an **office**. The *office* is the place where the broker displays their license and where consultations with clients are held.

If more than one place of business is maintained, the broker applies for and obtains an additional license for each office branch.

Qualifying for a broker license

An agent who has held a real estate agent license for at least two years within the last five years may apply for a broker license.

The agent is required to have worked on a full-time basis (at least 40 hours per week) as an agent during the two-year time requirement.

The DRE requires verification of the agent's employment using the **Employment Verification Form** issued by the DRE. [See the DRE's Employment Verification Form (DRE 226)]

Exceptions to the agent employment requirements will be given to an applicant who has:

- at least two years of general real estate experience; or
- graduated with a real estate-specific degree from a four-year college or university.

Experience qualifications

To qualify for the employment exemption based on experience, the broker applicant needs to file a written petition with the DRE setting forth the applicant's qualifications. [See the DRE's Equivalent Experience Verification Form (DRE 227)]

The DRE considers the following activities, conducted within the five-year period immediately prior to the date of application for the broker examination, as qualification in lieu of employment as a sales agent:

- experience as an escrow or title officer;
- experience as a mortgage officer directly related to the financing or conveying of property;

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1 Bus & P C §§10153.2

- experience as a subdivider, contractor or speculative builder, if the agent performed substantial duties relating to the purchase, finance, development and sale or lease of real property.

Other types of direct real estate-related experience will be considered by the DRE if it satisfies the intent of the law.[2]

Pre-licensing coursework

All broker applicants need to complete **eight statutory courses** of three-semester units or the quarter equivalent, unless exempt.

Five of the eight courses need to be in:

- real estate practice;
- legal aspects of real estate;
- real estate appraisal;
- real estate finance; or
- real estate economics or accounting.[3]

The remaining three courses can be selected from any of the following:

- real estate principles;
- business law;
- property management;
- real estate office administration;
- escrows;
- mortgage brokering and lending;
- advanced legal aspects of real estate;
- common interest developments (CIDs);
- advanced real estate finance;
- advanced real estate appraisal; or
- computer applications in real estate.[4]

The three courses taken to meet the agent licensing requirements count towards the eight courses a broker needs to complete. Thus, a licensed agent only needs to take five additional courses to qualify to take the broker exam.

Taking the broker exam

On completion of the course requirements, the broker applicant applies to take the state broker licensing exam. The applicant has two years from the DRE receipt of the *examination application* to meet the license qualification requirements and take the exam.

If the broker applicant fails the exam, they may apply for reexamination within two years after filing the examination application. No limit is placed on the number of times the applicant may take the exam.

2 See the DRE's *Instructions to License Applicants*, July 2009

3 Bus & P C §10153.2(a)(1)

4 Bus & P C §10153.2(a)(2)

The California real estate salesperson and broker examination

The DRE broker and agent licensing examination consists of seven major areas of real estate practice, divided as follows:

1 — Property Ownership and Land Use Controls and Regulations
Approximately 15% of the sales and broker exam.

- *classes of property [See Chapter 31 and 32];*
- *property characteristics [See Chapter 84];*
- *encumbrances [See Chapter 47 and 52];*
- *types of ownership [See Chapter 33];*
- *descriptions of property [See Chapter 40];*
- *government rights in land [See Chapter 31];*
- *public controls [See Chapter 85];*
- *environmental hazards and regulations [See Chapter 16];*
- *private controls [See Chapter 37];*
- *water rights [See Chapter 36]; and*
- *special categories of land.*

2 — Laws of Agency
Approximately 17% of the sales and broker exam.

- *law, definition and nature of agency relationships, types of agencies, and agents [See Chapter 2 and 3];*
- *creation of agency and agency agreements [See Chapter 3];*
- *responsibilities of agent to seller/buyer as principal [See Chapter 2];*
- *disclosure of agency [See Chapter 3 and 28];*
- *disclosure of acting as principal or other interest [See Chapter 3];*
- *termination of agency [See Chapter 24];*
- *commission and fees [See Chapter 24 and 25]; and*
- *responsibilities of agents to non-client third-parties [See Chapter 2].*

3 — Valuation and Market Analysis
Approximately 14% of the sales and broker exam.

- *value [See Chapter 29];*
- *methods of estimating value [See Chapter 29]; and*
- *financial analysis [See Chapter 29 and 54].*

4 — Financing
Approximately 9% of the sales and broker exam.

- *general concepts [See Chapter 54 and 54];*
- *types of loans [See Chapter 54 and 57];*
- *sources of financing [See Chapter 54 and 57];*
- *government programs [See Chapter 56];*
- *mortgages/deeds of trust/notes [See Chapter 61 and 65];*
- *financing/credit laws [See Chapter 54];*
- *loan brokerage [See Chapter 58]; and*
- *types of loan originators. [See Chapter 54]*

5 — Transfer of Property
Approximately 8% of the sales and broker exam.

- *title insurance [See Chapter 51 and 52];*

- *deeds [See Chapter 65];*
- *escrow [See Chapter 30];*
- *tax aspects [See Chapter 72];*
- *special processes; and*
- *transfer through court supervision [See Chapter 49]; and*
- *types of vesting. [See Chapter 49]*

6 — Practice of Real Estate and Disclosures (Includes specialty areas)

Approximately 25% of the sales and broker exam.

- *trust account management [See Chapter 6];*
- *fair housing laws [See Chapter 7];*
- *truth in advertising [See Chapter 12];*
- *record keeping requirements [See Chapter 6];*
- *agent supervision [See Chapter 2];*
- *permitted activities of unlicensed sales assistants [See Chapter 26];*
- *DRE jurisdiction and disciplinary actions [See Chapter 1 and 8];*
- *licensing, continuing education requirements and procedures [See Chapter 1];*
- *California Real Estate Recovery Fund [See Chapter 1];*
- *general ethics [See Chapter 7 and 9];*
- *technology [See Chapter 25];*
- *property management [See Chapter 73 and 74];*
- *commercial/industrial/income properties [See Chapter 76];*
- *specialty areas;*
- *transfer disclosure statement (TDS) [See Chapter 15];*
- *natural hazard disclosure (NHD) statements [See Chapter 17];*
- *disclosure of material facts affecting property value [See Chapter 13];*
- *need for inspection and obtaining/verifying information [See Chapter 21];*
- *reports [See Chapter 21 and 22]; and*
- *servicing diverse populations. [See Chapter 7 and 8]*

7 — Contracts

Approximately 12% of the sales exam and 12% of the broker exam.

- *general [See Chapter 24, 27 and 55];*
- *listing agreements [See Chapter 24 and 25];*
- *buyer-broker agreements [See Chapter 25];*
- *offers/purchase Contracts [See Chapter 27];*
- *agreements [See Chapter 75 and 76];*
- *promissory notes/securities [See Chapter 61];*
- *purchase/lease options [See Chapter 24 and 67]; and*
- *advanced fees. [See Chapter 6]*

The California real estate salesperson and broker examination

Cont'd

Once the applicant has been notified by the DRE of their passing, the applicant may apply for a broker license and pay the appropriate licensing fee within one year.

Agent license

An agent is an individual employed by a real estate broker to directly participate in brokerage activities on the broker's behalf.

To qualify to take the *real estate agent license DRE exam*, an applicant completes a three-semester unit course, or the quarter equivalent, in:

- real estate principles;
- real estate practice; and
- one elective course in the following subjects:
- legal aspects of real estate;
- real estate finance;
- property management;
- real estate appraisal;
- real estate economics or accounting;
- business law;
- real estate office administration;
- escrows;
- mortgage brokering and lending;
- common interest developments (CIDs); or
- computer applications in real estate.[1]

The applicant has two years from the date the exam application is filed with the DRE to take the exam.[2]

An applicant who fails to take the exam and pass within two years from the date of filing the application will have to file a new application to take the exam.

principal
A person, an individual or an entity, acting as a buyer or seller, represented by a broker and their agents.

An applicant who fails the agent exam may apply for reexamination. No restriction exists on the number of times the applicant may take the test within the two-year period following the application.[3]

Once the DRE notifies the applicant of passing, the applicant may apply for an agent license. The application for the license and the fee are to be submitted to the DRE within one year of the examination date.

Exemptions from license requirements

The following are major categories of persons and activities which are exempt from real estate licensing requirements:

- a person dealing with their own property, called a **principal**;

1 Bus & P C §10153.4
2 Bus & P C §10153.8
3 Bus & P C §10153.8

- an officer of a corporation, or a general partner of a partnership or a manager of a limited liability company (LLC), collectively called **entities**, with respect to property owned or leased by the entity. To be exempt, the acts may not be performed in expectation of a fee;
- an individual with *power-of-attorney* authority;
- an attorney rendering legal services for a client;
- a receiver, trustee in bankruptcy or any person acting under order of a court;
- a trustee of a trust deed lien who is acting under a power-of-sale provision in the trust deed;[4] or
- a resident manager of an apartment complex, hotel, motel or trailer park.[5]

Also exempt are individuals acting on behalf of others, such as **unlicensed employees** of real estate brokers, who arrange, accept reservations or money for transient occupancy in:

- vacation rentals such as hotels, motels or residence clubs;
- *common interest developments (CIDs),* such as condominium projects, planned urban developments (PUDs), community apartment projects and stock cooperatives; or
- an apartment unit or single family residence (SFR).[6]

An individual acting without a real estate license, either as a broker or agent, is guilty of a public offense punishable by a maximum fine of $20,000 for an individual or $60,000 for a corporation, six months in jail, or both a fine and imprisonment.[7]

Continuing education requirements

A real estate broker and real estate agent license is valid for *four years* from the date of issuance noted on the license certificate.[8]

All real estate brokers and sales agents need to complete at least **45 hours of continuing education (CE)** to renew a license issued by the DRE.[9]

The CE requirements for license renewal were legislated to help maintain and improve the level of competence of real estate brokers and agents.

A DRE sales agent renewing for the first time needs to complete **45 hours** of CE, consisting of:

- 18 hours of *Consumer Protection* courses;
- 15 hours comprised of five separate three-hour courses in:
  - *Agency;*
  - *Fair Housing*;

4 Bus & P C §10133
5 Bus & P C §10131.01
6 Bus & P C §10131.01
7 Bus & P C §10139
8 Bus & P C §§10153.6; 10153.7
9 Bus & P C §10170.5

- *Trust Funds;*
- *Ethics*; and
- *Risk Management;* and

- the remaining 12 hours composed of either *Consumer Protection* or *Consumer Service* courses, including *Office Management and Supervision* course if they choose to take it.

While brokers and sales agents beyond their first renewal are required to include the Office Management and Supervision course in their 45 CE hours, the DRE allows them the option of choosing how to study it.

A licensee may study the Office Management and Supervision material separately or aggregated into an eight-hour "survey" course with the five mandated courses.

Here, the 45 CE hours will consist of:

- 18 hours of Consumer Protection courses;
- mandated topical courses, structured as either:
  - 18 hours comprised of six separate three-hour courses in:
    - Agency;
    - Fair Housing;
    - Trust Funds;
    - Ethics;
    - Risk Management; and
    - Office Management and Supervision; OR
  - eight hours in a survey course covering all six subjects; and
- the remaining hours composed of Consumer Protection or Consumer Service.

Consumer protection

Courses covering the following real estate-based topics are considered *consumer protection* courses:

- real estate financing;
- land use regulation and control;
- consumer disclosures;
- agency relationships;
- capital formation for real estate development;
- fair practices in real estate;
- appraisal and property valuation technique;
- property management;
- energy conservation;
- environmental regulation;
- probate;

DRE licensing and renewal fees

Examinations and Exam/License Applications

Broker		Agent	
Examination fee	$150	Examination fee	$100
Broker 1st reschedule	$45	Agent 1st reschedule	$40
Broker subsequent reschedule	$45	Agent subsequent reschedule	$40

Original Exam/License Applications and Corporation License Applications

Original Broker/Corporation License	$450
Original Agent License	$350

Renewal License Applications

Broker/Corporation renewing on-time	$450
Broker/Corporation renewing late	$675
Agent renewing on-time	$350
Agent renewing late	$525

- mineral, oil and gas conveyancing;
- government programs such as redevelopment;
- business opportunities; and
- taxation of real estate transactions.[1]

Consumer service courses cover topics designed to help licensees achieve a higher level of competence in sales, organizational and management skills. Examples of consumer service courses include:

- how to market property;
- how to hold an open house;
- how to motivate sellers; and
- how to obtain a listing.

A licensee is exempt from CE requirements if, on the actual renewal date of the real estate license, the licensee:

- is at least 70 years of age; and
- has been a real estate licensee in California for at least 30 consecutive years.[2]

The corporate license

Acts for which a real estate license is required may be performed in the name of a **corporation** if a licensed officer of the corporation qualifies the corporation for a license issued by the DRE.[3]

1 Bus & P C §10170.5(a)(6)
2 Bus & P C §10170.8
3 DRE Reg §2740

Violations of real estate law

Violation of a real estate law by a broker or his sales agent may result in the suspension or revocation of the license by the Real Estate Commissioner. The following are grounds for suspension or revocation of a DRE license.

Business and Professions Code §10176

The commissioner may, upon his or her own motion, and shall, upon the verified complaint in writing of any person, investigate the actions of any person engaged in the business or acting in the capacity of a real estate licensee within this state, and he or she may temporarily suspend or permanently revoke a real estate license at any time where the licensee, while a real estate licensee, in performing or attempting to perform any of the acts within the scope of this chapter has been guilty of any of the following:

a. Making any substantial misrepresentation.

b. Making any false promises of a character likely to influence, persuade or induce.

c. A continued and flagrant course of misrepresentation or making of false promises through real estate agents or salespersons.

d. Acting for more than one party in a transaction without the knowledge or consent of all parties thereto.

e. Commingling with his or her own money or property the money or other property of others which is received and held by him or her.

f. Claiming, demanding, or receiving a fee, compensation or commission under any exclusive agreement authorizing or employing a licensee to perform any acts set forth in Section 10131 for compensation or commission where the agreement does not contain a definite, specified date of final and complete termination.

g. The claiming or taking by a licensee of any secret or undisclosed amount of compensation, commission or profit or the failure of a licensee to reveal to the employer of the licensee the full amount of the licensee's compensation, commission or profit under any agreement authorizing or employing the licensee to do any acts for which a license is required under this chapter for compensation or commission prior to or coincident with the signing of an agreement evidencing the meeting of the minds of the contracting parties, regardless of the form of the agreement, whether evidenced by documents in an escrow or by any other or different procedure.

h. The use by a licensee of any provision allowing the licensee an option to purchase in an agreement authorizing or employing the licensee to sell, buy, or exchange real estate or a business opportunity for compensation or commission, except when the licensee prior to or coincident with election to exercise the option to purchase reveals in writing to the employer the full amount of licensee's profit and obtains the written consent of the employer approving the amount of the profit.

i. Any other conduct, whether of the same or a different character than specified in this section, which constitutes fraud or dishonest dealing.

j. Obtaining the signature of a prospective purchaser to an agreement which provides that the prospective purchaser shall either transact the purchasing, leasing, renting or exchanging of a business opportunity property through the broker obtaining the signature, or pay a compensation to the broker if the property is purchased, leased, rented

Violations of real estate law

Cont'd

or exchanged without the broker first having obtained the written authorization of the owner of the property concerned to offer the property for sale, lease, exchange or rent.

k. *Failing to disburse funds in accordance with a commitment to make a mortgage loan that is accepted by the applicant when the real estate broker represents to the applicant that the broker is either of the following:*
   1. *The lender.*
   2. *Authorized to issue the commitment on behalf of the lender or lenders in the mortgage loan transaction.*

l. *Intentionally delaying the closing of a mortgage loan for the sole purpose of increasing interest, costs, fees, or charges payable by the borrower.*

m. *Generating an inaccurate opinion of the value of residential real property, requested in connection with a debt forgiveness sale, in order to do either or both of the following:*
   1. *Manipulate the lienholder to reject the proposed debt forgiveness sale.*
   2. *Acquire a financial or business advantage, including a listing agreement, that directly results from the inaccurate opinion of value, with regard to the subject property.*

designated officer (DO)
The individual who is the licensed officer qualifying a corporation for a corporate broker license.

The officer qualifying the corporation for a corporate broker license is called the **designated officer (DO)**. The corporation holds its brokerage license through the *DO*.

The DO is responsible for the supervision and control of the activities of officers and employees of the corporation. This includes supervision of the activities of agents and brokers employed to act as agents for the corporate broker. Failure of the DO to supervise may result in the suspension or revocation of the DO's real estate license.

The individual broker, when acting as the DO, acts on behalf of the corporation in the capacity of a corporate officer only. The individual who is the DO may also become an employee of the corporation and act as an agent of the corporation rendering services to the corporation's clients.

The DO is liable to the corporation for any failure to supervise agents. However, the DO is not liable to corporate clients for breaching their duty to supervise agents – this supervision is a duty owed to their employer, the corporation and the DRE who entrusted them as a designated officer.

fictitious business name
The name under which a business or operation is conducted, also known as a d.b.a. ("doing business as...").

Fictitious business name

A licensee may use a **fictitious business name** in any activity for which a real estate license is required, if the license is issued under the fictitious name.[1]

1 DRE Reg. §2731(a)

A *fictitious business name* license will only be granted to a broker who has complied with the filing requirements for a fictitious business name, also known as a *d.b.a. ("doing business as...").*[1]

The DRE will refuse to issue a license under a fictitious business name when:

- the name is misleading or would constitute false advertisement;
- implies a partnership or corporation exists when one does not;
- includes the name of a real estate agent;
- violates California's Business and Professions Code on fictitious business name requirements; or
- is the name formerly used by a licensee whose license has been revoked.[2]

Mineral, oil and gas

A real estate broker and agent may solicit and negotiate for the purchase, lease or exchange of mineral, oil and gas property. The licensee may also arrange or negotiate and service loans on mineral, oil and gas property.[3]

Finally, the licensee may rent mineral, oil and gas property and collect the rents or royalties from the mineral, oil and gas property.[4]

Child support obligations

The DRE cannot issue or renew a real estate license if the applicant is on a list of persons not in compliance with **child support orders** provided by the State Department of Social Services.[5]

However, the DRE may issue a **150-day temporary license** to an otherwise qualified applicant who is on the list of persons neglecting child support. Only one 150-day license will be issued, and a four-year license cannot be issued until a release is obtained from the district attorney's office.[6]

The State Department of Social Services also provides the DRE with a supplemental list of real estate licensees who are delinquent in child support payments for more than four months. If the licensee does not renew their license with the DRE within six months of the DRE's receipt of the supplemental list, the license will be subject to suspension.

The DRE has the authority to suspend the license of any licensee placed on the supplemental four-month delinquency list. However, before a license can be suspended, the DRE gives the licensee notice that the license will be suspended 150 days after the notice is served, unless the licensee receives a release from the district attorney.

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1 DRE Reg. §2731(b)
2 DRE Reg. §2731(c)
3 Bus & P C §10500
4 Bus & P C §10500
5 Calif. Family Code §17520
6 Fam C §17520

Also, any real estate licensee whose name appears on the certified list or supplemental list provided by the State Department of Social Services for noncompliance with an order for child support is liable to the DRE for a special handling fee of $95 for each time their name is on the list.[7]

The DRE commissioner will not issue a license or reinstate a suspended license until the $95 fee is paid.[8]

Business opportunities

A **business opportunity** is the sale or lease of the operations and goodwill of an existing business enterprise or opportunity.

business opportunity
The assets for a business enterprise including its goodwill. The term includes the sale or lease of the business and goodwill of an existing business enterprise or opportunity.

Common types of *business opportunities* include:

- liquor stores;
- gas stations; and
- restaurants.

The arranging of a sale or purchase of a business opportunity is governed by the DRE. To receive a fee for the sale of a business opportunity, it is necessary to hold a real estate license, unless the person receiving the fee is licensed as a **securities broker** or **dealer** by California or the United States.

The sale of a business opportunity consists of two transactions:

- the sale of the business, including inventory, trade fixtures and goodwill; and
- the sale of the real property itself, whether a fee or leasehold interest, including the building and land.

The documents used in the sale of a business include a:

- *bill of sale;*
- *Uniform Commercial Code (UCC)-1 Financing Statement* for the personal property [See **RPI** Form 436-1]; and
- a *deed* (or assignment of the leasehold and a trust deed) for the transfer of the real property. [See **RPI** Form 404]

Bulk sales

On the sale of a business opportunity, the inventory of the business is transferred to the buyer by a **bill of sale**. The transfer of more than one-half the inventory of a business' materials or goods to a person other than the business' customers is called a **bulk sale**. A *bulk sale* needs to comply with the UCC since it is the transfer of personal property.[9]

bulk sale
The transfer of more than one-half the inventory of a business' materials or goods to a person other than the business' customers.

The buyer of the inventory gives public notice of the transfer 12 days before the transfer takes place to perfect their interest in the acquisition of the inventory on closing.[10]

7 Fam C §17520; DRE Reg. §2716.5
8 DRE Reg. §2716.5
9 Calif. Commercial Code §6102
10 Com C §6105

Mobilehome sales

mobilehome
Property designed to be used as a dwelling, classified as either personal or real property depending on the method of attachment to a parcel of real estate. Also known as a manufactured home.

Mobilehomes have a unique legal status, being either real estate or personal property.

A *mobilehome*, also called a *manufactured home*, is a structure:

- at least eight feet in width, 40 feet in length or more than 320 square feet when transported in one or more sections;
- built on a permanent chassis; and
- designed to be used as a dwelling with or without a permanent foundation.[1]

A mobilehome that meets the requirements and is attached to a permanent foundation is no longer considered personal property but **real estate**, since it is a permanent fixture or an improvement to real estate.[2]

The broker handling the sale of a mobilehome that is considered real estate conducts themselves as though they are handling the sale of real estate.

The rules for buying, selling, registering and encumbering mobilehomes that are not considered real property differ from the rules for real estate sales.

The government agency responsible for the registration of mobilehomes is the **California Department of Housing and Community Development (HCD)**. Mobilehomes are registered with the *HCD*, unless the mobilehome is considered real estate.[3]

When a new mobilehome is first purchased it is registered on a form provided by the HCD, referred to as the **original registration** of the mobilehome.

At the time of the *original registration* of the mobilehome, the HCD creates a permanent title record for the mobilehome.

Real Estate Recovery Fund

Real Estate Recovery Fund
Funds available to individuals who have obtained a final-court judgment against a licensee and are unable to recover the judgment from the licensee. Also known as the Consumer Recovery Account.

The **Real Estate Recovery Fund**, also known as the *Consumer Recovery Account*, is available to individuals who have obtained a final-court judgment against a real estate licensee for losses caused while acting as an agent and are unable to recover the judgment from the licensee.

The judgment needs to be based on:

- fraud, misrepresentation or deceit;
- conversion of trust funds; or
- criminal restitution.[4]

For causes of action which occurred on or after January 1, 2009, the threshold is $50,000 for one transaction and $250,000 for any one licensee.[5]

1 Calif. Health and Safety Code §18007
2 Health & S C §§18039.1; 18551
3 Health & S C §§18206; 18000 et seq.
4 Bus & P C §10471
5 Bus & P C §10474

A licensee's license will be suspended and will not be reinstated until the licensee repays any amounts paid from the *Real Estate Recovery Fund* to satisfy a judgment against them.[6]

Mortgage loan brokerage

Licensees who make or arrange residential mortgages are required to obtain a DRE **mortgage loan originator (MLO) license endorsement**.

mortgage loan originator (MLO)
A Department of Real Estate (DRE) licensee who receives fees to arrange a consumer mortgage other than a carryback.

A *residential mortgage* is any loan primarily for personal, family or household use, known as a **consumer purpose mortgage**, secured by a deed of trust on a dwelling. Dwellings include:

- one-to-four unit residential properties;
- mobile homes; and
- trailers or houseboats, if they are used as residences.[7]

In order for a transaction to trigger the DRE MLO license endorsement requirement, it needs to meet both the prongs of the residential mortgage definition:

- a *consumer purpose*; and
- security in the form of a *dwelling*.

Thus, whether or not a DRE MLO license endorsement is required depends on the purpose of the mortgage, not just the property securing it. Mortgages for personal and household purposes when secured by a dwelling are consumer purpose mortgages, and trigger the endorsement requirement. On the other hand, loans made for business, investment or agricultural purposes whether or not secured by a dwelling are not made for a consumer purpose, and do not trigger the endorsement requirement.

MLO endorsement

To become DRE-endorsed as an MLO, a licensee needs to:

- complete the national and state California-specific mortgage brokerage examination;
- submit a MLO licensee endorsement application through the *Nationwide Mortgage Licensing System and Registry (NMLS)*;
- complete and supply a criminal background check, including fingerprinting, to the NMLS;
- complete 20 hours of pre-license education; and
- provide authorization for the NMLS to obtain a credit report on the licensee.

The NMLS is an offshoot of the larger regulatory scheme known as the **Secure and Fair Enforcement (SAFE) Mortgage Licensing Act**.

6 Bus & P C §10475
7 Bus & P C §10166.01; 12 Code of Federal Regulations §108.103

To keep their DRE endorsement, MLOs need to meet minimum licensing/endorsement standards, pay the yearly renewal fee and complete a minimum of eight hours of continuing education annually, including:

- three hours of federal law and regulations;
- two hours of ethics (including instruction on fraud, consumer protection and fair lending issues); and
- two hours on lending standards for nontraditional mortgages.

Chapter 1 Summary

The California Legislature created the Department of Real Estate (DRE) to oversee and regulate the real estate law. The chief officer of the DRE is the Real Estate Commissioner, who enforces all the real estate laws pertaining to real estate licensing and the Subdivided Lands Act.

To engage in the business of real estate as a real estate broker or agent, a person first obtains a real estate license issued by the DRE.

A real estate broker is a person who, for compensation or in expectation of compensation, engages in real estate activities, such as:

- negotiating the sale, purchase or exchange of real estate;
- soliciting listings, buyers or sellers; or
- leasing or renting on behalf of an owner or tenant.

A real estate agent is a person who, for compensation or in expectation of compensation, is employed by a licensed broker to do one or more of the acts of a licensed broker.

To qualify to take the DRE real estate agent license exam, an applicant completes three statutory courses of three-semester units or the quarter equivalent, unless exempt, and pass the DRE agent licensing exam.

An agent who has held a real estate agent license for at least two years within the last five years may apply for a broker license. All broker applicants are to complete eight statutory courses of three-semester units or the quarter equivalent, unless exempt, and pass the DRE broker licensing exam.

A real estate broker and agent license is valid for four years from the date of issuance. To renew their DRE license, real estate brokers and sales agents are to complete at least 45 hours of continuing education (CE) every four years.

The Real Estate Recovery Fund is available to individuals who have obtained a final-court judgment against a real estate licensee and are unable to recover the judgment from them. The threshold for recovery is $50,000 for one transaction and $250,000 for any one licensee

Licensees who make or arrange residential mortgages are required to obtain a DRE mortgage loan originator (MLO) license endorsement. A residential mortgage is any mortgage primarily for personal, family or household use secured by a deed of trust on a dwelling.

To become DRE-endorsed as an MLO, a licensee first completes the national and state mortgage brokerage examination, and completes 20 hours of pre-license education. To keep their endorsement, MLOs complete a minimum of eight hours of continuing education annually.

Chapter 1 Key Terms

Quiz 1 Covering Chapters 1-3 is located on page 606.

Notes:

Chapter
2

Agency: authority to represent others

Learning Objectives

After reading this chapter, you will be able to:

- understand the variations of the agency relationship;
- determine how agency relationships are created and the primary duties owed; and
- discuss why real estate licensing is necessary to protect the licensees and their clients.

Key Terms

agent

principal

Department of Real Estate (DRE)

For a further discussion of this topic, see *Agency* Chapter 1 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Introduction to agency

An **agent** is described as *"One who is authorized to act for or in place of another; a representative…"* [1]

An **agency relationship** exists between principal and agent, employer and employee.

The **Department of Real Estate (DRE)** was created to oversee licensing and police a minimum level of *professional competency* for individuals desiring to represent others as *real estate agents*. This mandate is pursued through the education of individuals seeking an original broker or salesperson license. It is also pursued on the renewal of an existing license, known as *continuing education*. The education is offered in the private and public sectors under government certification.

agent
One who is authorized to represent another, such as a broker and client or sales agent and their broker.

1 Black's Law Dictionary, Ninth Edition (2009)

Department of Real Estate (DRE)
A government agency which oversees, regulates, administers and enforces California real estate law as practiced by licensees.

Agency in real estate related transactions includes relationships between:

- *brokers* and members of the public (clients or third parties);
- licensed *sales agents* and their brokers; and
- *finders* and their brokers or principals.

The extent of representation owed to a client by the broker and their agents depends on the *scope of authority* the client gives the broker. Authority is given orally, in writing or through the client's conduct with the broker.

Agency and *representation* are synonymous in real estate transactions. A broker, by accepting an exclusive employment from a client, undertakes the task of aggressively using **due diligence** to represent the client and attain their objectives. Alternatively, an open listing only imposes a *best efforts* standard of representation until a match is located and negotiations begin which imposes the due diligence standard for the duration of negotiations.

What is an agent?

An agent is an individual or corporation who represents another, called the **principal**, in dealings with third persons. Thus, a principal can never be their own agent. A principal acts for their own account, not on behalf of another.

principal
A person, an individual or an entity, acting as a buyer or seller, represented by a broker and their agents.

The representation of others undertaken by a real estate broker is called an *agency*. Three parties are referred to in agency law: a principal, an agent and third persons.[1]

In real estate transactions:

- the *agent* is the real estate broker retained to represent a client for the purposes hired;
- the *principal* is the client, such as a seller, buyer, landlord, tenant, lender or borrower, who has retained a broker to sell or lease property, locate a buyer or tenant, or arrange a real estate loan with other persons; and
- *third persons* are individuals, or associations (corporations, limited partnerships and limited liability companies) other than the broker's client, with whom the broker has contact as an agent acting on behalf of their client.

Real estate jargon

Real estate jargon used by brokers and agents tends to create confusion among the public. When the jargon is used in legislative schemes, it adds statutory chaos, academic discussion and consternation among brokers and agents over the duties of the real estate licensee.

For example, the words real estate agent, as used in the brokerage industry, mean a *real estate salesperson employed by and representing a real estate broker*. Interestingly, real estate salespersons rarely refer to themselves as *sales agents*; a broker never does. Instead, they frequently call themselves

1 Calif. Civil Code §2295

"broker associates," or "realtors," especially if they are affiliated with a local trade union. The public calls licensees "realtors," the generic term for the trade, much like the term "Kleenex."

Legally, a client's real estate agent is defined as a *real estate broker who undertakes representation of a client in a real estate transaction*. Thus, a salesperson is legally *an agent of the agent*.

The word "subagency" suffers from even greater contrasts. *Subagency* serves both as:

- jargon for fee-splitting agreements between Multiple Listing Service (MLS) member brokers in some areas of the state; and
- a legal principle for the authorization given to the third broker by the seller's broker or buyer's agent to also act as an agent on behalf of the client, sometimes called a *broker-to-broker arrangement*.

Fundamental to a real estate agency are the **primary duties** a broker and their agents owe the principal. These duties are distinct from the **general duties** owed by brokers and agents to all other parties involved in a transaction.

Primary duties

Primary duties owed to a client in a real estate transaction include:

- a *due diligence investigation* into the subject property;
- *evaluating* the financial impact of the proposed transaction;
- *advising* on the legal consequences of documents which affect the client;
- *considering* the tax aspects of the transfer; and
- *reviewing* the suitability of the client's exposure to a risk of loss.

To care for and protect both their clients and themselves, all real estate licensees are to:

- *know* the scope of authority given to them by the employment agreement;
- *document* the agency tasks undertaken; and
- *possess* sufficient knowledge, ability and determination to perform the agency tasks undertaken.

A licensee need to conduct themselves at or above the minimum acceptable levels of competency to avoid liability to the client or disciplinary action by the DRE.

Creation of the agency relationship

An agency relationship is created in a real estate transaction when a *principal* employs a broker to act on their behalf.[2]

2 CC §2307

A broker's representation of a client, such as a buyer or seller, is properly undertaken on a written employment agreement signed by both the client and the broker. A written employment agreement is necessary for the broker to have an enforceable *fee agreement*. This employment contract is loosely referred to in the real estate industry as a "listing agreement."[1] [See **RPI** Form 102 and 103]

The broker's agency can also be created by an oral agreement or conduct of the client with the broker or other individuals. However, fee arrangements are unenforceable if no written agreement exists.

1 **Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247

Chapter 2 Summary

An agent is an individual who represents another in dealings with third persons. The representation of others undertaken by a real estate broker or agent is called agency. Agency in real estate related transactions includes relationships between brokers and members of the public, licensed sales agents and their brokers, and finders and their brokers or principals.

The primary duties a broker owes his client includes evaluating the financial impact, legal consequences, tax aspects and exposure to risk of loss inherent in all transactions.

The agency relationship is created when a client employs a broker to act on his behalf. This relationship is best undertaken with a signed written employment agreement containing a fee provision.

The Department of Real Estate (DRE) was created to oversee licensing and establish a minimum level of professional competency in real estate transactions.

Chapter 2 Key Terms

Quiz 1 Covering Chapters 1-3 is located on page 606.

Chapter 3

The agency law disclosure

Learning Objectives

After reading this chapter, you will be able to:

- understand the origin and necessity of the statutorily-mandated Agency Law Disclosure;
- know the roles and obligations of all participants involved in a real estate transaction; and
- identify when the agency law disclosure is required.

Key Terms

agency confirmation provision

Agency Law Disclosure

buyer's agent

exclusive agent

fiduciary duty

seller's agent

For a further discussion of this topic, see *Agency* Chapter 2 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Legislated order

As a result of licensee misconceptions about the duties they owe to members of the public and the public's lack of awareness, the California legislature enacted the **agency disclosure law**. The goal is to better inform the public (and licensees) in an effort to eliminate some of these deficiencies.

The real estate agency disclosure law addresses two separate sets of agency-related matters on real estate transactions:

- an **Agency Law Disclosure**, also known as the **Disclosure Regarding Real Estate Agency Relationships**, setting out the "rules of agency" which control the conduct of real estate licensees when dealing with the public in an agency capacity [See Form 305 accompanying this chapter]; and

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]

agency confirmation
A provision in all purchase agreements and counteroffers disclosing the agency of each broker in the transaction.

- an **agency confirmation provision**, contained in documents signed by principals used to negotiate the purchase of real estate or the leasing of real estate and lease agreements with a term exceeding one year, declaring the agency relationships undertaken by each of the brokers with the participants in the transaction. [See **RPI** Form 150]

In creating an agency scheme, the California legislature established uniform real estate terminology and brokerage conduct covering **targeted transactions**, as specified later in this chapter.

The real estate agency disclosure law previously applied only to one-to-four unit residential sales and leases for greater than one year. It has since been expanded to include more diverse types of property. Thus, the **Agency Law Disclosure** needs to be presented to all parties when listing, selling, buying exchanging or leasing for a term greater than one year:

- single family residential property;
- multi-unit residential property with more than four dwelling units;
- commercial property;
- vacant land;
- a ground lease coupled with improvements; or
- manufactured homes.[1]

At its core, the Agency Law Disclosure form is a restatement of pre-existing agency codes and case law on agency relationships in all real estate transactions. [See Form 305]

Uniform jargon and agency law

The Agency Law Disclosure was created for use by brokers and their agents to educate and familiarize principals with:

- a uniform jargon for real estate transactions; and
- the various agency roles licensees undertake on behalf of their principals and other parties in a real estate transaction.

This information is presented in a two-page form. The exact wording of its content is dictated by statute.[2] [See Form 305]

The Agency Law Disclosure defines and explains the words and phrases commonly used in the real estate industry.

buyer's agent
An agent representing the buyer. Also known as a selling agent. [See **RPI** Form 103]

seller's agent
An agent representing the seller. Also known as a listing agent. [See **RPI** Form 102]

These industry terms are used to express:

- the *agency relationships* of brokers to the parties in the transaction;
- *broker-to-broker relationships*; and
- the *employment relationship* between brokers and their agents.

A **buyer's agent** and **seller's agent** are mentioned but not defined. Legally, an agent is a licensed real estate broker. Thus, the word "agent," when used

1 Calif. Civil Code §§2079.13(j), 2079.14
2 CC §2079.16

in the disclosure, is not a reference to the broker's agents. Ironically, a broker rarely refers to themselves as an agent, which in law, they always are when using their license to earn a fee.

Two sections on the face of the Agency Law Disclosure, entitled "seller's agent" and "buyer's agent," address the duties owed to the seller and buyer in a real estate transaction by these otherwise undefined brokers.

The seller's broker is correctly noted as being an agent for the seller, and is also known within the trade as a *listing broker* or *listing office*. The buyer's broker is known as a *buyer's agent*. However, peculiar to real estate brokerage, the buyer's broker is also known as the *selling agent*, a term the Agency Law Disclosure used prior to 2019.

The Agency Law Disclosure does not mention, much less define, the broker's role as an **exclusive agent** for either the buyer or seller. Yet the separate agency confirmation provision included in all targeted transactions calls for the broker to make this distinction known to all the parties involved. The mandated provision requires the broker to characterize their conduct with the parties as the agent of the seller or buyer exclusively, or both as a dual agent.

exclusive agent
An agent who is acting exclusively on behalf of only one party in a transaction.

These exclusive characterizations of agency conduct have no relationship to employment under exclusive listings to sell or buy property. The seller's agent with an exclusive right-to-sell listing understands the prospective buyer may turn out to be one of their buyer clients. This representation of opposing parties makes the broker a "non-exclusive" **dual agent**. [See Chapter 5]

Editor's note — This chapter is discussed primarily in the context of an agent representing a buyer or seller. Though not mandated by statute, use of the disclosure in leasing situations is also recommended as it helps to clarify the duties of the licensees involved.

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.

The parties, their brokers and duties owed

The Agency Law Disclosure states the generally accepted principles of law governing the conduct of brokers who are acting as agents solely for a seller or a buyer.

Two categories of **broker obligations** arise in a transaction, including:

- the *special* or *primary agency duties* of an agent which are owed by a broker and their agents to their principal, known as **fiduciary duties;** and
- the *general duties* owed by each broker to all parties in the transaction, requiring them to be honest and avoid deceitful conduct, known as **general duties**.

Agencies confirmed

In addition to the use requirements for the Agency Law Disclosure form, a separate, long-mandated **agency confirmation** is also required on all targeted transactions. [See **RPI** Form 150]

Form 305

Agency Law Disclosure

Page 1 of 2

AGENCY LAW DISCLOSURE
Disclosure Regarding Real Estate Agency Relationships
For Negotiating the Sale or Exchange of Real Estate

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

NOTE: This form is used by agents as an attachment when preparing a listing agreement, purchase agreement or a counteroffer on the sale or exchange of residential property, commercial property, raw land 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 Buyer and the Seller:
      a. Diligent exercise of reasonable skill and care in performance of the Agent's duties.
      b. A duty of honest and fair dealing and good faith.
      c. A duty to disclose all facts known to the Agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of the parties.
   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 Buyer's 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 Buyer and the Seller:
      a. Diligent exercise of reasonable skill and care in performance of the Agent's duties.
      b. A duty of honest and fair dealing and good faith.
      c. A duty to disclose all facts known to the Agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation, of the parties. An Agent is not obligated to reveal to either party any confidential information obtained from the other party that does not involve the affirmative duties set forth above.
4. **AGENT REPRESENTING BOTH THE SELLER AND THE BUYER:** A Real Estate Agent, either acting directly or through one or more salespersons and broker associates, 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 Seller and Buyer, a dual agent may not, without the express permission of the respective party, disclose to the other party confidential information, including, but not limited to, facts relating to either the Buyer's or Seller's financial position, motivations, bargaining position or other personal information that may impact price, including the Seller's willingness to accept a price less than the listing price or the Buyer's willingness to pay a price greater than the price offered.
5. **SELLER AND BUYER RESPONSIBILITIES:** Either the purchase agreement or a separate document will contain a confirmation of which agent is representing you and whether that agent is representing you exclusively in the transaction or acting as a dual agent. Please pay attention to that confirmation to make sure it accurately reflects your understanding of your agent's role.
6. 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.
7. If you are a Buyer, you have the duty to exercise reasonable care to protect yourself, including as to those facts about the property which are known to you or within your diligent attention and observation.
8. Both Sellers and Buyers should strongly consider obtaining tax advice from a competent professional because the federal and state tax consequences of a transaction can be complex and subject to change.
9. 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.
10. 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
(Signature of Salesperson or Broker-Associate, if any)	Date	(Buyer's Signature)	Date
(Seller's Broker)	Date	(Seller's Signature)	Date
(Signature of Salesperson or Broker-Associate, if any)	Date	(Seller's Signature)	Date

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The *agency confirmation* provision declares the agency relationships each broker may have with the principals in the specific transaction underway. With the agency confirmation included in written negotiations to purchase, this relationship is consented to by all parties when they sign the documents.

The agency confirmation provision discloses each broker's actual agency relationship presently existing with the participants. Further, it memorializes the relationship established by the broker's and their agents' conduct with

Form 305

Agency Law Disclosure

Page 2 of 2

PAGE 2 OF 2 — FORM 305

2079.13. As used in Sections 2079.14 to 2079.24, inclusive, the following terms have the following meanings:

a. "Agent" means a person acting under provisions of Title 9 (commencing with Section 2295) in a real property transaction, and includes a person who is licensed as a real estate broker under Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code, and under whose license a listing is executed or an offer to purchase is obtained. The agent in the real property transaction bears responsibility for that agent's salespersons or broker associates who perform as agents of the agent. When a salesperson or broker associate owes a duty to any principal, or to any buyer or seller who is not a principal, in a real property transaction, that duty is equivalent to the duty owed to that party by the broker for whom the salesperson or broker associate functions.

b. "Buyer" means a transferee in a real property transaction, and includes a person who executes an offer to purchase real property from a seller through an agent, or who seeks the services of an agent in more than a casual, transitory, or preliminary manner, with the object of entering into a real property transaction. "Buyer" includes vendee or lessee of real property.

c. "Commercial real property" means all real property in the state, except (1) single-family residential real property, (2) dwelling units made subject to Chapter 2 (commencing with Section 1940) of Title 5, (3) a mobilehome, as defined in Section 798.3, (4) vacant land, or (5) a recreational vehicle, as defined in Section 799.29.

d. "Dual agent" means an agent acting, either directly or through a salesperson or broker associate, as agent for both the seller and the buyer in a real property transaction.

e. "Listing agreement" means a written contract between a seller of real property and an agent, by which the agent has been authorized to sell the real property or to find or obtain a buyer, including rendering other services for which a real estate license is required to the seller pursuant to the terms of the agreement.

f. "Seller's agent" means a person who has obtained a listing of real property to act as an agent for compensation.

g. "Listing price" is the amount expressed in dollars specified in the listing for which the seller is willing to sell the real property through the seller's agent.

h. "Offering price" is the amount expressed in dollars specified in an offer to purchase for which the buyer is willing to buy the real property.

i. "Offer to purchase" means a written contract executed by a buyer acting through a buyer's agent that becomes the contract for the sale of the real property upon acceptance by the seller.

j. "Real property" means any estate specified by subdivision (1) or (2) of Section 761 in property, and includes (1) single-family residential property, (2) multiunit residential property with more than four dwelling units, (3) commercial real property, (4) vacant land, (5) a ground lease coupled with improvements, or (6) a manufactured home as defined in Section 18007 of the Health and Safety Code, or a mobilehome as defined in Section 18008 of the Health and Safety Code, when offered for sale or sold through an agent pursuant to the authority contained in Section 10131.6 of the Business and Professions Code.

k. "Real property transaction" means a transaction for the sale of real property in which an agent is retained by a buyer, seller, or both a buyer and seller to act in that transaction, and includes a listing or an offer to purchase.

l. "Sell," "sale," or "sold" refers to a transaction for the transfer of real property from the seller to the buyer and includes exchanges of real property between the seller and buyer, transactions for the creation of a real property sales contract within the meaning of Section 2985, and transactions for the creation of a leasehold exceeding one year's duration.

m. "Seller" means the transferor in a real property transaction and includes an owner who lists real property with an agent, whether or not a transfer results, or who receives an offer to purchase real property of which he or she is the owner from an agent on behalf of another. "Seller" includes both a vendor and a lessor of real property.

n. "Buyer's agent" means an agent who represents a buyer in a real property transaction.

§2079.14. A seller's agent and buyer's agent shall provide the seller and buyer in a real property transaction with a copy of the disclosure form specified in Section 2079.16, and shall obtain a signed acknowledgment of receipt from that seller and buyer, except as provided in Section 2079.15, as follows:

a. The seller's agent, if any, shall provide the disclosure form to the seller prior to entering into the listing agreement.

b. The buyer's agent shall provide the disclosure form to the buyer as soon as practicable prior to execution of the buyer's offer to purchase. If the offer to purchase is not prepared by the buyer's agent, the buyer's agent shall present the disclosure form to the buyer not later than the next business day after receiving the offer to purchase from the buyer.

§2079.15. In any circumstance in which the seller or buyer refuses to sign an acknowledgment of receipt pursuant to Section 2079.14, the agent shall set forth, sign, and date a written declaration of the facts of the refusal.

§2079.17. (a) As soon as practicable, the buyer's agent shall disclose to the buyer and seller whether the agent is acting in the real property transaction as the buyer's agent, or as a dual agent representing both the buyer and the seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller, the buyer, and the buyer's agent prior to or coincident with execution of that contract by the buyer and the seller, respectively.

b. As soon as practicable, the seller's agent shall disclose to the seller whether the seller's agent is acting in the real property transaction as the seller's agent, or as a dual agent representing both the buyer and seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller and the seller's agent prior to or coincident with the execution of that contract by the seller.

c. The confirmation required by subdivisions (a) and (b) shall be in the following form:

______[Do not fill out]______ is the broker of (check one):
(Name of Seller's Agent, Brokerage firm and license number)
☐ the seller; or
☐ both the buyer and seller. (dual agent)
______[Do not fill out]______ is (check one):
(Name of Seller's Agent and license number)
☐ is the Seller's Agent. (salesperson or broker associate)
☐ is both the Buyer's and Seller's Agent. (dual agent)

______[Do not fill out]______ is the broker of (check one):
(Name of Buyer's Agent, Brokerage firm and license number)
☐ the buyer; or
☐ both the buyer and seller. (dual agent)
______[Do not fill out]______ is (check one):
(Name of Buyer's Agent and license number)
☐ the Buyer's Agent. (salesperson or broker associate)
☐ both the Buyer's and Seller's Agent. (dual agent)

d. The disclosures and confirmation required by this section shall be in addition to the disclosure required by Section 2079.14. An agent's duty to provide disclosure and confirmation of representation in this section may be performed by a real estate salesperson or broker associate affiliated with that broker.

§2079.19. The payment of compensation or the obligation to pay compensation to an agent by the seller or buyer is not necessarily determinative of a particular agency relationship between an agent and the seller or buyer. A listing agent and a selling agent may agree to share any compensation or commission paid, or any right to any compensation or commission for which an obligation arises as the result of a real estate transaction, and the terms of any such agreement shall not necessarily be determinative of a particular relationship.

§2079.20. Nothing in this article prevents an agent from selecting, as a condition of the agent's employment, a specific form of agency relationship not specifically prohibited by this article if the requirements of Section 2079.14 and Section 2079.17 are complied with.

§2079.21. (a) A dual agent may not, without the express permission of the seller, disclose to the buyer any confidential information obtained from the seller.

b. A dual agent may not, without the express permission of the buyer, disclose to the seller any confidential information obtained from the buyer.

c. "Confidential information" means facts relating to the client's financial position, motivations, bargaining position, or other personal information that may impact price, such as the seller is willing to accept a price less than the listing price or the buyer is willing to pay a price greater than the price offered.'

d. This section does not alter in any way the duty or responsibility of a dual agent to any principal with respect to confidential information other than price.

§2079.22. Nothing in this article precludes a seller's agent from also being a buyer's agent. If a seller or buyer in a transaction chooses to not be represented by an agent, that does not, of itself, make that agent a dual agent.

§2079.23. A contract between the principal and agent may be modified or altered to change the agency relationship at any time before the performance of the act which is the object of the agency with the written consent of the parties to the agency relationship.

§2079.24. Nothing in this article shall be construed to either diminish the duty of disclosure owed buyers and sellers by agents and their associate licensees, subagents, and employees or to relieve agents and their associate licensees, subagents, and employees from liability for their conduct in connection with acts governed by this article or for any breach of a fiduciary duty or a duty of disclosure.

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the principals in a transaction. The agency relationship confirmed is the broker's legal determination of the actual agency created by their prior and present conduct with the parties.

Other agency related conflicts may exist for the broker or agent with other parties or service providers in a transaction, such as a dual agency relationship or conflict of interest. These are set out and disclosed in other forms. [See **RPI** Form 117 and 527]

The Agency Law Disclosure form contains the wording for the agency confirmation provision to be included in targeted transactions. However, the confirmation provision in the Agency Law Disclosure form is not filled out or used in lieu of the agency confirmation provision contained in a document such as a purchase agreement.

The agencies to be confirmed by each broker in the purchase agreement are not known at the time of the initial employment when the Agency Law Disclosure is first presented to the principal. For example, the agency in a potential future sales transaction cannot be determined, much less confirmed at the time the broker firsts presents their seller with the Agency Law Disclosure form.[1]

When two brokers are involved in a targeted transaction, each broker needs to disclose whether they are acting as the agent for the buyer or the seller. Alternatively, when only one broker is involved, they need to confirm whether they and their agents are acting as the *exclusive agent* for one party or as a dual agent for both the buyer and seller.

Written disclosures tend to eliminate later disputes over agency duties. Agency conflicts discovered when in escrow often become the basis for cancelling a transaction, the payment of a brokerage fee, or both.[2]

Use of the Agency Law Disclosure

The Agency Law Disclosure needs to be presented to all parties in *targeted transactions*. However, not all transactions are targeted. For example, arranging the secured interests of lenders and borrowers under trust deeds or collateral mortgages, are not targeted transactions.

The sale, exchange or creation of interests in transactions targeted by the agency disclosure law include transfers of:

- fee simple estates in real estate or registered ownerships for mobilehomes;
- life estates;
- existing leaseholds with more than one year remaining, such as ground leases;
- multi-unit residential property with more than four dwelling units; and
- leases created for more than one year.[3]

What is targeted?

The Agency Law Disclosure needs to be attached to the following documents and signed by all parties in targeted transactions:

- a seller's listing [See **RPI** Form 102];
- a buyer's listing [See **RPI** Form 103];
- a purchase agreement [See **RPI** Form 150 and 159];

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1 CC §2079.17(d)

2 **L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300

3 CC §2079.13(l)

- an option to purchase [See **RPI** Form 161 and 161-1]
- an exchange agreement [See **RPI** Form 171];
- a counteroffer, by attachment or by reference, to a purchase agreement containing the disclosure as an attachment [See **RPI** Form 180];
- any letter of intent (LOI) prepared and submitted on behalf of a buyer [See **RPI** Form 185];
- a residential or commercial lease agreement for a term exceeding one year [See **RPI** Form 550 and 552 –552-8]; and
- an offer to lease. [See **RPI** Form 556]

However, there are exceptions. The Agency Law Disclosure is not required on negotiations and agreements concerning:

- property management;
- financing arrangements; and
- month-to-month rental agreements.

Agency rules for a seller's listing

Failure of the seller's agent to provide the seller with the Agency Law Disclosure prior to entering into the listing agreement is a violation of disclosure laws. As a consequence of this upfront failure, the broker will lose the fee on a sale if challenged by the seller. The loss of the fee is not avoided by a later disclosure made as an addendum to a purchase agreement or escrow instructions.[4]

The Agency Law Disclosure is also required when listing and submitting offers on a long-term ground lease on a property, coupled with improvements, that is being conveyed to a buyer and will be security for any purchase-assist financing.[5]

The seller's signature acknowledges receipt of the Agency Law Disclosure at both:

- the listing stage, as an addendum to the listing; and
- on presentation of a buyer's offer, as an addendum to the purchase agreement.[6]

Thus, the Agency Law Disclosure is treated by the seller's agent as a preliminary and compulsory listing event, if the listing broker expects to enforce collection of a brokerage fee on a later sale of the property. The Agency Law Disclosure is signed by the seller and handed back to the broker or their agent before settling down to finalize the listing to which it will be attached.

Further, when the broker or their sales agent fails to hand the seller the Agency Law Disclosure at the listing stage, the listing, and thus the agency, can be cancelled by the seller at any time. When the Agency Law Disclosure

4 **Huijers** v. **DeMarrais** (1992) 11 CA4th 676

5 CC §§2079.13(j), 2079.13(l), 2079.14

6 CC §2079.14

is not delivered up front with the listing, the seller may cancel payment of the fee due their broker after the transaction is in escrow and the brokerage fee has been further agreed to.

Agency rules for a buyer's agent

Similarly, the buyer's agent provides the Agency Law Disclosure form to the buyer prior to their signing any writing that initiates negotiations contemplating a sale.[7]

*Editor's note — Agency disclosure law requires a buyer's agent provide the Agency Law Disclosure form as soon as practicable prior to execution of an offer to purchase. Thus, as a matter of good practice, the disclosure form is best provided and signed by the buyer when entering into a buyer's listing agreement, as this is the moment affirmative agency duties commence. [See **RPI** Form 103 and 111]*

The buyer's agent perfects their fee

For the buyer's broker to protect themselves against loss of the fee due to the seller's broker's failure to timely disclose, the buyer's broker needs to *perfect* their right to collect their portion of any brokerage fee to be paid by the seller. Here, the buyer's broker's share of the fee to be paid by the seller needs to be agreed to be paid directly to the buyer's broker under the terms of the purchase agreement and escrow instructions.

Also, the Agency Law Disclosure form needs to be attached as a signed addendum to the buyer's purchase agreement offer submitted to the seller.

However, the buyer's broker might erroneously agree to let the seller's broker receive the entire fee from the seller. Under this risky arrangement, the seller's broker pays the buyer's broker a share of the fee under their separate *fee-sharing agreement*. [See Chapter 5]

When the seller's broker fails to obtain a signed Agency Law Disclosure as an addendum to the listing, the seller may legally avoid paying their broker their fee. Thus, when the seller has not agreed to directly pay the buyer's broker, a risk for the buyer's broker is created. If the seller refuses to pay their broker the entire fee for lack of disclosure, the buyer's broker is left without a fee as agreed from the seller's broker.

For the buyer's broker to protect their fee, the seller needs to agree in the body of the purchase agreement that the seller will pay both brokers themselves.

Documenting a refusal to sign

A seller may accept a purchase agreement offer or enter into a counteroffer but refuse to sign an Agency Law Disclosure. If the seller refuses to return a signed copy of the Agency Law Disclosure, the broker or their agent needs to document the refusal to preserve their right to receive a fee from the seller.[8]

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7 CC §2079.13

8 CC §2079.15

If a party claims they were never handed the Agency Law Disclosure, the broker's written documentation, created at the time of the refusal, dispels such a claim. The written documentation would also preserve the fee.

Chapter 3 Summary

The Agency Law Disclosure was created by the California legislature to familiarize brokers, agents and their principals with the uniform industry jargon. It also reveals the duties owed by licensees in the sale or lease for more than one year of real estate in targeted transactions involving:

- single family residential property;
- multi-unit residential property with more than four dwelling units;
- commercial property;
- vacant land;
- a ground lease coupled with improvements; or
- manufactured homes.

The disclosure describes the various agency roles licensees undertake on behalf of their principals and other participants in a real estate related transaction.

A separate agency confirmation provision is included in purchase agreements and counteroffers. It advises the buyer and seller of any agency relationships each broker has with the participants in the transaction.

Chapter 3 Key Terms

Quiz 1 Covering Chapters 1-3 is located on page 606.

Notes:

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

For a further discussion of this topic, see *Ethics* Chapter 1 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

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 are required to be **disclosed** to the client. This includes compensation in the form of:

- professional courtesies;
- familial favors; and

Form 527

Conflict of Interest

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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 ----

- preferential treatment by others toward the broker or their agents. [See **RPI** Form 119]

affiliated business arrangement (ABA)
Referral of a client to a financially controlled business whose earnings are shared with the broker which requires a written disclosure. [See **RPI** Form 205 and 519]

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

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.

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: ______________________

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Conflict of Interest

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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 continues 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.

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.

Relative's participation in a transaction

A seller's broker is to disclose their acquisition of any direct or indirect interest in the seller's property. The broker also discloses 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]

A broker cannot act for more than one participant in a transaction, including themselves, without disclosing their **dual agency** and obtaining the **client's consent** at the time the conflict arises.[1] [See Chapter 5; see Form 527]

1 Bus & P C §10176(d)

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.[1]

A relative owns the property sold

A buyer's broker is to 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.

Acting as 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 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.[2]

1 **Whitehead** v. **Gordon** (1970) 2 CA3d 659
2 **Robinson** v. **Murphy** (1979) 96 CA3d 763

However, when a *broker-seller* receives a brokerage 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.

Chapter 4 Summary

A broker's positive or negative bias toward the opposing participant, or an indirectly involved third party in a transaction, needs to 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.

Chapter 4 Key Terms

affiliated business arrangement .... **pg. 36**
conflict of interest .... **pg. 35**
dual agency .... **pg. 38**

Quiz 2 Covering Chapters 4-7 is located on page 607.

Notes:

Chapter 5

Dual agency and subagency

Learning Objectives

After reading this chapter, you will be able to:

- differentiate between agency and fee sharing; and
- identify situations in which a dual agency or subagency is established and managed.

Key Terms

dual agent **subagent**
multiple listing service (MLS)

For a further discussion of this topic, see *Agency* Chapter 4 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

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 listing broker to cooperate with other brokers. Thus, the seller's broker may share property information with other brokers and share any brokerage fee due from the seller. [See **RPI** Form 102 §4.2]

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.

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.

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

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.[1]

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.[2]

1 CC §2307
2 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 is to be promptly disclosed to each client.[3]

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 brokerage fee;
- liability for their principals' money losses; and
- disciplinary action by the Department of Real Estate (DRE).[4]

Undisclosed knowledge

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 is to remain the undisclosed knowledge of the dual agent, unless authorized to release the information in a writing signed by the principal in question.[5]

The decision by the broker not to release pricing information needs to 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

3 CC §2079.17
4 Calif. Business and Professions Code §10176(d)
5 CC §2079.21

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.

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.

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.

Chapter 5 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 is to 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 brokerage fee, liability for money losses incurred by the clients, and disciplinary action by the Department of Real Estate (DRE) on a complaint.

Confidential pricing information needs to 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 5 Key Terms

Quiz 2 Covering Chapters 4-7 is located on page 607.

Chapter 6

Trust funds overview

Learning Objectives

After reading this chapter, you will be able to:

- identify the general laws and regulations governing broker-held trust funds;
- manage, receive, deposit, hold, and disburse trust funds; and
- understand trust fund recordkeeping and accounting procedures.

Key Terms

conversion	**subaccount ledger**
general account	**trust funds**
owner's statement	

For a further discussion of this topic, see *Trust Funds* Chapter 1 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Introduction to trust funds

Real estate licensees often handle other people's items which have or evidence monetary value, called **funds.** *Funds* belonging to others which a broker and their agents handle when acting as agents in a transaction are called **trust funds**.

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

Trust funds generally include:

- rents and security deposits collected under a property management agreement [See **RPI** Form 550];
- good faith deposits tendered by a buyer with an offer to purchase;
- fees and costs handed to the broker in advance of their performance of agreed-to services;
- loan payments and funds on contract collection and loan brokerage; and
- any other personal property of value.

Trusts funds are held by brokers for safekeeping and may not be treated casually. **Recordkeeping** and accounting requirements are imposed on brokers when they receive, transfer or disburse trust funds.

This chapter familiarizes brokers and their agents with the requirements and procedures for the handling of trust funds.

Identification of trust funds

Brokers, while acting on behalf of others in their capacity as agents in real estate transactions, receive funds which are not theirs and are *held in trust* for the owner of the funds. These trust funds include:

- deposits on offers to purchase and applications to rent or borrow;
- fees advanced for any brokerage services to be provided in the future, called *advance fees;*
- funds advanced for future costs;
- funds from sellers, borrowers and landlords as reserves to cover future costs;
- rental income and tenant security deposits;
- funding for a loan or the purchase of real estate; and
- proceeds from a sale or financing.

Trust funds are received by a broker, or by an employee acting on behalf of the broker.

Evidence of value

Trust funds include any *item or evidence of value* handed to the broker or the broker's employee while acting as an agent in a real estate transaction.

Trust funds come in many forms, including:

- checks;
- precious metals/stones;
- stocks/bonds;
- collectibles;
- promissory notes; and
- any other item or evidence of value.[1]

Managing the trust funds

Consider a broker who enters into a *property management agreement* with an owner of income-producing real estate. Management services to be performed by the broker under their license include locating tenants, collecting rent and deposits, and disbursing funds for payment of operating expenses and installments on a trust deed loan encumbering the real estate.

The broker is further authorized to withdraw their fee and send any funds remaining to the owner.

1 Calif. Business and Professions Code §10145

The broker takes possession of the property under the property management agreement. The broker locates several new tenants and collects monthly rent and deposits.

The broker deposits the rent and security deposits they receive into their **general account.** They then enter the amount of each transaction as trust funds on the client's **subaccount ledger.**

Although sufficient funds are held in the client's subaccount to meet operating expenses and make the loan payment, the broker first withdraws their fee before making the loan payment authorized by the owner. The disbursement of the brokerage fee reduces the balance on the client's ledger below the amount needed to make the loan payment.

general account
A broker or agent's personal or business account, not to be commingled with trust funds.

The broker then issues a check to the lender for the loan payment. The check bounces due to insufficient funds remaining in the broker's general account. The owner is notified by the lender and contacts the broker who provides funds to cover the loan payment.

subaccount ledger
An accounting document or file identifying the owner of trust funds and the amount held for the owner.

In this instance, the broker *illegally commingled* the owner's funds with their funds when the rent and security deposits were deposited into the broker's general account rather than a trust account. Even though a subaccount ledger for the client's trust funds was maintained, the funds were improperly commingled with funds belonging to the broker.

Further, the broker breached their agency duty owed the client by withdrawing the brokerage fee before paying all other obligations the broker agreed to disburse on behalf of the owner, including payment on the loan, known as a **conversion.** The brokerage/management fee is to be paid last, after agreed-to services have been performed, including all authorized disbursements.

conversion
The unlawful appropriation of another's property, as in the conversion of trust funds.

Lastly, by writing a check for the loan payment when the broker knew insufficient funds existed in the account to cover the check, the broker misrepresented the availability of immediate funds. This is considered fraud and is grounds for the revocation or suspension of the broker's license.[2]

Conversion trust of funds

Alternatively, consider a broker who maintains a brokerage trust account. The trust account contains loan payments received by the broker while servicing loans on behalf of trust deed investors.

The broker pledges the trust account to secure a personal loan from the same bank which holds the trust account.

The broker defaults on the loan, and the bank seizes the trust account funds.

An investor seeks to recover their trust account funds from the bank, claiming the bank's seizure of the funds is a *conversion* since trust funds cannot be taken to satisfy the broker's personal debt.

2 **Apollo Estates, Inc.** v. **Department of Real Estate** (1985) 174 CA3d 625

The bank claims the seizure of the trust account is not a conversion since it exercised its right to an offset under the security agreement.

Is the investor entitled to recover their portion of the trust funds?

Yes! The trust funds belong to the investor and need to be returned. The bank's right to an offset for the broker's personal debt to the bank does not extend to seizure of funds held for others in the broker's trust account.[1]

Handling cash and checks

Funds received in the form of cash or checks made payable to the broker while acting as an agent are to be:

- deposited into the broker's trust account;
- held undeposited as instructed; or
- endorsed and handed to others entitled to the funds.

Further, the broker has a duty to *secure trust funds* that are not in the form of cash or checks, such as gems, coins, notes or other personal property, from loss or damage after they are received. These nonnegotiable types of trust funds cannot be deposited in a bank account. Thus, the broker is to place the nonnegotiable items in a safe or safe-deposit box for safekeeping until they are delivered to others.

Trust funds received in the form of checks or cash may only be used for expenditures authorized and incurred for the benefit of the owner of the funds.

owner's statement
An accounting on the status, expenditure and location of negotiable trust funds provided to the owner of those funds.

Further, the broker is required to regularly account to the owner on the status, expenditure and location of the negotiable trust funds, called an **owner's statement.**

Prior to the end of the *third business* day following the day the broker receives negotiable trust funds, the broker needs to deposit the funds:

- with the *person or escrow* depository entitled to the funds (as payee or by endorsement); or
- in a *trust account* maintained by the broker at a bank or other state-recognized depository.[2]

Agent delivery to the broker

Also, when an agent of the broker accepts trust funds on behalf of the broker, the agent is to immediately deliver the funds to the broker, unless directed by the broker to:

- deliver the trust funds to the person or the escrow entitled to the funds; or
- deposit the trust funds into the broker's trust account.[3]

1 **Chazen** v. **Centennial Bank** (1998) 61 CA4th 532
2 Bus & P C §10145; Department of Real Estate Regulation §2832(a)
3 Bus & P C §10145(c)

For example, when a broker negotiates the purchase or lease of real estate, they usually receive a check as a good faith deposit.

The broker may hold the check undeposited until an event occurs, such as the offer is accepted or escrow is opened, if:

- the check is made payable to someone other than the broker; or
- the check is made payable to the broker with written instructions, typically from the buyer or tenant, to hold the check undeposited until acceptance of the offer or escrow is opened; and
- the person to whom the offer is submitted, usually the seller or landlord, is informed the check for the good faith deposit is being held by the broker when the offer is submitted.[4]

The instructions to hold the check undeposited until acceptance are included in the terms for receipt of the deposit contained in the offer to purchase or lease. [See **RPI** Form 150 §1]

After a buyer's offer is accepted, the broker may continue to hold the buyer's check for the good faith money undeposited if the seller has given the broker written instructions to continue to hold the check undeposited.

However, without instructions to further retain the check undeposited, the broker is to deposit or deliver the funds no later than *three business days* after acceptance:

- to the payee entitled to the funds, such as a title company or escrow;
- into the broker's trust account at a bank or other state-recognized depository, such as a thrift; or
- to an escrow depository on the broker's endorsement, if the broker is the payee and does not want to deposit and disburse the funds from their trust account to escrow.[5]

Identifying the owner

A broker needs to know who owns and controls the funds held in their trust account at all times. Trust funds can only be disbursed on the authorization of the owner of the funds. *Subaccount ledgers* are set up to identify the owner of funds and the amount held for the owner.

However, persons other than the owner of the trust funds may have an interest in the funds. If so, their authorization is also required to withdraw the funds.

4 DRE Reg. §2832(c)

5 DRE Reg. §2832

Chapter 6 Summary

Funds belonging to others which a broker and their agents handle are called trust funds. Trust funds include rents, security deposits, good faith deposits, advance fees, loan payments, and any other personal property of value.

The safekeeping of trust funds is ensured by the imposition of recordkeeping and accounting requirements on brokers when they receive, transfer or disburse trust funds.

Trust funds come in many forms, including checks, precious metals/stones, stocks/bonds, collectibles, promissory notes and any other item or evidence of value handed to the broker or the broker's employee while acting as an agent in a real estate transaction.

Trust funds are illegally commingled when a broker deposits the funds into an account other than a dedicated trust fund account. A broker's use of trust funds for any reason other than those expressly authorized by the owner of the funds constitutes a conversion of the client's funds to the broker's own use.

Cash and checks held as trust funds are to be deposited into the broker's trust account, held undeposited as instructed, or endorsed and handed to others entitled to the funds.

A broker needs to regularly account to the owner on the status, expenditure and location of the negotiable trust funds held by the broker. Similarly, a broker needs to know who owns and controls the funds held in their trust account, identified through the use of subaccount ledgers.

Chapter 6 Key Terms

Quiz 2 Covering Chapters 4-7 is located on page 607.

Chapter
7

Civil rights and fair housing laws

Learning Objectives

After reading this chapter, you'll be able to:

- understand federal and California anti-discrimination laws; and
- know how the laws affect the management of residential and nonresidential rental property.

Key Terms

blockbusting	**familial status**
Civil Rights Act	**Federal Fair Housing Act**
disabled person	**steering**
dwelling	**Unruh Civil Rights Act**

For a further discussion of this topic, see Chapter 36 of Landlords, Tenants and Property Management.

Property rights cannot be based on status

Regardless of race, all citizens of the United States have the right to purchase or rent real estate under the federal **Civil Rights Act**.[1]

Further, all individuals within the United States are given the same rights to make and enforce contracts (rental and lease agreements), sue, be sued, enjoy the full benefits of the law and be subject to the same punishments, penalties, taxes and licenses, regardless of race or legal status.[2]

The federal *Civil Rights Act* applies to race discrimination on the sale or rental of all types of real estate, both residential and commercial. Racially motivated activities in any real estate leasing transaction are prohibited.

Civil Rights Act
A federal law which provides broad protections to numerous classes of individuals in the United States against discriminatory activities.

1 42 United States Code §1982
2 42 USC §1981

Federal protection against racial discrimination given under the Civil Rights Act is a broad protection which applies to types of discrimination prohibited in all activities between individuals present in the country.

Anti-discrimination in residential property

While the federal Civil Rights Act provides general protection against all prohibited discriminatory activity, the **Federal Fair Housing Act (FFHA)** protections are specifically limited to dwellings, including rental housing.[1]

Federal Fair Housing Act (FFHA)
A collection of policies designed to prevent discrimination in the access to housing based on an occupant's inclusion in a protected class.

A **dwelling** includes any building or structure that is occupied, or designed to be occupied, as a residence by one or more families. A *dwelling* also includes vacant land offered for lease for residential dwelling purposes, such as a lot or space made available to hold a mobilehome unit.[2]

dwelling
A building occupied or designed to be occupied as a residence by one or more families.

The FFHA bars the use of any discriminatory actions a seller, landlord or property manager might take against a prospective buyer or tenant based on an individual's:

- race or color;
- national origin;
- religion;
- sex;
- familial status; or
- handicap.[3]

Familial status refers to whether a household includes individuals under the age of 18 in the legal custody of a parent or legally designated guardian.[4]

familial status
A status which indicates a household includes individuals under the age of 18.

Handicapped persons are individuals who have:

- a physical or mental impairment which substantially limits the individual's life activities; or
- a record of, or are regarded as having, a physical or mental impairment.[5]

The term "handicap" excludes individuals who illegally use a controlled substance. However, alcoholics and individuals who are considered "recovering or recovered addicts" are protected as handicapped individuals.[6]

Qualifying and processing tenants

The FFHA prohibits a seller, landlord or property manager from unlawfully discriminating against individuals during solicitations and negotiations for the sale or rental of a dwelling.[7]

Thus, in the context of leasing, a landlord or property manager may not:

- refuse to rent a dwelling or to negotiate the rental of a dwelling for prohibited discriminatory reasons;

1 42 USC §§3601 et seq.
2 42 USC §3602(b)
3 42 USC §3602
4 42 USC §3602(k)
5 42 USC §3602(h)
6 **United States** v. **Southern Management Corporation** (4th Cir. 1992) 955 F2d 914
7 42 USC §3604(a)

- impose different rental charges on a dwelling for prohibited discriminatory reasons;
- use discriminatory qualification criteria or different procedures for processing applications in the rental of a dwelling; or
- evict tenants or tenants' guests for prohibited discriminatory reasons.[8]

Different terms, different privileges

Consider a broker who is hired by a residential apartment landlord to perform property management activities. One of the broker's duties as a property manager is to locate tenants to fill vacancies.

A tenant from a religious minority group contacts the broker about the availability of an apartment.

The broker (or their agent) informs the prospective tenant of the monthly rent. However, the rate the broker communicates to the prospective tenant is higher than the rent nonminority tenants are asked to pay for similar apartments.

When the prospective minority tenant asks the broker for an application, the broker informs the tenant a nonrefundable screening fee is charged to process the application. The creditworthy minority tenant fills out the application, pays the fee and is told the processing will take several days.

In the meantime, a nonminority tenant inquires about the rental of the same or similar apartment. The monthly rent rate the broker quotes the nonminority is lower than the rent rate the minority tenant was quoted, even though the nonminority tenant is not as creditworthy as the minority tenant. Further, the nonminority tenant is not charged a screening fee with their application. The apartment is immediately rented to the nonminority tenant.

Here, the broker's actions were racially or religiously motivated, a violation of the FFHA. The broker misrepresented the availability of the apartment based on the tenant's religion by using different procedures and qualification standards in accepting and processing the tenant's application.[9]

Selective reduction

Selective reduction of buyer or tenant privileges, conditions, services and facilities offered to protected individuals is prohibited. *Selective reduction* can take the form of:

- using less favorable provisions in lease or purchase agreements, such as in rental charges and closing requirements;
- delaying or failing to perform maintenance;
- limiting use of privileges, services or facilities to different classes of individuals; or

8 24 Code of Federal Regulations §100.60(b)

9 **United States** v. **Balistrieri** (7th Cir. 1992) 981 F2d 916

steering
An unlawful housing practice that includes words or actions by a real estate sales licensee intended to influence the choice of a prospective buyer or tenant.

- refusing or failing to provide services or facilities due to an individual's refusal to provide sexual favors.[1]

Further, the landlord or property manager may not discriminate based on an individual's status by representing that a dwelling is not available for rent in order to direct the individual to a particular Section 8 project or neighborhood, when the dwelling is available. This practice is called **steering**.

Steering involves the restriction of an individual seeking to rent or purchase a dwelling in a community, neighborhood or development, when the guidance perpetuates segregated housing patterns.[2]

Discrimination in advertisement

A broker or their agent making a notice, statement or advertisement when handling the sale or rental of a dwelling unit is barred from using any wording that indicates a discriminatory preference or limitation against individuals of protected classes of people.[3]

The prohibition against prohibited discriminatory advertisements applies to all oral and written statements.

Notices and statements include any applications, flyers, brochures, deeds, signs, banners, posters and billboards used to advertise the availability of a dwelling for rent.

Blockbusting for exploitation

An agent, residential landlord or property manager may not induce or attempt to induce an individual to offer, or abstain from offering a dwelling to prevent the entry of certain classes of people into the neighborhood. This prohibited practice is known as **blockbusting**.[4]

blockbusting
The prohibited practice of a real estate licensee inducing a property owner to list their property for sale in response to a change taking place in the neighborhood demographics.

Further, a landlord's or agent's actual financial gain is not necessary to establish *blockbusting* conduct. The mere profit motivation is sufficient to establish blockbusting activity.[5]

Examples of blockbusting activities by a landlord or property manager include:

- encouraging an owner-occupant to offer their home for sale or rent by insinuating that a neighborhood is undergoing or is about to undergo a change in the race, color, religion, sex, handicap, familial status or national origin of its residents; or
- discouraging an owner-occupant from offering their home for sale or rent by claiming the entry of individuals of a particular race, color, religion, sex, familial status, handicap or national origin will result in undesirable consequences for the neighborhood or community, such as an increase in criminal activity or a decline in schools and other facilities.[6]

1 24 CFR §100.65(b)
2 42 USC §3604(d); 24 CFR §100.70
3 42 USC §3604(c)
4 42 USC §3604(e)
5 24 CFR §100.85(b)
6 24 CFR §100.85(c)

Exemptions from prohibited discrimination

There are exemptions to the FFHA prohibitions. A landlord who rents out a single family residence is exempt from FFHA discrimination prohibitions if they:

- own three or fewer single-family residences;
- do not use a real estate licensee to negotiate or handle the tenancy; and
- do not use a publication, posting or mailing for any discriminatory advertisement.[7]

Thus, the FFHA prohibitions apply to all notices, statements and advertisements promoting rentals by anyone in the *business of renting dwellings*.[8]

A person is in the business of renting (or selling) dwellings if the person:

- has participated within the past 12 months as a *principal* in three or more transactions involving the sale or rental of any dwelling or interest in a dwelling;
- has participated within the past 12 months as an *agent*, negotiating two or more transactions involving the sale or rental of any dwelling or interest in a dwelling, excluding the agent's personal residence; or
- is *the owner* of a dwelling structure intended to be occupied by five or more families.[9]

If a broker is the agent for any of the participants in a sale or rental transaction, the FFHA anti- discrimination rules apply.

However, attorneys, escrow agents, title companies and professionals other than brokers who are employed by a landlord to complete a transaction do not bring the transaction under the FFHA, unless they participate in negotiations with the buyer or tenant.[10]

Limited exemptions

Also exempt from FFHA discrimination rules is the sale or rental of a residence in a one-to-four unit residential rental property which is occupied in part by the owner.[11]

Religious organizations who limit the sale, rental or occupancy of dwellings to individuals of the same religion are also exempt, provided the dwelling is owned for noncommercial reasons. No religious exemption exists if the religion is restricted to individuals of a particular race, color or national origin.[12]

Private clubs which provide their members with residential dwelling space for noncommercial purposes may limit rental or occupancy of the dwellings to members.

7 42 USC §3603(b)(1)
8 42 USC §3603
9 42 USC §3603(c)
10 42 USC §3603(b)(1)(B)
11 42 USC §3603(b)(2)
12 42 USC §3607(a)

Housing for older persons

Finally, housing qualified for older citizens which excludes children is not considered prohibited discrimination against buyers or tenants with children based on familial status. However, for housing to exclude children it needs to first qualify as housing for the elderly.[1]

A provision in a written instrument which refers to *qualified senior citizen housing* is enforceable as allowable age discrimination.

A **senior citizen housing** project is housing:

- intended for and *solely occupied* by persons 62 years of age or older; or
- intended and operated for *occupancy* by persons of 55 years of age or older.[2]

Failure to comply with the FFHA

Any individual who claims they have been injured by a prohibited discriminatory housing practice under the FFHA or believes they will be injured by such a practice is considered an **aggrieved individual**.[3]

An *aggrieved individual* may file a complaint with the Secretary of Housing and Urban Development (HUD), within one year of the alleged discriminatory housing practice.[4]

HUD then attempts to resolve the dispute by having the parties enter into informal negotiations, called **mediation**.[5]

If mediation is not successful, a judicial action may be initiated by HUD as a complaint to resolve the issue of discrimination. The dispute will then be resolved by an administrative law judge.

Unruh Civil Rights Act
A California law which prohibits discrimination by a business establishment based on sex, race, color, religion, ancestry, national origin, disability or medical condition. A real estate practice is a business establishment.

Any party to the complaint may elect to have the claims decided in a civil action before a court of law in lieu of using an administrative law judge.[6]

When a real estate broker subjected to a judicial action is found guilty of discriminatory housing practices, HUD is to notify the DRE and recommend disciplinary action.[7]

When a court determines discriminatory housing practices have taken place, actual and punitive amounts of money awards may be granted. Also, an order may be issued preventing the landlord or broker from engaging in any future discriminatory housing practice.[8]

California's Unruh Civil Rights Act

California's **Unruh Civil Rights Act**, another anti-discrimination law, prohibits discrimination by a business establishment based on numerous status classifications, including: an individual's sex, race, color, religion, ancestry, national origin, disability or medical condition.[9]

1 42 USC §3607(b)
2 42 United States Code §3607(b)
3 42 USC §3602(i)
4 42 USC §3610(a)
5 42 USC §3610(b)
6 42 USC §3612(a)
7 42 USC §3612(g)(5)
8 42 USC §3613(c)(1)
9 Calif. Civil Code §§51; 51.2; 51.3

However, age restriction is a legitimate discrimination as long as the restriction is in a project that qualifies as a senior citizen housing development.

The *Unruh Civil Rights Act* applies to anyone in the business of providing housing. Brokers, developers, apartment owners, condominium owners and single family residential owners renting or selling are considered to be in the business of providing housing.

As business establishments, landlords may not boycott, blacklist, refuse to lease or rent because of the race, creed, religion, color, national origin, sex, disability or medical condition of an individual's, or that individual's business partners, members, stockholders, directors, officers, managers, agents, employees, business associates or customers.[10]

Full and equal access guaranteed

Consider a blind prospective tenant who has a guide dog and seeks to rent an available unit in a multi-unit residential dwelling structure.

The landlord refuses to rent a unit to the blind tenant, claiming the guide dog violates the building's pet restriction in the *covenants, conditions and restrictions (CC&Rs)*.

The blind tenant claims the landlord is discriminating against them due to their disability since the landlord denied them housing on account of the guide dog.

Here, a landlord may not refuse to rent residential property to a blind tenant because of inclusion of the tenant's guide dog. Landlords are also prohibited from discriminating against tenants with dogs specially trained to assist deaf and other disabled individuals.[11]

Fair housing for disabled individuals

Disabled individuals are protected from discrimination when renting or leasing California residential real estate. A *disabled individual* is anyone who:

- has a physical or mental impairment which significantly limits major life activities;
- has a record of a disability; or
- is regarded as being disabled.[12]

People with disabilities are entitled to full and equal access to housing accommodations offered for rent.[13]

The only exception is the rental of no more than one room in a single-family residence.[14]

disabled person
Anyone who has a physical or mental impairment which significantly limits major life activities, has a record of disability, or is regarded as being disabled.

10 CC §51.5
11 CC §54.1(b)(6)
12 CC §54(b)
13 CC §54.1(b)(1)
14 CC §54.1(b)(2)

The examples of the blind tenant and their seeing-eye dog illustrate how a landlord might attempt to avoid anti-discrimination laws. While the landlord claims to justify their behavior based on their equal application of a single pet restriction rule to pet owners (an unprotected class of people), the refusal to rent to a disabled tenant based on their reliance on a trained dog is a prohibited discrimination.

Accommodating the disabled

A landlord is not required to structurally modify existing residential rental property to meet the special needs of disabled tenants.[1]

Although not required to modify the structure for a disabled tenant, the landlord is to allow the tenant to make reasonable modifications themselves or pay the landlord to do so. The landlord may require the disabled tenant who modifies the structure to restore the property to its original condition when the tenancy is terminated.[2]

Anti-discrimination laws require new residential properties consisting of four or more units per building to be built to allow access by disabled individuals. Required improvements include kitchens and bathrooms designed to allow access to disabled tenants in addition to wheelchair ramps.

Failure to provide the disabled with access to a newly constructed residential property with four or more units is prohibited discrimination.[3]

California prohibitions against discrimination in housing

California prohibits discrimination in the sale or rental of housing accommodations based on an individual's: race, color, religion, sex, sexual orientation, gender identity, genetic information, marital status, national origin, ancestry, familial status, source of income or disability. This list of protected individuals is more extensive than all others.[4]

Discriminatory activities and conduct include:

- making a written or oral inquiry into the race, sex, disability, etc. of any individual seeking to rent housing;
- ads or notices for rental of housing which state or infer preferences or limitations based on any of the prohibited discrimination factors;
- a broker refusing to represent an individual in a real estate transaction based on any prohibited factor; and
- any other practice that denies housing to a member of a protected class.[5]

The denial of housing based on the landlord or broker's perception that a prospective buyer or tenant has any of the protected characteristics is absolutely prohibited. An individual who has been the victim of discriminatory housing practices may recover their money losses.[6] [See Case in point, "Prohibited discrimination"]

1 CC §54.1(b)(4)
2 Calif. Government Code §12927
3 Gov C §12955.1
4 Gov C §12955
5 Gov C §12955
6 Gov C §12955(m)

Standards of conduct applied equally by a broker to all individuals are not classified as prohibited discrimination against a protected group of individuals as they are considered reasonable and thus permitted.

Income standards for tenants

For example, to qualify a tenant for occupancy based on their creditworthiness (which is not a prohibited discrimination), a landlord or property manager may establish income ratios or standards to determine a tenant's ability to pay the rent. The higher the ratio of income to rent established by a landlord, the less the risk of loss of rent borne by the landlord. The lower the ratio established by the landlord, the greater the risk of their loss of rent. Once set, the ratio is to be applied to all prospective tenants equally.

However, two or more individuals who desire to live in the same unit might apply to rent a unit. Whether related or unrelated, married or not, the income of all tenants is to be treated as the total income used by the landlord to determine their collective eligibility to qualify to pay the rent amount sought for the unit.

Separately, each prospective tenant may be unable to qualify by meeting the income standard for the total rent sought by the landlord. However, if aggregating the income of all who intend to occupy the unit and enter into the rental or lease agreement results in total income sufficient under the ratio applied to qualify a tenant or tenants for occupancy, the tenants qualify.[7]

Also, under rent subsidy programs, such as **Section 8** housing arrangements, the landlord or property manager will evaluate the tenant's income when determining whether the tenant qualifies to pay based on only the portion of the rent that is not subsidized.[8]

Familial status

Recall that **familial status** in anti-discrimination laws refers to whether children under the age of 18 will be living with a parent or guardian on the premises.[9]

Rental policies excluding children under the age of 18 are classified as prohibited discrimination under state, as well as federal laws, unless the property qualifies as senior citizen housing.[10]

Marital status of co-applicants for housing

Consider a landlord who refuses to rent an apartment to an unmarried couple based on the landlord's religious beliefs about such conduct.

The couple files a complaint with California's Civil Rights Department, claiming the landlord violated fair housing laws that prohibit discrimination based on marital status.

The landlord claims they are exempt since renting to an unmarried couple violates the landlord's religious beliefs regarding the cohabitation of unmarried couples.

7 Gov C §12955(n)
8 Gov C §12955(o)
9 Gov C §12955.2
10 Gov C §12955.9

However, the landlord's refusal to rent to unmarried couples violates the fair housing laws. The landlord's religious beliefs do not also require them to participate in the business of renting dwelling units.

Thus, fair housing laws prohibiting discrimination based on marital beliefs do not interfere with the practice of the landlord's religion. The faithful landlord can go into a business that does not violate their religious convictions.[1]

Guidelines for broker conduct

The DRE has regulations prohibiting discriminatory practices by real estate brokers acting on behalf of a client. A broker or their agent engaging in discriminatory business practices may be disciplined by the DRE.[2]

Prohibited practices include any situation in which a broker, while acting as an agent, discriminates against anyone based on race, color, sex, religion, ancestry, disability, marital status or national origin. Examples of discriminatory practices include:

- refusing to negotiate for the sale or rental of real estate;
- refusing to show property or provide information, or steering clients away from specific properties;
- refusing to accept a listing;
- publishing or distributing advertisements that indicate a discriminatory preference;
- any discrimination in the course of providing property management services;
- agreeing with a client to discriminate when selling or leasing the client's property, such as agreeing not to show the property to members of particular minority groups;
- attempting to discourage the sale or rental of real estate based on representations of the race, sex, disability, etc. of other inhabitants in an area; and
- encouraging or permitting employees to engage in discriminatory practices.

Disclosure of disability of other inhabitants

Consider a broker who is aware a licensed care facility for disabled people is located in a single family residence near a residence the prospective tenant is interested in renting.

The presence of the facility might influence the tenant's decision to rent the property. However, for the broker or their agents to inform the tenant of the facility would be unlawful discrimination. The broker may not attempt to influence the tenant's decision based on representations of the disability of other inhabitants in the area.[3]

1 **Smith** v. **Fair Employment and Housing Commission** (1996) 12 C4th 1143

2 Department of Real Estate Regulations §2780

3 73 Ops. Cal. Atty. Gen. 58 (1990)

Case in point

Prohibited discrimination

An ethnic or religious minority tenant seeks to rent an apartment. The landlord informs the prospective tenant they cannot rent the apartment until they complete a credit check. The landlord also declines to accept a deposit from the tenant.

Later the same day, a nonminority tenant seeks to rent the same apartment. The landlord agrees to rent the apartment to the nonminority tenant without first requiring a credit check, and immediately accepts the tenant's check for a deposit on the apartment. The minority tenant is informed the apartment has been rented to another individual.

The minority tenant files a complaint against the landlord, claiming the landlord discriminated against them based on their ethnicity or religion by refusing to rent them an apartment. The landlord claims no discrimination occurred since they were entitled to require a credit check of prospective tenants.

*However, requiring a credit check of minority tenants, but not nonminority tenants, is a prohibited discriminatory practice which allows the minority tenant to recover their money losses. [**Stearns** v. **Fair Employment Practice Commission** (1971) 6 C3d 205]*

However, on a direct inquiry from a tenant, the broker or agent need to respond based on their knowledge of the existence of a care facility.

No duty exists to disclose the prior tenant's affliction with the HIV virus or AIDS.[4]

Further, California public policy prohibits a broker from responding to a buyer's or tenant's inquiry for disclosure of a prior occupant's affliction with AIDS.[5]

Individuals afflicted with the HIV virus are considered handicapped and are protected by the FFHA.[6]

Broker's duty to manage employees

A broker has a duty to advise their agents and employees of anti-discrimination rules, including DRE regulations, the Unruh Civil Rights Act, the California Fair Employment and Housing Act, and the FFHA.[7]

The broker, in addition to being responsible for their own conduct, owes the public a duty to ensure their employees follow anti-discrimination regulations when acting as agents on the broker's behalf.

Disclosing a death

An owner, landlord or property manager will voluntarily disclose to prospective buyers and tenants the death of a prior occupant on the premises which occurred more than three years earlier when they have reason to believe the death might affect the buyer's decision to purchase or the tenant's decision to lease.

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4 CC §1710.2(a)
5 CC §1710.2(d)
6 24 CFR §100.201
7 DRE Reg. §2725(f)

Further, the seller, seller's agent, landlord and property manager will disclose their knowledge of any deaths which took place on the property in response to a direct inquiry.

Consider a tenant who asks the property manager if any *AIDS-related deaths* occurred on the property.[1]

If the property manager is aware an AIDS-related death occurred on the property, they have a duty on direct inquiry from the tenant to disclose:

- the prior occupant's death; and
- the death was AIDS-related.

If the property manager has no knowledge of any AIDS-related deaths occurring on the property, they will disclose:

- their lack of knowledge; and
- whether or not they intend to undertake an investigation to determine if an AIDS-related death occurred on the property.

Death as a material fact

Consider a property manager who is aware a death, from any cause, occurred on the property within three years of the commencement of a tenant's lease agreement. The tenant has not inquired if any deaths have occurred on the property.

Here, the property manager will need to determine if the death on the property is a *material fact* which might affect the tenant's decision to lease and occupy the property.

The property manager (or seller's agent) as good practice discloses *any death* occurring on the property within three years when they have reason to believe the fact might affect the tenant's decision to lease. However, on inquiry from the tenant, the property manager discloses their knowledge of any death, including AIDS-related deaths, which occurred on the property within the last three years.

1 CC §1710.2(d)

Chapter 7 Summary

A broker has a duty to inform their agents and employees of anti-discrimination rules, including Department of Real Estate (DRE) regulations, the Unruh Civil Rights Act, the California Fair Employment and Housing Act, and the Federal Fair Housing Act.

California law prohibits discrimination in the sale or rental of housing accommodations based on race, color, religion, sex, sexual orientation, gender identity, genetic information, marital status, national origin, ancestry, familial status, source of income or disability.

The federal Civil Rights Act applies to race discrimination on the sale or rental of all types of real estate, both residential and nonresidential. Racially motivated activities in any real estate sales or leasing transaction are prohibited.

The Federal Fair Housing Act (FFHA) prohibits any discriminatory actions a seller, seller's agent, landlord or property manager may take in the handling of a residential sale or rental based on an individual's race or color, national origin, religion, sex, familial status or handicap.

Disabled individuals are protected from discrimination when renting or leasing California residential real estate. However, a landlord is not required to structurally modify existing residential rental property to meet the special needs of disabled tenants.

Rental policies excluding children under the age of 18 are classified as prohibited discrimination, unless the property qualifies as senior citizen housing.

Chapter 7 Key Terms

blockbusting **pg.54**
Civil Rights Act .... **pg. 51**
disabled person .... **pg. 57**
dwelling .... **pg. 52**
familial status .... **pg. 52**
Federal Fair Housing Act .... **pg. 52**
steering .... **pg. 54**
Unruh Civil Rights Act .... **pg. 56**

Quiz 2 Covering Chapters 4-7 is located on page 607.

Notes:

Chapter 8

California Fair Employment and Housing Act

Learning Objectives

After reading this chapter, you will be able to:

- recognize the agencies who enforce housing anti-discrimination rules in California.

Key Terms

Civil Rights Department
discriminatory practices
implicit discrimination
senior citizen housing

For a further discussion of this topic, see *Fair Housing* Chapter 6 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Discriminatory practices, exemptions and remedies

Consider a minority tenant who seeks to rent an apartment. The landlord states they will not rent an apartment to a tenant until a credit check has been completed. The landlord declines to accept a deposit from the tenant until their credit has been cleared.

Later the same day, a non-minority tenant seeks to rent the same apartment. The landlord agrees to rent the apartment to the non-minority tenant without first requiring a credit check. The landlord immediately accepts a check from the tenant as a deposit on the apartment.

The minority tenant is then informed the apartment has been rented to another individual.

The minority tenant files a complaint against the landlord, claiming the landlord discriminated by refusing to rent an apartment based on the tenant's race. The landlord claims no discrimination occurred since they are entitled to require a credit check of prospective tenants.

Was the landlord's conduct discriminatory?

Yes! Requiring a credit check of minority tenants, but not non-minority tenants, is an unlawful discriminatory practice. The minority tenant is entitled to an award for money collectible from the landlord.[1]

Prohibited factors

California law prohibits discrimination in the sale or rental of housing accommodations. **Discriminatory** practices include:

- *making an inquiry*, written or oral, into the race, sex, disability, etc., of any individual seeking to rent or purchase housing;
- publishing ads or notices for the sale or rental of housing which *indicate a preference* or limitation based on any of the prohibited factors;
- use of prohibited discrimination when providing or arranging *real estate mortgages and financing*;
- refusal based on a prohibited factor by a broker to *represent* an individual in a real estate transaction; and
- any other practice that *denies housing* to a member of a protected class.[2]

Civil Rights Department
State agency designated with protecting Californians from housing, employment, and public accommodation discrimination.

The **Civil Rights Deparment (Department)** is the California government agency which enforces anti-discrimination law.[3]

Editor's note – The Civil Rights Department was formally called the California Department of Fair Employment and Housing (DFEH)

Any individual who feels they have been discriminated against may file a complaint with the *Department*. The Department investigates the complaint to determine any wrongful conduct. If grounds exist, the Department then seeks to resolve the situation through discussions with the individual against whom the complaint is made.[4]

If the Department believes a discriminatory practice has occurred, it will first attempt to reach a resolution through the Department's mandatory dispute resolution division. The dispute resolution is provided without charge to either party. If the dispute cannot be effectively resolved, the Department will file a civil action on behalf of the individual who was discriminated against in the county where the discriminatory conduct is alleged to have occurred.[5]

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1 **Stearns** v. **Fair Employment Practice Commission** (1971) 6 C3d 205

2 Calif. Government Code §12955

3 Gov C §§12901, 12903, 12930, 12935

4 Gov C §12980

5 Gov C §12981

Unlawful discrimination based on familial status

Familial status in anti-discrimination law refers to a situation in which children under the age of 18 live with a parent or guardian.[6]

Until *familial status* was added to the anti-discrimination laws in 1992, it was legal to exclude minors under the age of 18 from housing accommodations. However, policies excluding children under the age of 18 are now classified as unlawful discrimination, unless the property qualifies as **senior citizen housing**.[7]

Religious exemption

An exemption from anti-discrimination laws exists for **religious organizations**. Religious organizations may give preference to members of the same religious group when providing residential property for noncommercial purposes. However, membership in that religion may not be restricted on account of race, color or national origin.[8]

Further, a landlord may not use *religious beliefs*, such as those regarding marital status, to shield their discriminatory conduct.

senior citizen housing
Housing intended for individuals 55 or 62 years of age or older.

DRE regulation of discrimination

The Department of Real Estate (DRE) also enforces numerous regulations prohibiting discriminatory practices by real estate brokers and agents. A broker or agent found guilty of engaging in **discriminatory business practices** may be disciplined by the DRE.[9]

DRE prohibited *discriminatory practices* include situations in which a broker or agent discriminates against anyone based on race, color, sex, religion, ancestry, disability, marital status or national origin.

discriminatory practices
Unequal treatment given to members of a protected class of individuals.

Blatant discriminatory practices are not as common now as they once were. However, the DRE's focus now has shifted to more subtle forms of discrimination — **implicit discrimination**. *Implicit discriminatory practices* are those which are not openly discriminatory, but result in discriminatory effects.

implicit discrimination
Actions which are not openly discriminatory but yield discriminatory results.

A broker has a duty to advise their agents and employees of anti-discrimination rules. This includes DRE regulations, the Unruh Civil Rights Act, the Fair Employment and Housing Act, and federal fair housing law. [See Chapters 7, 8 and 9]

Thus, the broker is not only responsible for their own conduct, but need to also ensure their employees follow anti-discrimination regulations when acting as agents on their behalf.

6 Gov C §12955.2
7 Gov C §12955.9
8 Gov C §12955.4
9 California Department of Real Estate Regulation §2780

Chapter 8 Summary

Discriminatory practices include:

- inquiring about an individual's race, sex, disability, or other prohibited factors;
- indicating a preference or limitation based on a prohibited factor;
- discriminating against a prohibited factor when arranging loans or financing;
- refusal to represent an individual based on a prohibited factor; and
- any other practice that denies housing to an individual based on a prohibited factor.

The California Civil Rights Department (CRD) is the primary agency of the California state government which enforces anti-discrimination law. Further, the Department of Real Estate (DRE) maintains regulations prohibiting real estate brokers and their agents from discriminating against protected classes.

Brokers are responsible for their own compliance with anti-discrimination regulations as well as their agents.

Chapter 8 Key Terms

Quiz 3 Covering Chapters 8-12 is located on page 608.

Chapter 9

The Housing Financial Discrimination Act of 1977

Learning Objectives

After reading this chapter, you will be able to:

- understand the California state law prohibiting discriminatory lending practices; and
- identify the practices in lending and mortgage brokering which are considered discriminatory.

Key Term

redlining

For a further discussion of this topic, see *Fair Housing* Chapter 9 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

California's fair lending laws

To achieve a healthy state economy, all residential housing for sale needs to be available to any homebuyer who is creditworthy and qualifies for **purchase-assist financing.**[1]

An efficient real estate market requires the value of housing to be immune from fluctuations caused by lenders who arbitrarily deny financing to qualified homeowners. Thus, state law prohibits discriminatory lending practices. The goal of anti-discrimination law in home financing is to:

- increase the availability of housing to creditworthy buyers; and
- increase lending in communities where lenders have made conventional home mortgages unavailable.[2]

1 Calif. Health and Safety Code §35801(b)

2 Health & S C §35802

Increased availability of home mortgages

Lenders need to make financing available to *qualified creditworthy mortgage applicants* to:

- buy, build, repair, improve or refinance an existing mortgage on a one-to-four unit, owner-occupied residence; or
- improve one-to-four unit residences which are not owner-occupied.[1]

Lenders violate public policy when they indicate a **discriminatory preference** by denying or approving financing to creditworthy mortgage applicants based on the applicant's protected status. [2]

In a community which is composed mainly of residents of a certain race, color, religion or other protected class, a lender may not:

- refuse to fund a mortgage based on the **demographics** of that community; or
- appraise real estate in that community at a lower value than comparable real estate in communities predominantly composed of non-minority residents.[3]

redlining
Failure to provide financing or insurance in certain communities based on the demographics of that community.

Failure to provide financing in certain communities is called **redlining.** *Redlining* is specifically targeted for correction by the law since it adversely affects the health, welfare and safety of California residents.[4]

Lenders who deny mortgage applications based on the characteristics of the community discourages homeownership in that community. Thus, redlining leads to a decline in the quality and quantity of housing in areas where financing is generally unavailable.[5]

However, a lender can consider neighborhood conditions when making a mortgage under certain circumstances. When doing so, the lender is required to demonstrate a mortgage denial is based on neighborhood conditions which render the mortgage unsafe and unsound as a matter of good business practice.[6]

Further, if the property's topography, structure or location is unsafe or unhealthy, the lender is not required to provide purchase-assist financing.[7]

Notice of loan applicant's rights

Lenders are required to post in a conspicuous public location at their place of business a written notice informing applicants for mortgages to be secured by an owner-occupied, one-to-four unit residential property of:

- their right to file a lending discrimination claim; and
- the name and address of the Secretary of the California Business, Consumer Services and Housing Agency (Agency).[8]

1 Health & S C §35805(d)
2 Health & S C §35811
3 Health & S C §§35810, 35812
4 Health & S C §35801(e)(4)
5 Health & S C §35801
6 Health & S C §35810(a)
7 Health & S C §35813
8 Health & S C §35830

Lenders subject to this posting requirement include **state regulated:**

- banks;
- thrifts;
- public agencies; or
- other institutions which make, arrange or buy mortgages funded to buy, build, repair, improve or refinance one-to-four unit, owner-occupied housing.[9]

Administrative remedies

A mortgage applicant may file a discrimination claim with the Agency against a state regulated lender if the applicant believes their mortgage application was denied due to:

- their race, color, religion, sex, marital status, national origin, ancestry or any of the other protected classifications described above; or
- trends, conditions or characteristics of the community where the real estate is located. [10]

A home mortgage applicant who believes they have been unfairly discriminated against by a state lending institution needs to exhaust the Agency administrative remedies before suing the lender for money losses.

Federally regulated banks and thrifts are not subject to state regulation and discipline.[11]

Once the claim is received, the Agency will attempt to work with the lender to end any unlawful discriminatory lending practices.[12]

The Agency will determine if the lender has engaged in an unlawful discriminatory practice within 30 days of receiving the complaint. The Agency will then serve the lender with its written decision and an order requiring the lender to end the unlawful discriminatory practice.[13]

The order will also require the lender to review the mortgage application under nondiscriminatory terms and provide the denied financing, if feasible. The lender may also be required to pay the borrower's money losses in an amount no greater than $1,000.[14]

9 Health & S C §35805
10 Health & S C §§35800 et seq.
11 **Conference of Federal Savings and Loans Associations** v. **Stein** (1979) 604 F2d 1256
12 Health & S C §35821
13 Health & S C §35822
14 Health & S C §§35822(a), 35822(b)

Chapter 9 Summary

California state law prohibits discriminatory lending practices. This is done to achieve and maintain a healthy state economy and an efficient real estate market.

Lenders must make financing available to all qualified creditworthy applicants seeking to buy, build, repair, improve or refinance an existing mortgage on a one-to-four unit residence, owner-occupied or not. The financing available to a borrower cannot be based on the applicant's race, color, religion, sex, marital status, sexual orientation, source of income, genetic information, disability, national origin, or ancestry.

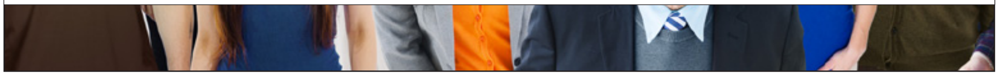
The practice of denying mortgages and under-appraising properties in minority communities based on demographics is called redlining and is prohibited by law. Redlining discourages homeownership in minority communities and thus has adverse effects on the economic and social health of those communities. Denial can be based on neighborhood conditions, but not neighborhood demographic characteristics.

Chapter 9 Key Term

Quiz 3 Covering Chapters 8-12 is located on page 608.

Chapter 10

Equal Credit Opportunity Act



Learning Objectives

After reading this chapter, you will be able to:

- recognize the protected classes under the Equal Credit Opportunity Act;
- identify who is subject to the rules of the Equal Credit Opportunity Act and what activities are prohibited; and
- distinguish the exemptions from anti-discrimination rules under the Equal Credit Opportunity Act.

Key Terms

credit reporting agency **Equal Credit Opportunity Act**

For a further discussion of this topic, see *Fair Housing* Chapter 8 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Federal fair lending laws

The federal **Equal Credit Opportunity Act** prohibits discrimination in lending based on race, color, religion, national origin, sex, marital status or age (provided an individual is of legal age).

Equal Credit Opportunity Act
A 1974 federal enactment prohibiting lenders from discriminating against borrowers from a protected class.

The anti-discrimination rules apply to institutional lenders, mortgage brokers, and others who *make or arrange mortgages.*[1]

Discriminatory practices take many forms, including:

- treating minority mortgage applicants less favorably than non-minority applicants;
- placing additional burdens on minority applicants;
- requiring a spouse's signature on a mortgage application when an applicant qualifies for a mortgage individually;[2]

1 15 United States Code §1691a(e)

2 **Anderson** v. **United Finance Company** (1982) 666 F2d 1274

- discouraging mortgage applicants based on their race, color, sex, etc.;[1] and
- making inquiries into the marital status of mortgage applicants.[2]

The lender may not make any inquiries into whether an applicant's income is derived from *alimony* or *child support*. The lender may not inquire whether the applicant intends to bear children.[3]

Further, to deny a mortgage based on an applicant's receipt of income from a public assistance program, such as *welfare* or *social security*, is unlawful discrimination.[4]

However, discrimination is rarely practiced overtly. Most lenders are not transparent enough for the consumer to see the discrimination. Most often, discrimination takes the form of a lender denying a mortgage to a minority borrower without a valid reason, or applying different standards to minority and non-minority borrowers.

Different treatment is discrimination

Lenders need to be careful not to provide more assistance to non-minority borrowers than to minority borrowers when preparing applications and working out problems which arise. The *different treatment* of minority and non-minority applicants is another form of unlawful discrimination.

For example, an African-American couple applies for a mortgage to be insured by the **Federal Housing Administration (FHA),** which will fund the purchase of a residence. The home the couple seeks to purchase is 75 miles from their place of work. The couple intends to occupy the home as their principal residence and commute to work.

The lender suspects the couple wants to purchase the home as an investment, and not to occupy it themselves. Since the type of FHA insurance sought may only be used to purchase homes which the buyer will occupy, the lender denies the mortgage application.

The lender does not discuss with the couple whether they intend to occupy the home. Also, the lender never suggests the couple can apply for a non-FHA mortgage. Due to a mortgage contingency, the couple loses their right to buy the home and incurs expenses in the process.

The couple seeks to recover their money losses from the lender under the *Equal Credit Opportunity Act,* claiming the lender's denial of their mortgage application was due to unlawful discrimination.

The lender claims the denial of the mortgage application was proper since it believed the couple did not intend to occupy the home, and thus did not qualify for an FHA-insured mortgage.

1 12 Code of Federal Regulations §1002.5(b)
2 12 CFR §1002.5(d)
3 12 CFR §1002.5(d)
4 15 USC §1691(a)(2)

Lenders are to provide the same level of assistance to non-minority borrowers as minority borrowers. Thus, the lender may not unilaterally decide the couple did not intend to occupy the home without first discussing the couple's intentions with them. Also, even if the couple did not qualify for an FHA-insured mortgage, as a matter of professional practice, the lender needs to refer them to other forms of financing.

Thus, the lender discriminated against the African-American couple by denying their mortgage application without a valid reason. Further, there was a failure to use diligence in assisting the couple to obtain other financing.[5]

Differing levels of assistance

Consider a California-regulated institutional lender who regularly arranges alternative forms of financing. The lender consistently informs non-minority applicants of their financing options when they deny a mortgage application.

The lender's failure to diligently provide the same assistance for minority applicants subjects the lender to liability for the minority applicant's money losses caused by the discrimination. Here, the unlawful discrimination is based on the lender's selective release of information based on status.[6]

Discrimination by age and public assistance

Some exceptions to the anti-discrimination rules exist.

For example, a lender may lawfully consider a mortgage applicant's age when determining the applicant's creditworthiness. A lender may also consider whether the applicant receives income from a public assistance program, if such an inquiry is for the purpose of determining the amount and likely continuance of income levels from public assistance.[7]

Editor's note — Allowing lenders to consider an applicant's age or receipt of income from a public assistance program as an exception in determining the applicant's creditworthiness effectively removes these two factors from the anti-discrimination protection previously discussed.

While a lender may not refuse to accept applications or impose different mortgage terms based on an applicant's age or receipt of public assistance income, the lender can lawfully deny a mortgage based on these factors simply by stating the applicant is not creditworthy.

Further, lenders may consider an applicant's **immigration status** when considering a mortgage application. Immigration status is used by the lender to determine whether the applicant is a permanent resident of the United States.[8]

5 **Barber** v. **Rancho Mortgage & Investment Corp.** (1994) 26 CA4th 1819

6 **Barber**, *supra*

7 15 USC §1691(b)(2)

8 12 CFR §1002.6(b)(7)

Denial of credit and notification

After the lender's receipt of a mortgage application, the lender has 30 days to notify the applicant as to whether the mortgage is approved or denied. If the lender denies the mortgage, the lender is to deliver a statement to the applicant listing the specific reasons for the denial.[1] [See **RPI** Form 219]

Alternatively, if the lender does not give the applicant a statement of the specific reasons for the denial, the lender is required to deliver a notice to the applicant stating the applicant has the right, upon request, to obtain a statement listing the reasons for denial.

credit reporting agency
A private agency which collects and reports information regarding an individual's credit history.

In addition to the *Equal Credit Opportunity Act,* California law controls **credit reporting agencies.** Consumers may request a free copy of their credit report once every year to review it for errors.[2]

Penalties for discrimination in lending include actual money losses sustained by a person who has been discriminated against and punitive money awards of up to $10,000, plus attorney fees.[3]

1 15 USC §1691(d)
2 Calif. Civil Code §1785.10
3 15 USC §1691e

Chapter 10 Summary

The Equal Credit Opportunity Act prohibits discrimination in lending based on race, color, religion, national origin, sex, marital status or age. The Equal Credit Opportunity Act applies to institutional lenders, mortgage brokers, and others who regularly make or arrange mortgages.

Discrimination is rarely practiced overtly. Unlawful discrimination includes applying different standards to minority and non-minority borrowers, and providing more assistance to non-minority borrowers than to minority borrowers.

Exemptions to anti-discrimination rules exist, such as a lender's consideration of an applicant's age, public assistance program income, or immigration status when determining creditworthiness.

If the lender denies a mortgage application, it is to deliver a statement to the applicant listing the specific reasons for the denial, or deliver a notice to the applicant advising them of their right, upon request, to obtain a statement listing the reasons for denial.

Chapter 10 Key Terms

Quiz 3 Covering Chapters 8-12 is located on page 608.

Chapter 11

Home Mortgage Disclosure Act

Learning Objectives

After reading this chapter, you will be able to:

- identify the social goals of the federal Home Mortgage Disclosure Act (HMDA);
- identify which lenders and mortgage types the HMDA applies to; and
- find and interpret the data required for HMDA disclosure statements.

Key Terms

debt-to-income (DTI) ratio	**Home Mortgage Disclosure Act (HMDA)**

For a further discussion of this topic, see *Fair Housing* Chapter 10 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Lenders release home mortgage data

The federal **Home Mortgage Disclosure Act (HMDA)** seeks to prevent lending discrimination and unlawful redlining practices. The HMDA requires lenders to disclose home mortgage origination information to the public when the borrower is seeking a residential or home improvement mortgage.[1]

Home Mortgage Disclosure Act (HMDA)
A regulatory scheme requiring lenders to publicly release loan data.

State and federally regulated banks and mortgage brokers are required by the HMDA to compile home mortgage origination data. This data is submitted to their respective supervisory agencies.[2]

Home mortgage originations include:

- purchase-assist financing;
- construction for a new home;

1 Department of Housing and Urban Development Mortgagee Letter 94-22

2 12 United States Code §§2802, 2803; Calif. Health and Safety Code §35816

- improvement of the borrower's home; or
- the refinance of an existing home mortgage.

Federal disclosure requirements

Lenders with total assets of more than $28 million, and for-profit mortgage brokers with total assets of more than $10 million, need to compile origination data and make it available to the public.

The data includes:

- the type and purpose of the mortgage;
- the owner-occupancy status of the real estate securing the mortgage;
- the amount of the mortgage;
- the action taken by the lender on the application;
- the sex, race and national origin of the mortgage applicant; and
- the income of the mortgage applicant.[3]

The data is grouped according to census tracts to determine the lender's activity within the tract.[4]

Lender exemptions

Lenders are exempt from HMDA disclosure requirements if:

- the lender does not have a branch office in a *metropolitan statistical area (MSA);*
- the lender's assets on the preceding December 31 totaled less than $28 million.[5]

For-profit mortgage brokers are exempt from HMDA disclosure requirements if on the preceding December 31:

- the mortgage broker did not have a branch office in a MSA; or
- the mortgage broker's assets totaled less than $10 million and they originated less than 100 home purchase mortgages in the preceding year.[6]

Regardless of exemptions, all lenders approved by the *Department of Housing and Urban Development (HUD)* are to report to HUD and disclose the census tract information on all *Federal Housing Administration (FHA)* mortgages they originate. [7]

The data is compiled by the **Federal Financial Institutions Council** into a *disclosure statement* sent to the lender.[8]

3 12 Code of Federal Regulations §1003.4(a)
4 12 USC §2803(j)(2)(C)
5 12 CFR §1003.3(a)(1)
6 12 CFR §1003.3(a)(2)
7 HUD Mortgagee Letter 94-22
8 12 CFR §1003.5(b)

The disclosure statement is required to be posted in a conspicuous location in the lender's office where it is readily accessible to the public. The disclosure is posted for a minimum of five years.[9]

On request from any member of the public, the lender is to make available a copy of the disclosure statement data.[10]

California state regulated lenders

Lenders who regularly originate residential mortgages who do not report to a federal or state regulatory agency are to compile data on the number and dollar amount of mortgage originations for each fiscal year. This includes both actual originations and completed mortgage applications.[11]

State regulated lenders who fall into this category include:

- insurers;
- mortgage bankers;
- investment bankers; and
- credit unions that do not make federally related mortgages.

The data is first categorized by geographical area, then by census tract. For each census tract, mortgage originations are grouped according to:

- FHA and Veterans Administration (VA) mortgage originations on owner-occupied, one-to-four unit dwellings;
- conventional purchase-assist mortgage originations on owner-occupied, one-to-four unit dwellings;
- home improvement mortgage originations on owner-occupied, one-to-four unit dwellings; and
- home improvement mortgage originations on occupied, one-to-four unit dwellings not occupied by the owner.[12]

California regulated lenders exempt from mortgage origination disclosures are:

- lenders whose originations of purchase-assist mortgages totaled less than 10% of the lender's mortgage volume during the current reporting year; and
- licensed real estate brokers who negotiate or arrange purchase-assist and home improvement mortgages.[13]

Monitoring federally regulated lenders

Federally regulated lenders are subject to investigation and penalties by federal authorities.[14]

9 12 USC §§2803(a)(2), 2803(c)
10 12 USC §2803(a)(1)
11 21 Calif. Code of Regulations §7118(a)
12 21 CCR §7118(b)(2)
13 21 CCR §7121
14 12 USC §2803(h)

While disclosure of mortgage statistics helps to identify lending patterns, mortgage statistics alone are not sufficient to determine whether a lender is unlawfully practicing *redlining* or other discriminatory practices. [See Chapter 9]

debt-to-income (DTI) ratio
Percentage of monthly gross income that goes towards paying debt.

The mortgage statistic disclosures may be relevant when considered in conjunction with other evidence. This includes the *credit histories* of denied mortgage applicants and their **debt-to-income (DTI) ratios.**[15]

15 **HUD Mortgagee Letter 94-22**

Chapter 11 Summary

The federal Home Mortgage Disclosure Act (HMDA) prevents lending discrimination and unlawful redlining practices on residential or home improvement mortgages. The HMDA requires lenders to disclose information on their home mortgage originations to the public.

State and federally regulated banks are to maintain data on the type of mortgages they originate, the amount, the occupancy status of the real estate, the action taken by the lender on the application, and demographic information about the applicant.

This data is categorized by mortgage type, geographical area and census tract. It is then compiled into a disclosure statement which lenders are to post publicly. These disclosures help identify lending patterns and prevent lending discrimination.

Chapter 11 Key Terms

debt-to-income (DTI) ratio .... pg. 80
Home Mortgage Disclosure Act (HMDA)...................... pg. 77

Quiz 3 Covering Chapters 8-12 is located on page 608.

Chapter 12

HUD advertising guidelines for sales and rentals

Learning Objectives

After reading this chapter, you will be able to:

- recognize the types of advertising considered discriminatory under the Federal Fair Housing Act (FFHA);
- use the Department of Housing and Urban Development (HUD) guidelines to avoid discriminatory preferences in advertising; and
- understand the consequences of failing to follow HUD advertising guidelines.

Key Terms

dwelling **Federal Fair Housing Act (FFHA)**

For a further discussion of this topic, see *Fair Housing* Chapter 11 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Avoiding discrimination in advertising

The printing or publishing of an advertisement for the sale or rental of residential property that indicates a wrongful *discriminatory preference* is a violation of the **Federal Fair Housing Act (FFHA).**[1] [See Chapter 7]

Federal Fair Housing Act (FFHA)
A collection of policies designed to prevent discrimination in the access to housing based on an occupant's inclusion in a protected class.

A property sold or leased for residential occupancy is referred to as a **dwelling.** The discriminatory preference rule applies to all brokers, developers and landlords in the business of selling or renting a *dwelling.*[2]

Real estate advertising guidelines are issued by the *Department of Housing and Urban Development (HUD).* The guidelines are the criteria by which

1 42 United States Code §3604(c)
2 42 USC §§3603, 3604

dwelling
A building occupied or designed to be occupied as a residence by one or more families.

HUD determines whether a broker has practiced or will practice wrongful discriminatory preferences in their advertising and availability of real estate services.

HUD guidelines also help the broker, developer, and landlord avoid signaling preferences or limitations for any group of persons when marketing real estate for sale or rent.

Marketing real estate for sale or rent

The selective use of words, phrases, symbols, visual aids and media in the advertising of real estate may indicate a wrongful *discriminatory preference* held by the advertiser. When published, the preference can lead to a claim of discriminatory housing practices by a member of the protected class.

Words in a broker's real estate advertisement that indicate a particular race, color, sex, sexual orientation, handicap, familial status or national origin are considered violations of the FFHA.

To best protect themselves, a broker refuses to use phrases indicating a wrongful preference, even if requested by a seller or landlord. Words or phrases indicating a preference in violation of the rights of persons from protected classes include:

- white private home;
- perfect for newlyweds;
- Jewish (or Christian) home;
- country club nearby;
- black home;
- walking distance from the synagogue;
- ideal bachelor pad;
- Hispanic neighborhood; or
- adult building.

Preferences are often voiced in prejudicial colloquialisms and words such as *restricted, exclusive, private, integrated or membership approval.*

Indicating a preference by age is an **exclusion** from unlawful age discrimination when marketing qualified 55-or-over residences or communities. [See Chapter 7]

Selective stereotypical use of *media* or *human models* in an advertising campaign can also lead to discrimination against minority groups.

Examples of these include:

- sexuality pride flags;
- religious images, such as a cross;
- gender symbols;
- handicap signs; and
- national flags.

The HUD fair housing poster

The HUD issues guidelines that require real estate brokers selling or renting single family residences to display a *fair housing poster*.[3]

The fair housing poster is available at any HUD office.[4]

The broker marketing dwellings for sale or rent is to display the fair housing poster:

- in the broker's place of business; and
- at any dwelling offered for sale, other than SFRs.[5]

Thus, a broker holding an open house at a SFR listed for resale is not required to display the fair housing poster at the residence.

However, if a dwelling is marketed as part of a residential development, the fair housing poster is to be displayed by the developer during construction of the development. Later, the poster is to be displayed in the model dwellings whether or not the dwellings are sold through a broker.[6]

The fair housing posters are to be placed where they can be easily seen by any persons seeking to:

- engage the services of the broker to list or locate a dwelling; or
- purchase a dwelling in a residential development.[7]

Failure to follow HUD guidelines

Even though it is required, a broker will not be subject to any penalties for failing to display the **fair housing poster.** However, failure to display the fair housing poster is initially considered sufficient evidence in a lawsuit to show that a broker practiced discriminatory housing practices.[8]

Also, a real estate broker and their agents who follow HUD advertisement guidelines and display the fair housing poster are less likely to practice a discriminatory activity.

The fair housing poster openly assures potential sellers/landlords and buyers/tenants the broker does not unlawfully discriminate in the services offered.

Also, the broker following HUD advertising and poster guidelines is in a better position to defend themselves against a fair housing lawsuit. Use of the fair housing poster indicates to the public the broker's invitation to work with all individuals.

3 24 CFR §§110.1, 110.10
4 24 CFR §110.20
5 24 CFR §110.10(a)
6 24 CFR §§110.10(a)(2)(ii), 110.10(a)(3)
7 24 CFR §110.15
8 24 CFR §110.30

Chapter 12 Summary

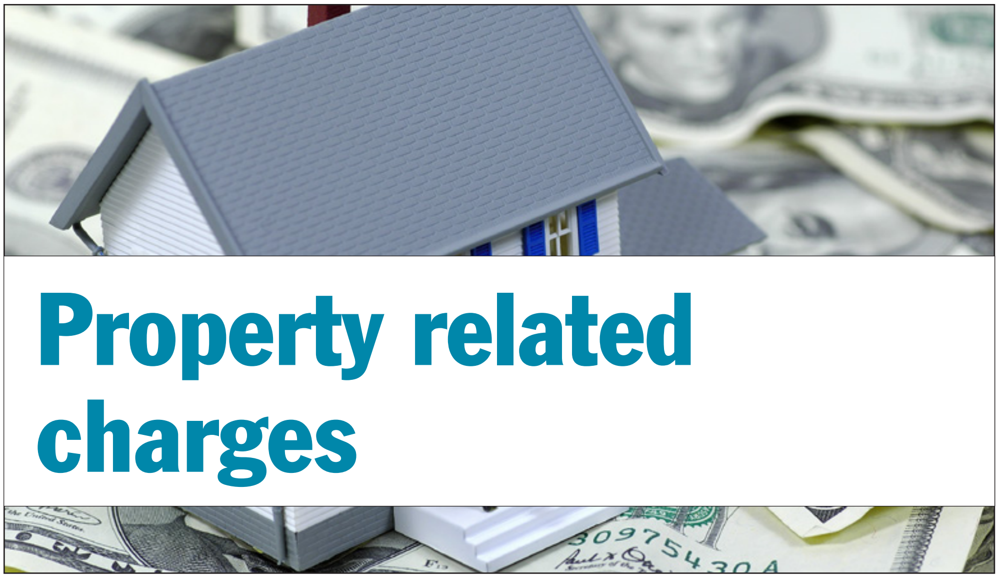
Printing or publishing the sale or rental of a dwelling indicating a discriminatory preference is a violation of the Federal Fair Housing Act (FFHA). This includes the selective use of words and phrases in the advertising of real estate. This rule applies to brokers and agents, developers and landlords.

The Department of Housing and Urban Development (HUD) provides guidelines controlling advertisements for dwellings. HUD also publishes a fair housing poster which is to be displayed, when offering a dwelling for rent or sale, in the place of business of brokers, agents, developers and landlords and the dwelling offered, except for single family homes other than those offered by developers.

Licensees following HUD advertising and poster guidelines are in a better position to defend themselves against a fair housing lawsuit.

Chapter 12 Key Terms

Quiz 3 Covering Chapters 8-12 is located on page 608.



Property related charges

Chapter 13

Learning Objectives

After reading this chapter, you will be able to:

- assess the conditions and circumstances a broker is to disclose in a real estate transaction;
- recognize a broker's general or agency duties owed to others to inspect, confirm, and report the physical, financial, legal and regulatory conditions of a property; and
- identify circumstances when a broker can or cannot be held liable for failing to disclose property information in a real estate transaction.

Key Terms

Annual Property Operating Data Sheet (APOD)

as-is clause

eminent domain

further-approval contingency

material fact

Transfer Disclosure Statement (TDS)

For a further discussion of this topic, see *Ethics* Chapter 3 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Sold "as-is" is a prohibited disclaimer — property is sold "as-disclosed"

A broker and their sales agents are to disclose the *physical nature* and *condition* of a property when first providing property information to individuals interested in making an offer to purchase. Thus, brokers and agents have a duty to *timely disclose* to all parties involved in a real estate transaction any significant physical aspects of a property that may affect the property's market value or the buyer's decision to purchase.

A broker has a general duty to all parties in any type of sales transaction to disclose to buyers at the earliest possible moment their awareness of any

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]

property defects. The duty to disclose known conditions on one-to-four unit residential property requires the seller's broker to provide prospective buyers or their agents with the seller's **Transfer Disclosure Statement (TDS)**.

To be effective, property disclosures including the *TDS* are to be provided to the buyer as soon as practicable – meaning as soon as possible – upon the commencement of negotiations and prior to making an offer.[1] [See **RPI** Form 304; see Chapter 15]

If the disclosures are not timely made, the buyer may:

- *cancel* the offer on discovery of the broker's failure to disclose prior to the buyer entering into a purchase agreement with the seller; or
- close escrow on the purchase and *seek recovery* of the costs to cure the untimely disclosure of known defects.

Any attempt to have the buyer of a one-to-four unit residential property waive their right to the mandated property disclosure statement (TDS) is unenforceable. [2]

All property conditions disclosed

For example, a seller's broker is aware the seller's residence fails to conform to building and zoning regulations. The defect, if known to a buyer, would likely affect the price they are willing to pay. The defect is more commonly known as a **material fact**.

The broker knows the buyer who is interested in making an offer is not aware of the violations and might reconsider the price they are willing to pay for the property if they learn of the violations. The broker decides not to disclose their knowledge of the defect.

In an attempt to cover the omission, the broker writes an **"as-is"** disclaimer into the purchase agreement. The "as-is" provision states the buyer accepts the property in its current "as-is" condition.

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.

After the buyer acquires the property, the city refuses to provide utility services to the residence due to the building and zoning violations.

The buyer demands their money losses from the broker, claiming the broker breached their *general agency duty* to disclose conditions of the property known to the broker before the buyer agreed to purchase.

The broker claims the buyer waived their right to collect money damages when they signed the purchase agreement with the "as- is" disclaimer.

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

Does an "as-is" disclaimer shield the broker from liability for the buyer's losses caused by the building and zoning violations?

No! The seller's broker has a *general duty* owed to all parties to a transaction. The general duty requires the seller's broker to disclose all property conditions known, or ought to have been known, to the seller's broker due to their

1 Calif. Civil Code §§1102 et seq
2 CC §1102

mandated inspection that affect the value and marketability of the property. The duty is not excused by writing an "as-is" disclaimer into the purchase agreement in lieu of making the factual disclosures before an agreement is entered into with the seller. [3]

No coverage under the statute of limitations

Consider a buyer who makes an offer to purchase a residence. The seller's broker is aware of a large structural crack in the foundation of the residence that is not apparent on a visual inspection. The broker delivers a TDS to the buyer's agent, who in turn hands it to the buyer, stating the residence has no defective conditions. Based on the report, the buyer acquires the property. [See **RPI** Form 304]

More than two years later, the buyer discovers the crack. The buyer claims the seller's broker is liable for the cost of repairing the foundation since the broker failed to disclose the crack. The broker claims the buyer's action is barred by the *two-year statute of limitations* for misrepresentation since the broker only owed the buyer the statutory duty to disclose defects which would be revealed by a visual inspection.

Is the broker liable to the buyer for intentionally misrepresenting the existence of the crack known to the broker, in spite of the two-year statute of limitations for negligent misrepresentations?

Yes! The buyer's claim is not time-barred under statutes requiring the broker to visually inspect and disclose observable defective property conditions. Liability is imposed on the broker for their intentional misrepresentation, by omission, of their actual knowledge of a condition of the property not readily visible when they stated defective conditions did not exist in the seller's TDS.[4]

further-approval contingency
A provision in an agreement calling for the further approval of an event or activity by the seller, buyer or third party as a condition for further performance or the cancellation of the transaction by a person benefitting from the provision. [See **RPI** Form 185 §9 and 279 §2]

Real estate size and boundaries will be accurately represented

Consider a broker who is the exclusive agent of a buyer in the purchase of a one-to-four unit residential property. Without first receiving a survey or title report to verify their representations, the broker advises their buyer about the amount of acreage and the extent of an easement on the property.

The buyer enters into a purchase agreement and acquires the property in reliance on the broker's verbal representations about the size and easement on the property. A **further-approval contingency** calling for the buyer to confirm the representations is not included in the purchase agreement.

More than two years after closing, the buyer discovers the acreage and easement representations made by the broker are false. The property was worth less than the price paid.

The buyer seeks to recover the difference in property value from the broker. The broker claims the buyer's recovery is barred by a *two-year statute of limitations* for breach of a broker's agency duty to inspect and disclose defects on one-to-four unit residential property.

3 **Katz** v. **Department of Real Estate** (1979) 96 CA3d 895
4 **Williams** v. **Bennet Realtors** (1997) 52 CA4th 857

The buyer claims their action is not time-barred since the two-year statute of limitations only applies to *negligent misrepresentations*, not to the recovery of a loss caused by the broker's intentional misrepresentations about facts related to the property's physical condition.

Is the buyer entitled to recover their loss in property value?

Yes! The broker intentionally misrepresented the property's size and easement without first confirming what they consisted of. The two-year statute of limitation only applies to a broker who inspects the property and, as a result of the inspection, *negligently fails* to disclose facts that a reasonably diligent on-site inspection would have revealed.

Here, the broker made representations *as fact* without first verifying the information. Nor did the broker advise the buyer of their source of information and that the information was not verified. Thus, a *three-year statute* of limitations for intentional misrepresentation applies, commencing on the date the buyer discovers the falsity of the broker's representation.[5]

Disclosure of potential and future use

A broker and their agents need to accurately represent the title restrictions, potential use, and any conditions, covenants and restrictions (CC&Rs) controlling real estate to a prospective buyer or tenant.

Further, a broker's duty to disclose a known potential **future use** of a property extends beyond disclosure of title and zoning conditions.

For example, a buyer is interested in purchasing undeveloped property for commercial development. The property is located next to a maintenance yard owned by the state.

eminent domain
The right of the government to take private property for public use on payment to the owner of the property's fair market value.

The seller's broker has been previously contacted by the state regarding its intent to someday acquire the property to expand the maintenance yard through **condemnation**, also known as **eminent domain**.

During purchase negotiations, the buyer asks the seller's broker if the state is interested in the property. The seller's broker informs the buyer the state has no interest in acquiring the property.

The buyer enters into a purchase agreement with the seller. During escrow, the buyer has plans drawn and obtains the necessary permits for development and construction on the property.

Just before escrow closes, the buyer discovers the state intends to acquire the property through condemnation.

The buyer proceeds to take title to the property and later grants the property to the state in a condemnation proceeding.

Here, the seller's broker is liable for the out-of-pocket losses incurred by the buyer for their lost use of the property. The broker is also liable for punitive damages for the intentional failure to disclose the state's interest in acquiring

5 **Field** v. **Century 21 Klowden-Forness Realty** (1998) 63 CA4th 18

the property. The buyer relied on the broker's information regarding the state's activities when they determined whether the property was suitable for their future development plans.[6]

Marketability disclosure

A broker and their agents need to advise a prospective buyer or tenant of any known **material facts** that may affect the value or desirability of the purchased or rented property.

Four categories of conditions contribute to or detract from the value of property:

- *physical condition of soil and improvements;*
- *land use and title conditions;*
- *operating income and expenses;* and
- *location hazards and surrounding area impact.*

For example, a buyer seeks property for investment purposes. The broker recommends an apartment complex as the source of spendable income and equity buildup for the buyer.

The broker analyzes the suitability of an income property which is for sale by preparing an **Annual Property Operating Data Sheet (APOD)** and reviewing it with the buyer. [See Form 352 accompanying this chapter]

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]

However, the property's scheduled rental income is represented to be far greater than the actual income. Additionally, the broker represents the property is in excellent physical condition. However, the property requires extensive renovation due to deferred maintenance.

The broker makes these representations based on information received from the seller. The broker does not investigate maintenance, expense, and income records of the property to check the accuracy of the seller's representations. Further, the broker does not advise the buyer the seller is the source of the property information.

At the urging of the seller, the buyer is dissuaded from inspecting the property by the broker.

Relying solely on the broker's representations as to the operating income and condition of the property, the buyer purchases the property.

After closing, the buyer realizes the operating income is far less than the scheduled income stated on the property operating statement. The buyer discovers tenants are delinquent in the payment of rent and incurs extensive deferred maintenance expenses. These conditions collectively reduce the projected net spendable income, and in turn the property's *market value*.

Eventually, the buyer defaults and loses the property in foreclosure.

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6 **Storage Services** v. **Oosterban** (1989) 214 CA3d 498

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]	$________	____%

A broker marketing property as an income-producing investment owes a duty to a buyer to research and disclose whether the property produces adequate income to meet expenses.

Alternatively, the broker may include a contingency provision in the purchase agreement calling for the buyer to confirm the representations or cancel the agreement prior to closing.

Brokers cannot merely pass on statements made by the seller as to the property's condition and income and expenses generated by the property

Form 352

Annual Property Operating Data Sheet (APOD)

Page 2 of 2

PAGE 2 OF 2 — FORM 352

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: ________

FORM 352 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

without first reviewing them for apparent inaccuracies. When property information is passed on to others, the broker needs to advise them about the source of the information and any known need for further investigation into their accuracy. Thus, the broker is liable to the buyer for the buyer's lost property value.[7]

7 **Ford** v. **Cournale** (1973) 36 CA3d 172

Verifying representations from others

A broker of one-to-four unit residential property is relieved of the responsibility of verifying the representations regarding property conditions they receive from others and pass on to buyers as long as the source of information is disclosed to the buyer.

The source of information is typically the seller, the seller's broker or a home inspector.[8]

Further, the broker only has a duty to inspect and disclose material facts **observable or known** to them, not to independently verify the claims of their disclosed source.[9]

8 CC §§2079 et seq.

9 **Robinson** v. **Grossman** (1997) 57 CA4th 634

Chapter 13 Summary

Brokers and agents are to disclose to all parties involved in a real estate transaction all significant physical aspects of a property which may affect the property's market value or a buyer's decision to purchase. Property disclosures will be made to the buyer before offers are prepared and prices agreed to.

A broker is obligated to disclose the physical condition of soil and improvements of a property, the land use and title conditions, the operating income and expenses of the property, and location hazards and the impact of the surrounding area. Further, the actual legal size and boundaries of a property need to be disclosed by a broker. A broker needs to also accurately represent the title restrictions and potential future use of real estate to a prospective buyer or tenant.

A broker marketing property as an income-producing investment owes a duty to a buyer to research whether the property produces adequate income to meet expenses.

Chapter 13 Key Terms

Quiz 4 Covering Chapters 13-17 is located on page 609.

Chapter 14

A 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
title conditions
Transfer Disclosure Statement (TDS)

For a further discussion of this topic, see Chapter 22 of Real Estate Practice.

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.

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.

Transparency as public policy objective

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.

The seller's agent may not:

- deliver up 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 inquiries 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

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 **first tuesday** Form 304];[1]
- assuring **seller compliance** with the **seller's duty** to deliver statements to prospective buyers as soon as possible 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;

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]

1 Calif. Civil Code §2079

- **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;
- 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; 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.

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]

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:

- the property's **title conditions** [See Chapter 51 and 52];
- the **operating expenses** for the property (and any tenant income) the buyer will experience during ownership;
- 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 [See Chapter 72];
- the **suitability of the property** based on the facts disclosed to actually meet the buyer's objectives in the acquisition; and
- information or data on any **mixed use** of the property.

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

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.

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.

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.

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).[1]

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
- the inquiry into or review of **public records** or permits concerning title or use of the property.[2]

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.

Common law duty

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).

1 CC §§2079 et seq.
2 CC §2079.3

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.

Chapter 14 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.

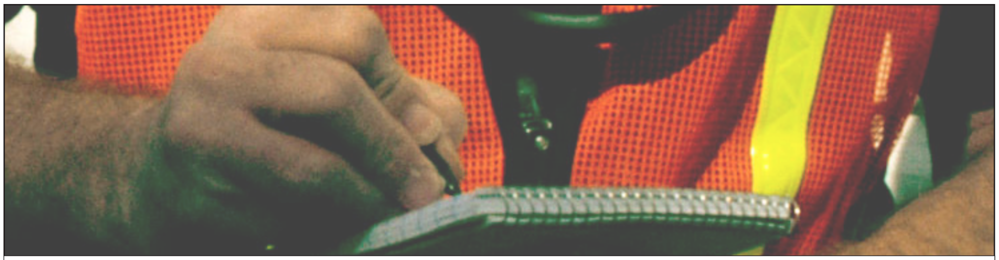
All property information received from a seller is reviewed by the seller's agent for inaccuracies or untruthful statements. However, a seller's agent need not investigate the seller's claims any further before using the information to market the property so long as they are not known to the agent to 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.

Chapter 14 Key Terms

fiduciary duty .... **pg. 94**
general duty .... **pg. 95**
title conditions .... **pg. 96**
Transfer Disclosure Statement (TDS) .... **pg. 94**

Quiz 4 Covering Chapters 13-17 is located on page 609.



Chapter 15

Condition of property: the seller's disclosures

Learning Objectives

After reading this chapter, you will understand:

- the affirmative duty a seller and the seller's agent have to inspect and disclose their observations and knowledge about the property's condition to a prospective buyer;
- the general duty of the seller and seller's agent owed to prospective buyers to prepare a Transfer Disclosure Statement (TDS) presenting known conditions of property improvements with an adverse effect on value and hand it to a buyer or buyer's agent before the seller enters into a purchase agreement; and
- the role of a home inspection report (HIR) to identify and disclose property conditions as a warranty of the property's condition.

Key Terms

home inspection	**home inspector**

For a further study of this discussion, see Chapter 24 of Real Estate Practice.

Mandated on one-to-four residential units

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

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

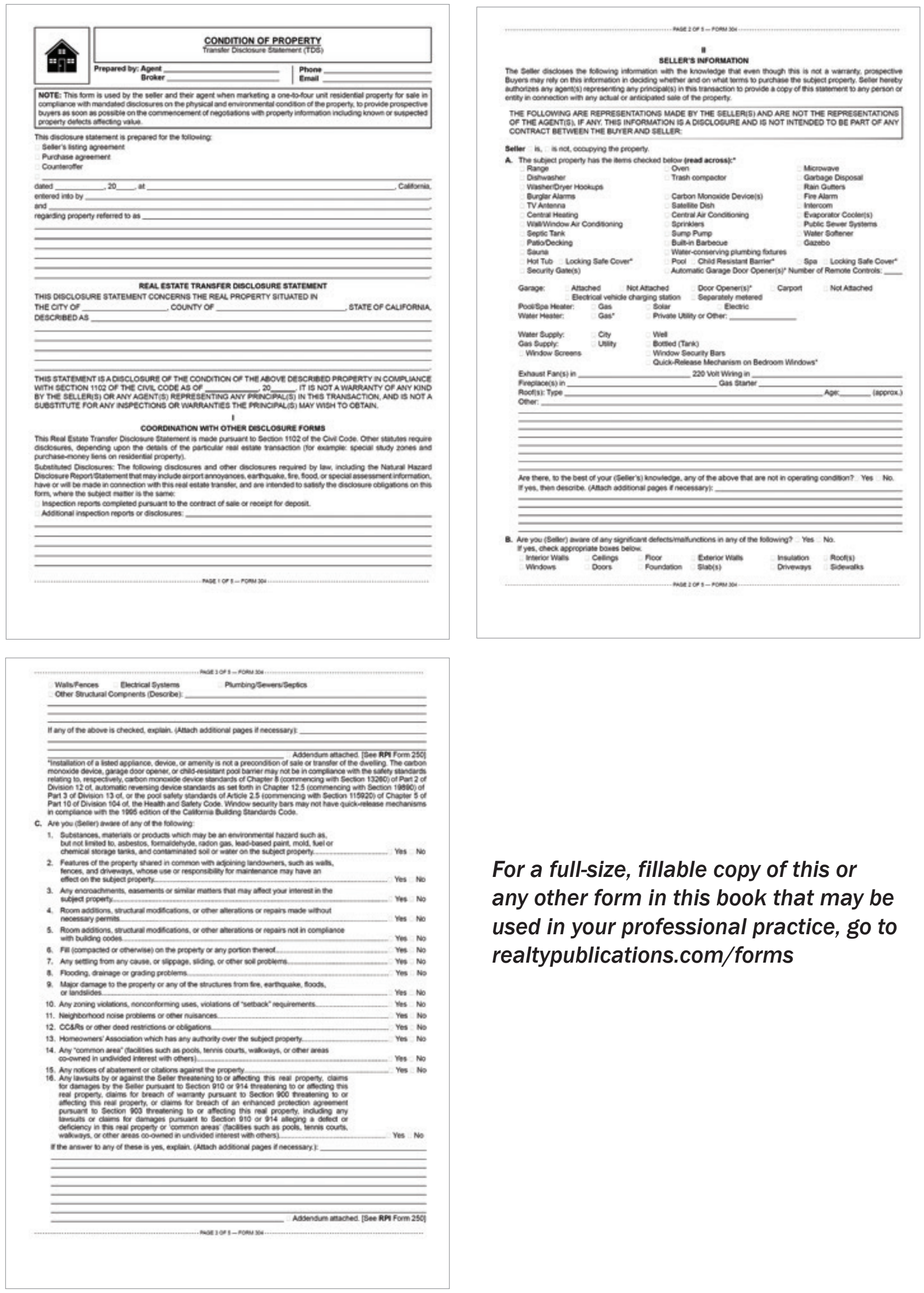
1 Calif. Civil Code §§1102(a), 1102.3

2 CC §1102.7

Figure 1

Form 304

Condition of Property Disclosure


CONDITION OF PROPERTY
Transfer Disclosure Statement (TDS)

REAL ESTATE TRANSFER DISCLOSURE STATEMENT

COORDINATION WITH OTHER DISCLOSURE FORMS

SELLER'S INFORMATION

For a full-size, fillable copy of this or any other form in this book that may be used in your professional practice, go to realtypublications.com/forms

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

Any conditions known to the seller which might *negatively affect* the value and desirability of the property for a prospective buyer are to be disclosed, even though they may not be an item listed on the TDS. Disclosures to the buyer are not limited to conditions preprinted for comment on the form.[1]

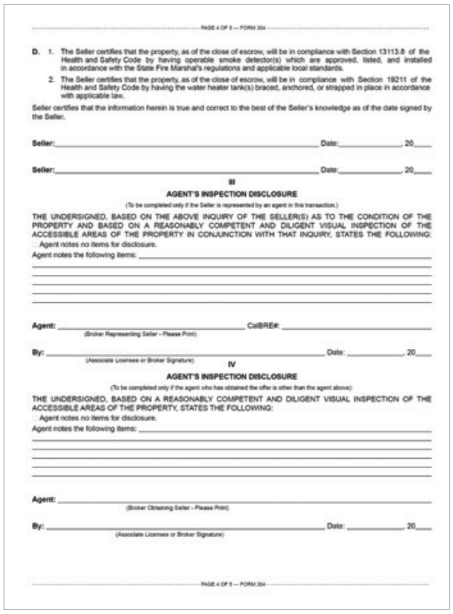
Also, the buyer cannot waive delivery of the statutorily-mandated TDS. Any attempted waiver, such as an "as-is" provision in the purchase agreement, is *void* as against public policy.

1 CC §1102.8

Figure 1

Form 304

Condition of Property Disclosure Cont'd



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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: __________

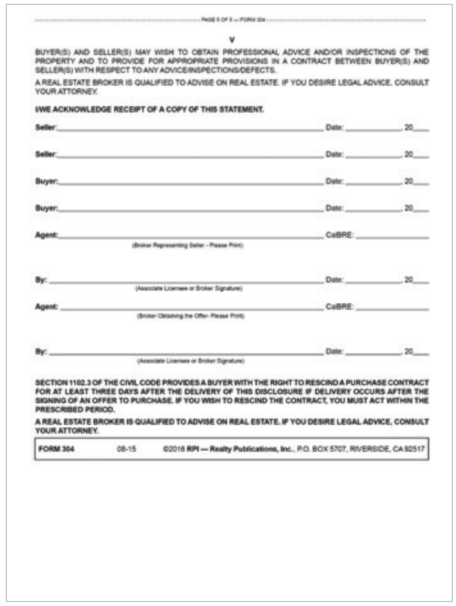
Agent: __________

(Broker Obtaining Seller - Please Print)

By: __________ Date: ______, 20___

(Associate Licensee or Broker Signature)

PAGE 4 OF 5 — FORM 304



PAGE 5 OF 5 — FORM 304

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	08-15	©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Delivery of the disclosure statement

While it is the seller who prepares the TDS, the TDS is delivered to the buyer by the agent who directly receives the purchase agreement offer from the buyer.

The failure of the seller or any of the agents involved to deliver the seller's TDS to the buyer will not invalidate a sales transaction after it has closed. However, the seller and the seller's broker are both liable for the actual monetary losses incurred by the buyer due to an undisclosed defect known to them.[2]

The TDS is handed to the buyer before the seller accepts a purchase agreement offer submitted by a buyer. If the TDS is delivered to the buyer *after* the seller enters into a purchase agreement, the delivery is untimely in violation of TDS rules, and the buyer may:

- *cancel* the purchase agreement on discovery of undisclosed defects known to the seller or the seller's agent and unknown and unobserved by the buyer or the buyer's agent prior to acceptance;[3]
- *make a demand* on the seller to correct the defects or reduce the price accordingly before escrow closes [See **RPI** Form 150 §11.2]; or
- *close escrow* and make a demand on the seller for the costs to cure the defects.[4]

Buyer's right to cancel on delayed disclosure

The TDS is to be delivered to prospective buyer *as soon as practicable* on commencement of negotiations. As with the delivery of the Natural Hazard

2 CC §1102.13

3 CC §1102.3

4 **Jue** v. **Smiser** (1994) 23 CA4th 312

Disclosure Statement (NHDS), which has been dictated by the California Attorney General to be delivered ASAP, the TDS is delivered before entry into a purchase agreement.[1]

If the TDS is belatedly delivered to the buyer — after the buyer and seller enter into a purchase agreement — the buyer may *elect to cancel* the purchase agreement under a statutory three-day right to cancel. The buyer's statutory cancellation right runs for three days following the day the TDS is actually handed to the buyer (five days if delivered by mail).[2]

Demand to cure an undisclosed material defect

As an alternative remedy to canceling the purchase agreement on receipt of an unacceptable TDS, the buyer may *make a demand* on the seller to cure any undisclosed material defect (affecting value) *known to the seller or the seller's agent* prior to entering into the purchase agreement. If the seller's agent knew or is charged with knowledge of the undisclosed defects at the time the buyer and seller entered into the purchase agreement, the buyer's demand to cure the material defect may also be made on the seller's agent. [See **RPI** Form 269]

If the seller will not voluntarily cure the defects on demand, the buyer may close escrow and recover the cost incurred (or valuation lost) to correct the defect without concern for the purchase agreement contingency provision stating the alternative statutory right to cancel the transaction. Defects *known and undisclosed*, or inaccurately disclosed, by the seller or the seller's agent at the time the seller accepts the buyer's purchase offer impose liability on those who knew or are charged with knowledge.[3]

Another alternative for the buyer is to perform on the purchase agreement by tendering a *price reduced* by the cost to repair or replace the defects known to the seller and untimely disclosed or discovered by the buyer while under contract. [See **RPI** Form 150 §11.2]

Include a home inspector

A competent seller's agent will aggressively recommend the seller retain a **home inspector** before they market the property**.** The inspector hired will conduct a physical examination of the property to determine the condition of its component parts. On the home inspector's completion of their examination, a **home inspection report (HIR)** will be prepared on their observations and findings, which is forwarded to the seller's agent. [See Chapter 21]

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

A **home inspector** often detects and reports property defects overlooked by the seller and not observed during a visual inspection by the seller's agent. Significant defects which remain undisclosed at the time the buyer goes under contract tend to surface during escrow or after closing as claims against the seller's broker for deceit. A home inspector troubleshoots for defects not observed or observable to the seller's agent's eye.[4]

1 Calif. Attorney General Opinion 01-406 (August 24, 2001)
2 CC §1102.3
3 Jue, *supra*
4 Calif. Business and Professions Code §7195

To greatly reduce the potential of buyer claims, and eliminate to the extent possible the risk of negligent property improvement disclosures, the HIR is coupled with preparation of the seller's TDS. Both are presented to buyers before the seller accepts an offer.

Mandatory inspection by the seller's broker

A seller's agent (or seller's broker) is obligated to personally carry out a competent *visual inspection* of the property. The seller's disclosures and defects noted in the HIR are entered on the TDS and reviewed by the seller's agent for discrepancies. The seller's agent then adds any information about their knowledge of material defects which have gone undisclosed by the seller (or the home inspector).

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

A buyer has *two years* from the close of escrow to pursue the seller's broker and agent to recover losses caused by the broker's or agent's *negligent failure* to disclose observable and known defects affecting the property's physical condition and value. Undisclosed and unknown defects permitting recovery are those observable by a reasonably competent broker during a visual on-site inspection. A seller's agent is expected to be as competent as their broker in an inspection.[5]

However, the buyer will be unable to recover their losses from the seller's broker if the seller's broker or agent inspected the property and would not have observed the defect and did not actually know it existed.[6]

Following their mandatory visual inspection, the seller's broker or agent needs to make disclosures on the seller's TDS in full reliance on *specific items* covered in a home inspector's report the seller obtained on the property. If the HIR is relied on after the seller's agent property inspection when preparing the TDS and the TDS is later contested by the buyer as incorrect or inadequate in a claim on the broker, the broker and their agent are entitled to indemnification – held harmless – from the home inspection company issuing the report.[7]

Controlled and exempt sellers

Unless a seller is *exempt*, sellers of one-to-four unit residential real estate are required to fill out and furnish buyers with a statutory TDS when entering into a purchase agreement.[8]

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

- by court order, such as probate, eminent domain or bankruptcy;
- by judicial foreclosure or trustee's sale;
- on the resale of real estate owned property acquired by a lender on a deed-in-lieu of foreclosure, or by foreclosure;
- from co-owner to co-owner;

5 CC §2079.4
6 CC §1102.4(a)
7 **Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109
8 CC §1102

- from parent to child;
- from spouse to spouse, including property settlements resulting from a dissolution of marriage;
- by tax sale;
- by reversion of unclaimed property to the state; and
- from or to any government agency.[1]

The best property disclosure tool for exempt sellers is the preparation and delivery of the statutory TDS form (and a property inspector's report) to prospective buyers or buyer's agents on every type of transaction. If the transaction is exempt or concerns property other than one-to-four residential units, the form as a practical matter needs to be used.

1 CC §1102.2

Chapter 15 Summary

The seller of a one-to-four unit residential property completes and delivers to a prospective buyer a statutory form called a Transfer Disclosure Statement (TDS), more generically called a Condition of Property Disclosure Statement. The TDS is given to prospective buyers to inform them of property conditions that have an adverse effect on the property's value.

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

If the TDS is belatedly delivered to the buyer — after the buyer and seller enter into a purchase agreement — the buyer may elect to cancel the purchase agreement under a statutory three-day right to cancel. As an alternative remedy, the buyer may make a demand on the seller to cure any undisclosed material defect affecting value that was known to the seller or the seller's agent prior to entering into the purchase agreement, or make a demand on the seller for the costs to cure the defects after the close of escrow.

Chapter 15 Key Terms

Quiz 4 Covering Chapters 13-17 is located on page 609.

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

For a further discussion of this topic, see Chapter 30 of Real Estate Practice.

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.

Hazards on the 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]
- *formaldehyde* used in the composition of construction materials;[2]
- *radon gas* concentrations in enclosed, unventilated spaces located within a building where the underlying rock contains uranium;[3]
- *hazardous waste* from materials, products or substances which are **toxic**, **corrosive**, **ignitable** or **reactive**;[4]
- *toxic mold*;[5]
- *smoke* from the combustion of materials, products, supplies or substances located on or within the building;[6]
- *security bars* which might interfere with an occupant's ability to exit a room in order to avoid another hazard, such as a fire;[7] and
- *lead*. [See Chapter 18]

Environmental hazards **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;[8]
- *industrial zoning* in the neighborhood of the property;[9]
- *airport influence* areas established by local airport land commissions [See **RPI** Form 308];[10] and
- *ground transportation* arteries which include train tracks and major highways in close proximity to the property.

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.

1 Calif. Health and Safety Code §§25915 et seq.
2 Calif. Civil Code §2079.7(a); Calif. Business and Professions Code §10084.1
3 CC §2079.7(a); Bus & P C §10084.1
4 Health & S C §25359.7; Bus & P C §10084.1
5 Health & S C §§26140, 26147
6 Health & S C §§13113.7, 13113.8
7 CC §1102.16; Health & S C §13113.9
8 CC §1102.15
9 CC §1102.17
10 CC §§1103.4(c), 1353; Bus & P C §11010(b)(13)

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.

Visual inspection for hazards

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 15]

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 Public Health (CDPH) to the buyer. Delivery of the booklet is confirmed in writing through a provision in the purchase agreement. [See **RPI** Form 150 §11.6 and Form 316-1]

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, window security bars and release mechanisms, 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]

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11 CC §2079

*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.[1]

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;
- 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.

Inquiries documented

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.

1 Attorney General Opinion 01-406 (August 24, 2001)

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.

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.[2]

However, asbestos is a known **carcinogen**. As an occupant of a building continues to inhale asbestos fiber, they increase their risk of developing negative health conditions.

carcinogen
A substance which causes cancer in human beings.

Construction materials which contain *friable asbestos* are those that can be crumbled, pulverized or reduced to powder by hand pressure when dry.

Construction materials which contain *non-friable* asbestos cannot be crushed by hand pressure. 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 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.

2 Health & S C §25925

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 soil

Radon is a naturally-occurring radioactive gas. It is not visible, cannot be tasted and has no odor. *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 and enters a building from the soil beneath the structure.

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 **one percent 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 (CalEPA).

Mold: the rogue in vogue

Mold produces spores which become airborne. 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.

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 CDPH has not yet set any **standards** for disclosures regarding the existence of mold or **guidelines** for the remediation of mold threats. However, the CDPH 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.

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 needs to 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 Public Health (CDPH) 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.

Chapter 16 Key Terms

carcinogen .... **pg. 109**
environmental hazards .... **pg. 105**
hazardous waste .... **pg. 110**

Quiz 4 Covering Chapters 13-17 is located on page 609.

Chapter 17

Natural hazard disclosures by the seller's agent

Learning Objectives

After reading this chapter, you will be able to:

- identify the various types of natural hazards which need to be disclosed as related to value and desirability;
- comply with mandated disclosures of natural hazards on all types of property; and
- avoid liability by the use of a natural hazard expert to investigate the public record for known hazards.

Key Terms

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

For a further discussion of this topic, see Chapter 28 of Real Estate Practice.

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.

1 Calif. Civil Code §1103(c)

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

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

The NHD form for uniformity

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

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

However, sellers who are excluded from using the form still need to make the disclosures referenced in the NHD. Use of the NHD form to make property disclosures is not required on:

- 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.[4]

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2 CC §1103.2
3 CC *§1103(d)*
4 CC §1103.1(a)

Natural hazards are to be disclosed

Delivery of the hazard information, whether disclosed by the use of one form or another, is not optional. Disclosure of a natural hazard is **mandated on all types of property**.[5]

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.

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**.[6]

termination
The cancellation of a transaction before escrow has closed or a lease has ended.

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.

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.

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;
- **review** the NHD form prepared by the expert and **enter** any actual knowledge the seller or seller's agent may possess; and

5 CC §1103.1(b)
6 **Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767
7 CC §1103.4(a)

Form 314

Natural Hazard Disclosure Statement

Page 1 and 2

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

- **sign** the NHD Statement provided by the NHD expert and **deliver** it with the NHD report to prospective buyers or buyer's agents.[8]

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

8 CC §1103.2(f)(2)

Form 314

Natural Hazard Disclosure Statement

Page 2 of 2

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

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.

9 CC §1103.4(c)

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]

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.

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.[11] [See **RPI** Form 150 §11.5]

However, when the seller's agent fails to disclose a natural hazard and then provides in the purchase agreement for the compliance to be an untimely "in escrow" disclosure, the 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.[12]

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

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10 CC §§1103.4(a), 1103.4(b)

11 CC §1103.3(b)

12 CC §1103.3(c)

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.[13]

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**.[14]

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.[15]

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

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.[16]

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.

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 (and TDS) law.

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

14 CC §1103.12(a)

15 CC §§1103.2, 1103.12

16 CC §1103.10

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 Chapter 16]

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.[17]

Editor's note — The following discussion details these different hazards which are disclosed on the NHD Statement.

Flood zones

Investigating flood problems was facilitated by the passage of the National Flood Insurance Act of 1968 (NFIA).

The NFIA established a means for property owners to obtain flood insurance with the National Flood Insurance Program (NFIP). The Federal Emergency Management Agency (FEMA) is the administrative entity created to police the NFIP by investigating and mapping regions susceptible to flooding.

Any flood zone designated with the letter "A" or "V" is a **special flood hazard area** and is to be disclosed as a natural hazard on the NHD Statement. [See Form 314 §1]

Zones "A" and "V" both correspond with areas with a 1% chance of flooding in any given year, called 100-year floodplains, e.g., a structure located within a special flood hazard area shown on an NFIP map has a 26% chance of suffering flood damage during the term of a 30-year mortgage.

However, Zone "V" is subject to additional storm wave hazards.

Both zones are subject to mandatory flood insurance purchase requirements.

Information about flood hazard areas and zones come from:

- city/county planners and engineers;
- county flood control offices;
- local or regional FEMA offices; and

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17 CC §1103.2

- the U.S. Corps of Engineers.

Another flooding disclosure which needs to be made on the NHD Statement arises when the property is located in an area of **potential flooding**. [See Form 314 §2]

An area of potential flooding is a location subject to partial flooding if sudden or total **dam failure** occurs. The inundation maps showing the areas of potential flooding due to dam failure are prepared by the California Governor's Office of Emergency Services.[18]

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

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 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.[19]

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.

State Fire Responsibility Area

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**.[20]

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.[21]

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.[22] [See Form 314 §4]

18 Calif. Government Code §8589.5(a)
19 Gov C §51179
20 Calif. Public Resources Code §4125(a)
21 Pub Res C §4125(c)
22 Pub Res C §4136(a)

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 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**.[23]

Alquist-Priolo Maps
Maps which identify earthquake fault areas available from the State Mining and Geology Board and the city or county planning department.

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 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;[24]
- tsunamis;[25] and
- dam failures.[26]

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 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.

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.

23 Pub Res C §2622
24 Pub Res C §2692(a)
25 Pub Res C §2692.1
26 Pub Res C §2692(c)

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.

Manifestations of 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.

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.

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 17 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 publicly 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:

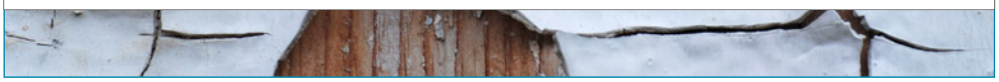
- an area of potential flooding;
- a very high fire hazard severity zone;
- a state fire responsibility area;
- an earthquake fault zone; and
- a seismic hazard zone.

Chapter 17 Key Terms

Quiz 4 Covering Chapters 13-17 is located on page 609.

Chapter 18

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**

For a further discussion of this topic, see Chapter 31 of Real Estate Practice.

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**.

Disclosed on two forms

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 accompanying this chapter]; 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.

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.

Seller's agent insures compliance

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]

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 — 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.*[1]

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 Form 313];
- filling out and signing the TDS containing the lead-based paint, environmental and other property conditions [See **RPI** Form 304];
- 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.

1 24 Code of Federal Regulations §35.88(a); 40 CFR §745.107(a)

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.[2]

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.[3]

LBP disclosure content

The **LBP disclosure** form includes the following:

- the *Lead Warning Statement* as written in federal regulations [See 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 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 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 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 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 313 §4]; and
- the *signatures* of the owner, buyer and seller's agent.[4]

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.[5]

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.[6]

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

2 24 CFR §35.86; 40 CFR §745.103

3 24 CFR §35.86; 40 CFR §745.103

4 24 CFR §35.92(a)(7); 40 CFR §745.113(a)(7)

5 24 CFR §35.92(c); 40 CFR §745.113(c)

6 24 CFR §35.92(a); 40 CFR §745.113(a)

Form 313

Lead-Based Paint Disclosure

LEAD-BASED PAINT DISCLOSURE

On Sale of Real Estate

NOTE: This form is used by an owner's agent when selling or leasing a residential unit built before 1978 and complying with lead-based paint disclosure laws, to notify the buyer or tenant whether lead-based paint or lead-based paint hazards are known to the owner to be present on the property and give the buyer and tenant an opportunity to conduct a risk assessment or inspection of the property.

PROPERTY ADDRESS: ______________________________

Items left blank or unchecked are not applicable.

1. Lead Warning:

1.1 Every Buyer of any interest in residential real property on which a residential dwelling was built prior to 1978 is notified that such property may present exposure to lead from lead-based paint that may place young children at risk of developing lead poisoning. Lead poisoning in young children may produce permanent neurological damage, including learning disabilities, reduced intelligence quotient, behavioral problems, and impaired memory. Lead poisoning also poses a particular risk to pregnant women.

1.2 Seller of any interest in residential property is required to provide Buyer with any information on lead-based paint hazards from risk assessments or inspections in Seller's possession and notify Buyer of any known lead-based paint hazards.

1.3 A risk assessment or inspection for possible lead-based paint hazards is recommended prior to purchase.

2. Seller's Certification:

2.1 Presence of lead-based paint and/or lead-based paint hazards

a. ☐ are known to be present in the housing as explained: ______________________________

____

____

b. ☐ are not known to Seller to be present in the housing.

2.2 Records and reports available to Seller

a. ☐ Seller has provided Buyer with all available records and reports listed below pertaining to lead-based paint and/or lead-based paint hazards in the housing: ______________________________

____

____

b. ☐ Seller has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

Date: ______________, 20______ Seller: ______________________________

Date: ______________, 20______ Seller: ______________________________

3. Buyer's Acknowledement:

3.1 Buyer has received:

a. ☐ Copies of all information listed above.

b. ☐ The pamphlet *Protect Your Family From Lead in Your Home.*

3.2 Buyer:

a. ☐ Will receive a ☐ 10-day, ☐ _____- day, opportunity from acceptance of the purchase offer to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

b. ☐ Waives the opportunity to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

3.3 I acknowledge that I have read and understood the attached lead warning statement in Section 1 of this form and received all information noted in Section 2 of this form.

Date: ______________, 20______ Buyer: ______________________________

Date: ______________, 20______ Buyer: ______________________________

4. Broker's Certification (When Applicable):

4.1 Broker certifies to have informed Seller of his/her obligation under 42 U.S.C. §4852d to disclose to Buyer and Broker all information known to Seller regarding the presence of lead-based paint and lead-based paint hazards within this target housing and that all information known to Broker regarding the presence of lead-based paint and lead-based paint hazards within this target housing has been disclosed to Buyer.

4.2 Broker further certifies that Buyer has received the lead hazard information pamphlet *Protect Your Family From Lead in Your Home* and that Buyer has or will be given a 10 calendar day period (unless otherwise agreed in writing) to conduct a risk assessment or inspection for the presence of lead-based paint before becoming obligated under the contract to purchase the housing.

Date: ______________, 20______ Broker: ______________________ CalBRE #:______________

FORM 313 03-11

is accepted to evaluate the lead-based paint risks involved. When timely disclosed, the buyer may not later, when under contract, use the existence of lead-based paint as justification for cancellation.

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.[7] [See Form 313]

7 40 CFR §745.110(a)

Foreclosure sale exemption

Exempt from the Federal LBP disclosures are **foreclosure sales** of residential property.[8]

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.[9]

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.[10]

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8 24 CFR §35.82(a)

9 **Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767

10 61 Federal Register 9063

Chapter 18 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 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 18 Key Terms

lead-based paint .... **pg. 125**
lead-based paint hazard .... **pg. 126**

Quiz 5 Covering Chapters 18-23 is located on page 610.

Chapter 19

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)

For a further discussion of this topic, see *Fair Housing* Chapter 12 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

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.

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 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?

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. Further, the buyer's and seller's agent have an affirmative duty to disclose prior deaths, regardless of when they occurred, when the death has an adverse effect on the property's market value.*[2]

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 is to disclose their knowledge of any deaths 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]

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.

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**.

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;
- the agent has disclosed all their knowledge concerning the inquiry; and

1 Calif. Civil Code §1710.2(a)
2 **Reed** v. **King** (1983) 145 CA3d 261
3 CC §1710.2(d)
4 CC §1710.2(d)

- whether the agent or others will further investigate any deaths on the property.

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.

Here, as a matter of prudent practice, the buyer's agent ought 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 19 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 is to be disclosed.

However, on direct inquiry by the buyer or the buyer's agent about deaths on the property, the seller's agent is to 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.

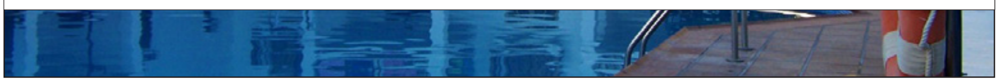
Chapter 19 Key Terms

material fact .... **pg. 132**
Transfer Disclosure Statement (TDS) .... **pg. 131**

Quiz 5 Covering Chapters 18-23 is located on page 610.

Chapter 20

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 assessment

For a further discussion of this topic, see Chapter 32 of Real Estate Practice.

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 [See Chapter 37]; 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.

regular assessments
Recurring HOA assessments which fund the operating budget to pay for the cost of maintaining the common areas.

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.

special assessment
A lien against real estate by a public authority to pay the cost of public improvements such as street lights, sidewalks, street improvements. In a common interest subdivision, an additional charge levied by the association for unanticipated repairs.

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.

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.

extraordinary expense
An emergency situation lifting the limits placed on the amount an HOA may charge for regular and special assessments.

The schedule for payment of assessments by a member varies depending on the type of assessment. **Regular assessments** are set annually and are due 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

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

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.

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.

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.

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).

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.

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 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.

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 **RPI** Form 135];
- **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.

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.[1]

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**.

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.[2] [See **RPI** Form 135]

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1 CC §§1368(b), 1368(d)

2 CC §§1368(a), 1368(b)

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. 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.[1]

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.

1 CC §1368(a)

Chapter 20 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. 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; and
- special assessments.

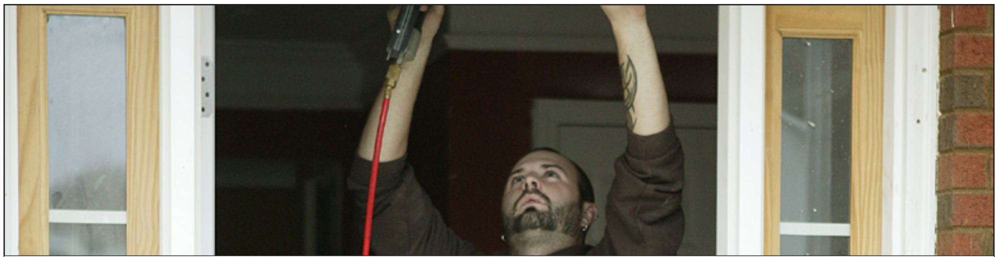
To determine if a HOA has its finances in order, a prospective buyer may look to the financial reports held by the owner or readily available from the HOA on the owner's request.

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 20 Key Terms

Quiz 5 Covering Chapters 18-23 is located on page 610.

Chapter 21



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 (HERS)

home inspection report (HIR)

home inspector

home energy audit

material defect

For a further discussion of this topic, see Chapter 26 of Real Estate Practice.

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 **RPI** Form 130]

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; see Chapter 15]

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.

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 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."

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.[1]

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.

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

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

Home inspectors occasionally **do not hold** any type of license relating to construction, such as a person who is a construction worker or building department employee. However, they are required to conduct an inspection of a property with the same "degree of care" a reasonably prudent home inspector would exercise to locate material defects during their *physical examination* of the property and report their findings.[2]

Hiring a home inspector

Sellers and seller's agents are encouraged by legislative policy to obtain and rely on the content of an 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.

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

2 Bus & P C §7196

The inspection and report

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

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

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

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

Defects are material if they adversely affect the price a reasonably prudent and informed buyer 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.[3]

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.[4]

The *home inspection report* 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.[5]

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.

In the first month of residence, the uncapped air conditioning ducts, badly sealed window frames and insufficient ceiling insulation cause the buyer's utility bills to skyrocket past the pre-closing estimates for operating the property as the owner.

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).

home energy audit
An audit conducted by a Home Energy Rater evaluating the energy efficiency of the home.

3 Bus & P C §7195(b)
4 Bus & P C §7195(a)(1)
5 Bus & P C §7195(c)

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.

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.

California Home Energy Rating System (HERS)
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 Department of Energy (DOE) as part of the **California Home Energy Rating System (HERS)** program. Audit providers have the exclusive rights to train, test and certify professional Raters.

Although Home Energy Raters are specially trained and certified, any home inspector may perform a home energy audit provided the audit conforms to the HERS regulations established by the California Energy Commission.[6]

6 Bus & P C §§ 7199.5, 7199.7

Chapter 21 Summary

A 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.

The home inspection describes any observed or suspected material defects, and makes recommendations for each condition. Reliance on a home inspection report (HIR) prepared by an inspector relieves the seller and the seller's broker from liability for errors in the Transfer Disclosure Statement (TDS) which are unknown to them to exist.

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.

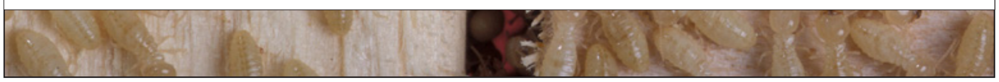
Chapter 21 Key Terms

California Home Energy Rating System (HERS) .... pg. 144
home inspection report (HIR) .... pg. 141
home inspector .... pg. 142
home energy audit .... pg. 143
material defect .... pg. 143

Quiz 5 Covering Chapters 18-23 is located on page 610.

Chapter 22

Structural pest control reports and repairs



Learning Objectives

After reading this chapter, you will be able to:

- explain the contents and consequences of information in a Structural Pest Control (SPC) Report; and
- manage the role of an SPC provider in real estate transactions.

Key Terms

inaccessible areas

Pest Control Certification

separated report

Structural Pest Control (SPC) report

For a further discussion of this topic, see Chapter 29 of Real Estate Practice.

Eliminate the risk

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 (SPC) Report**, begins.

Unlike a **Transfer Disclosure Statement (TDS)** or a **Natural Hazard Disclosure (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 Chapter 15 and 17]

Structural Pest Control (SPC) report
A report disclosing any active infestations, damage from infestations or conditions which may lead to infestations.

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 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*.

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).

A separated SPC report

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.

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:

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

1 Mortgagee Letter 05-48

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.

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.

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.

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.[2]

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.

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.[3]

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 *www.pestboard.ca.gov*.

The Board maintains a two-year history of complaints against every SPC company and information on the company's bond and insurance.[4]

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.

2 Calif. Business and Professions Code §8519
3 Bus & P C §§8516(d), 8519
4 Bus & P C §8621

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 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 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.

The standardized inspection 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;
- a statement of which areas have not been inspected due to inaccessibility with recommendations for further inspection of these areas if practical;
- recommendations for treatment or repair; and
- that a reinspection will be performed if an estimate for making repairs is requested by the person ordering the original report.

The SPC chosen furnishes the individual who ordered the inspection a copy of the report within 10 business days of the inspection.[1]

All original inspection reports are maintained by the SPC company for three years.[2]

1 Bus & P C §8516(b)

2 Bus & P C §8516(b)

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.[3]

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.[4]

Work completion and certificates

The person who ordered the report is never required to hire the SPC company that inspected the property to perform any corrective measures.[5]

The owner may hire a licensed contractor to remove 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.[6]

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.[7]

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.[8]

After any SPC company completes treatment or repairs, a **completion tag** is to be placed next to the inspection tag.

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3 16 CCR §1996.1

4 Bus & P C §8516(b); 16 CCR §1993

5 Bus & P C §8516(b); **Pestmaster Services, Inc.** v. **Structural Pest Control Board** (1991) 227 CA3d 903

6 Bus & P C §8556

7 Bus & P C §8516(b)

8 Bus & P C §8518; 16 CCR §1996.2; CC §1099(b)

Chapter 22 Summary

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.

A Structural Pest Control (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 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.

Chapter 22 Key Terms

inaccessible areas .... **pg. 148**
Pest Control Certification .... **pg. 147**
separated report .... **pg. 146**
Structural Pest Control (SPC) report .... **pg. 145**

Quiz 5 Covering Chapters 18-23 is located on page 610.

Chapter 23

Due diligence obligations

Learning Objectives

After reading this chapter, you will learn:

- the due diligence an exclusively employed broker owes a seller or buyer; and
- the best effort obligation as the broker's duty 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 (NHD)
property profile
seller's net sheet

For a further discussion of this topic, see Chapter 21 of Real Estate Practice.

The duty owed to clients

Every exclusive listing agreement entered into by an agent on behalf of their broker documents an employment which established 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.

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.

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.

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.

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.

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.

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.

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 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.

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 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;
- work authorization forms;
- advance fee and advance cost checklists; or
- income property analysis forms. [See **RPI** Form 403]

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

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.

Guidelines and checklists

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 51]
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 Chapter 15]
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 21]
4. A **natural hazard disclosure (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 17]
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** Form 352 and 562]
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.

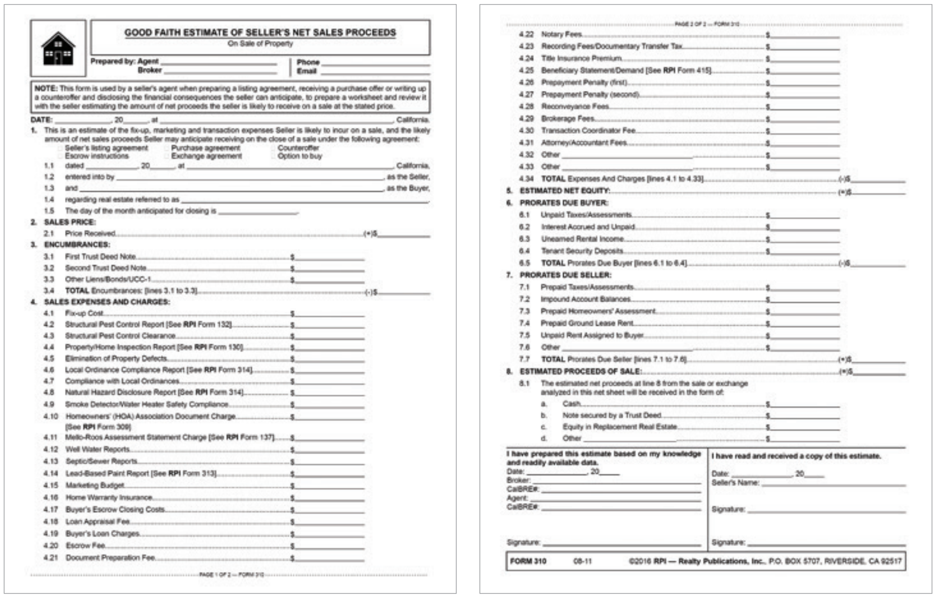
natural hazard disclosure (NHD)
A report provided by a local agency or NHD vendor and used by sellers and seller's agents to disclose natural hazards which exist on a property held out for sale. [See **RPI** Form 314]

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]

Figure 1

Form 310

Good Faith Estimate of Seller's Net Proceeds



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 .... $________

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   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.	**I have read and received a copy of this estimate.**
Date: ____________, 20____	Date: ____________, 20____
Broker: ____________	Seller's Name: ____________
CalBRE#: ____________	
Agent: ____________	
CalBRE#: ____________	Signature: ____________
Signature: ____________	Signature: ____________

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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.

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

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 Figure 1, **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 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.

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]

Duty to DRE 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.[1]

The *three-year period* for retaining the buyer's or seller's activity file for DRE 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.

1 Bus & P C §10148

Chapter 23 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.

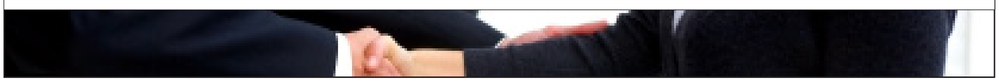
On entering into a listing employment, a physical file is set up to house information and document all the activity which arises within the broker's office due to the existence of the employment. All records of an agent's activities on behalf of a client during the listing period are retained by the 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 23 Key Terms

Quiz 5 Covering Chapters 18-23 is located on page 610.

Listings as employment



Chapter 24

Learning Objectives

After reading this chapter, you will be able to:

- distinguish the differences between exclusive and open listing agreements; and
- select between the variations of listing agreements.

Key Terms

agency relationship	**guaranteed sale listing**
employment relationship	**listing agreement**
exclusive right-to-sell listing	**net listing**
fiduciary duty	**open listing**
full listing offer	**option listing**

For an additional discussion of the materials presented in this chapter, see Chapter 8 of Real Estate Practice.

Authority to act on the client's behalf

A **listing agreement** is a written employment contract between a client and a licensed real estate broker. On entering into a listing agreement, the broker and their staff are *retained and authorized* to perform real estate related services on behalf of the client in exchange for a fee.[1] [See **RPI** Form 102 and 103]

listing agreement
A written employment agreement used by brokers and agents when an owner, buyer, tenant or lender retains a broker to render real estate transactional services as the agent of the client. [See **RPI** Form 102 and 103]

The client retaining a broker might hold an ownership interest in real estate, which the client seeks to *sell, lease* or *encumber* as collateral for trust deed financing.

Conversely, the client soliciting the services of a broker might be seeking to acquire an interest in real estate as a buyer, *tenant or trust deed lender*.

1 Calif. Civil Code §1086(f)

The person employed by a client to provide real estate services in expectation of compensation will always be a licensed real estate broker. Likewise, if a dispute arises with a client over the client's failure to pay a fee, only the broker employed in writing (a listing) signed by the client may pursue collection.

A real estate agent employed by the broker may have obtained the listing, but the agent did so acting on behalf of the broker. The agent has no independent right to enforce the listing agreement.

Right to a fee

The agent of a broker has a *right to a fee* on transactions based on the agent's written employment agreement with the broker, not under the separate listing agreement with the client. Through the broker-agent employment agreement, the agent is entitled to a share of the fees actually received by the broker on transactions in which the agent participates.

A licensed agent represents a broker acting as an *agent of the broker*. As the broker's agent, the agent performs on behalf of the broker (as well as the client) all the activities the broker has been retained by the client to provide. Further, an agent providing real estate related services on behalf of a client may not do so independently of their broker. Thus, an agent employed by a broker is referred to as "the agent of the [client's] agent."[1]

The listing agreement sets the *scope of the services* the broker is authorized to perform while representing the client. The listing also authorizes the broker to serve as the client's representative in the negotiation of a real estate transaction with others.

Further, the listing contains the client's promise to pay a fee. This promise is given in exchange for the broker's **promise to use diligence** in the broker's efforts to meet the client's objectives.

Employed to act as an agent

The relationship created between the client and the broker and properly documented by a written *listing agreement* has two distinct legal aspects:

- an **employment relationship**; and
- an **agency relationship**.

employment relationship
The scope of activities the broker and the broker's agents are to undertake in the employment of a client.

The *employment relationship* established on entering into a listing agreement specifies the *scope of activities* the broker and the broker's agents are to undertake in the employment and authorizes the broker to carry them out by contract.

On the other hand, the *agency relationship* is imposed on the broker by law as arising out of the representation authorized by the employment. Agency carries with it the **fiduciary duties** of loyalty and full disclosure owed by the broker (and their sales agents) to the client. [See **RPI** Form 305; see Chapter 2 and 28]

1 CC §2079.13(b)

As a *fiduciary*, the broker's and agents' conduct under the employment are equated to the conduct required of a trustee acting on behalf of a beneficiary. This fiduciary duty, also called **agency**, survives the termination of the contractual employment relationship.[1]

agency relationship
The scope of activities imposed on the broker by law as arising out of the representation authorized by the employment.

Also, an oral agreement to perform brokerage services on behalf of a client imposes an agency law obligation on the broker and agents to act as fiduciaries. However, the client's oral promise to pay a fee does not entitle the broker to enforce collection of the fee due from the client.

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.

A fee agreement employing a broker to purchase or sell real estate, lease a property for over one year, or arrange trust deed financing is controlled by the rules of **contract law.**

Thus, before a broker can enforce their right to collect a fee, the fee agreement is to be:

- in writing; and
- signed by the client.[2]

Types of listing agreements

A variety of listing agreements exist, each employing and authorizing a broker to perform real estate related services under different conditions. The variations usually relate to:

- the extent of the broker's representation;
- the type of services to be performed by the broker and their agents; and
- the events which trigger payment of a fee. [See **RPI** Form 102 and 103; see Figure 1, **RPI** Form 104]

Most listing agreements are for the sale or purchase of single-family residential property. Others are for residential and commercial income properties such as industrial, motel/hotel, office, farm or unimproved properties.

Despite the application of various agreements to the type of property described in the listing, all listings fall into one of two general categories:

- **exclusive**; or
- **open**.

Exclusive listings

Under an exclusive listing, a broker receives the sole right to represent:

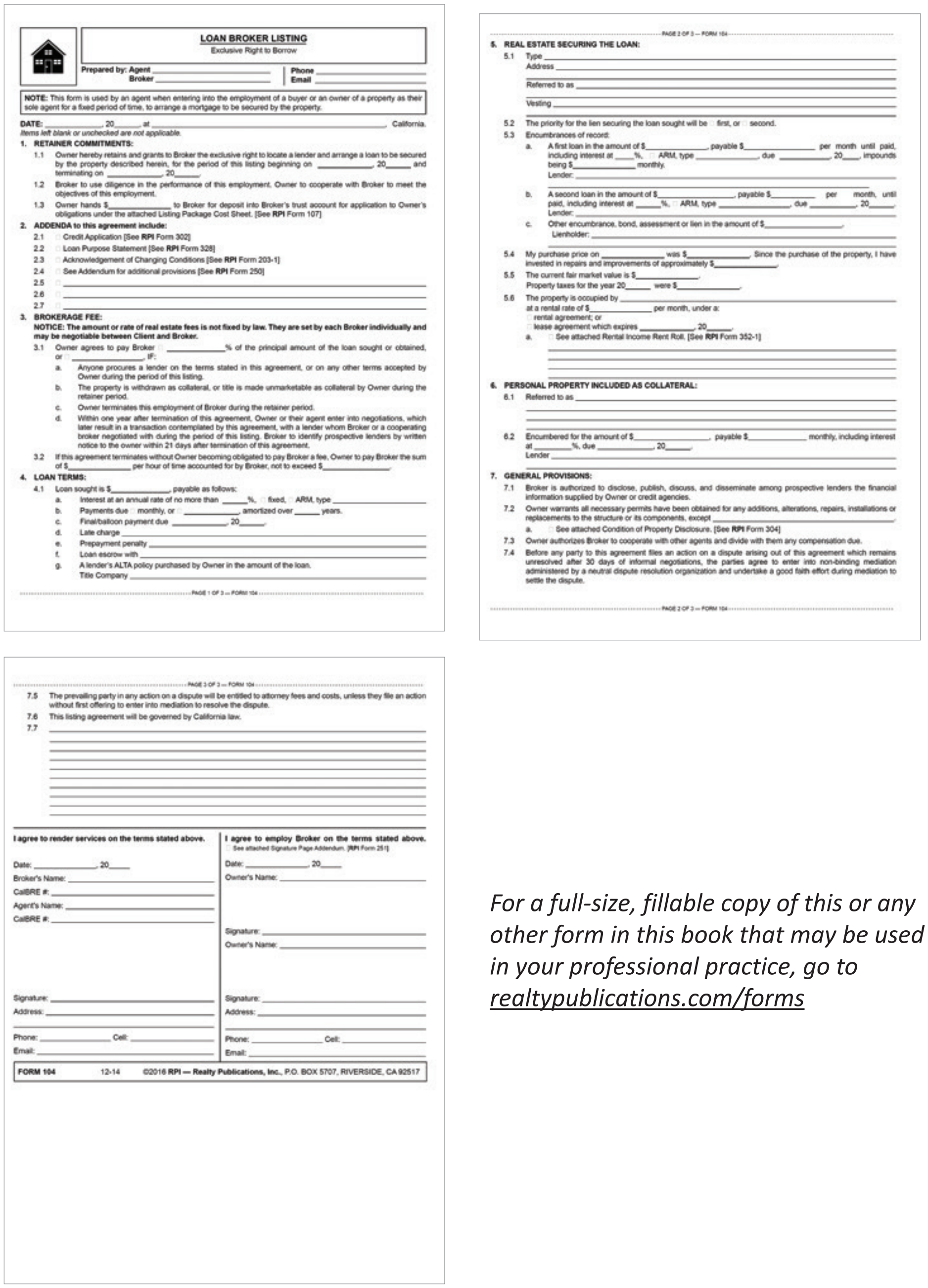
- an owner by marketing the listed property for sale or lease and locating a buyer or tenant;
- a buyer or tenant by locating property; or.
- the owner or a lender to originate a trust deed mortgage.

1 CC §2079.16
2 CC §1624(a)(4)

Figure 1

Form 104

Loan Broker Listing



LOAN BROKER LISTING

Exclusive Right to Borrow

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

NOTE: This form is used by an agent when entering into the employment of a buyer or an owner of a property as their sole agent for a fixed period of time, to arrange a mortgage to be secured by the property.

DATE: ______, 20___, at ______, California.

Items left blank or unchecked are not applicable.

1. **RETAINER COMMITMENTS:**
   1.1 Owner hereby retains and grants to Broker the exclusive right to locate a lender and arrange a loan to be secured by the property described herein, for the period of this listing beginning on ______, 20___ and terminating on ______, 20___.
   1.2 Broker to use diligence in the performance of this employment. Owner to cooperate with Broker to meet the objectives of this employment.
   1.3 Owner hands $______ to Broker for deposit into Broker's trust account for application to Owner's obligations under the attached Listing Package Cost Sheet. [See **RPI** Form 107]
2. **ADDENDA to this agreement include:**
   2.1 ☐ Credit Application [See **RPI** Form 302]
   2.2 ☐ Loan Purpose Statement [See **RPI** Form 328]
   2.3 ☐ Acknowledgement of Changing Conditions [See **RPI** Form 203-1]
   2.4 ☐ See Addendum for additional provisions [See **RPI** Form 250]
   2.5 ☐ ______
   2.6 ☐ ______
   2.7 ☐ ______
3. **BROKERAGE FEE:**
   NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between Client and Broker.
   3.1 Owner agrees to pay Broker ☐ ______% of the principal amount of the loan sought or obtained, or ☐ ______, IF:
      a. Anyone procures a lender on the terms stated in this agreement, or on any other terms accepted by Owner during the period of this listing.
      b. The property is withdrawn as collateral, or title is made unmarketable as collateral by Owner during the retainer period.
      c. Owner terminates this employment of Broker during the retainer period.
      d. Within one year after termination of this agreement, Owner or their agent enter into negotiations, which later result in a transaction contemplated by this agreement, with a lender whom Broker or a cooperating broker negotiated with during the period of this listing. Broker to identify prospective lenders by written notice to the owner within 21 days after termination of this agreement.
   3.2 If this agreement terminates without Owner becoming obligated to pay Broker a fee, Owner to pay Broker the sum of $______ per hour of time accounted for by Broker, not to exceed $______.
4. **LOAN TERMS:**
   4.1 Loan sought is $______, payable as follows:
      a. Interest at an annual rate of no more than ___%, ☐ fixed, ☐ ARM, type ______
      b. Payments due ☐ monthly, or ☐ ______, amortized over ___ years.
      c. Final/balloon payment due ______, 20___.
      d. Late charge ______
      e. Prepayment penalty ______
      f. Loan escrow with ______
      g. A lender's ALTA policy purchased by Owner in the amount of the loan.
         Title Company ______

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5. **REAL ESTATE SECURING THE LOAN:**
   5.1 Type ______
      Address ______
      Referred to as ______
      Vesting ______
   5.2 The priority for the lien securing the loan sought will be ☐ first, or ☐ second.
   5.3 Encumbrances of record:
      a. A first loan in the amount of $______, payable $______ per month until paid, including interest at ___%, ☐ ARM, type ______, due ______, 20___, impounds being $______ monthly.
         Lender: ______
      b. A second loan in the amount of $______, payable $______ per month, until paid, including interest at ___%, ☐ ARM, type ______, due ______, 20___.
         Lender: ______
      c. Other encumbrance, bond, assessment or lien in the amount of $______.
         Lienholder: ______
   5.4 My purchase price on ______ was $______. Since the purchase of the property, I have invested in repairs and improvements of approximately $______.
   5.5 The current fair market value is $______.
      Property taxes for the year 20___ were $______.
   5.6 The property is occupied by ______
      at a rental rate of $______ per month, under a:
      ☐ rental agreement; or
      ☐ lease agreement which expires ______, 20___.
      a. ☐ See attached Rental Income Rent Roll. [See **RPI** Form 352-1]
6. **PERSONAL PROPERTY INCLUDED AS COLLATERAL:**
   6.1 Referred to as ______
   6.2 Encumbered for the amount of $______, payable $______ monthly, including interest at ______%, due ______, 20___.
      Lender ______
7. **GENERAL PROVISIONS:**
   7.1 Broker is authorized to disclose, publish, discuss, and disseminate among prospective lenders the financial information supplied by Owner or credit agencies.
   7.2 Owner warrants all necessary permits have been obtained for any additions, alterations, repairs, installations or replacements to the structure or its components, except ______.
      a. ☐ See attached Condition of Property Disclosure. [See **RPI** Form 304]
   7.3 Owner authorizes Broker to cooperate with other agents and divide with them any compensation due.
   7.4 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.

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   7.5 The prevailing party in any action on a dispute will be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.
   7.6 This listing agreement will be governed by California law.
   7.7 ______

I agree to render services on the terms stated above.	**I agree to employ Broker on the terms stated above.** ☐ See attached Signature Page Addendum. [RPI Form 251]
Date: ______, 20___	Date: ______, 20___
Broker's Name: ______	Owner's Name: ______
CalBRE #: ______	
Agent's Name: ______	
CalBRE #: ______	
	Signature: ______
	Owner's Name: ______
Signature: ______	Signature: ______
Address: ______	Address: ______
Phone: ______ Cell: ______	Phone: ______ Cell: ______
Email: ______	Email: ______

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Exclusive listings require an agent to use diligence in their efforts to fulfill the client's objectives to locate a buyer, tenant or lender for the property. An exclusive listing has a specified period of employment set by an expiration date of the employment, such as 90 or 180 days after its commencement.

If an expiration date is not included in an exclusive listing, the broker faces suspension or revocation of their license by the Department of Real Estate (DRE).[1]

1 Calif. Business and Professions Code §10176(f)

Exclusive variations

Two types of exclusive employment agreements for buying and selling real estate exist:

- an *exclusive agency agreement* for a seller or buyer; and
- an *exclusive right-to-sell* or *right-to-buy* listing agreement.

Both types of exclusive listings establish the broker and their agents as the sole licensed real estate representatives of the client (seller or buyer). However, they are distinguished by whether or not the broker has any right to a fee when the property is sold or located solely by the efforts of the client.

Under an exclusive agency agreement's fee provision, the broker does not earn a fee when the client, acting independently of any other broker and the client's broker, accomplishes the objective of the employment, i.e., selling the listed property or locating and buying the property sought.

Conversely, under an exclusive right-to-sell/buy agreement's fee provision, the broker earns a fee no matter who during the listing period produces the buyer or locates the property sought under the listing, be it the client, another broker or other representative of the client, or the client's broker.

Exclusive right-to-sell listings

An **exclusive right-to-sell listing** affords a real estate broker the greatest fee protection. It is also the most commonly used type of employment. This listing employs the broker as the sole agent to act on behalf of the owner to market the property and negotiate any sale with all potential buyers and their agents. The broker is entitled to a fee regardless of who procures the buyer.

exclusive right-to-sell listing
An agreement employing a broker to act as agent for the seller of real property in which the seller promises to pay the broker a fee if the property is sold during the period of the employment, whether by the broker, through another broker or by the efforts of the owner. [See **RPI** Form 102]

Under an *exclusive right-to-sell agreement*, the owner relinquishes their right to list the property with other brokers or defeat entitlement of the seller's broker to compensation by selling the property themselves or removing it from the market.

An owner of real estate, on entering into an exclusive right-to-sell listing agreement, grants a broker the *right to locate a buyer* for the property prior to the expiration of the period of employment specified in the listing agreement. The broker is entitled to the fee agreed to in the listing agreement if, during the listing period:

- the property is sold on any terms, no matter who produces the buyer; or
- the broker or their agent presents the seller with a bona-fide offer from a ready, willing and able buyer on terms sought by the seller under the listing, or on other terms accepted by the seller.[1]

Exclusive right-to-sell listings give a broker and their agents the greatest incentive to work toward attaining the client's goal of locating a buyer. The seller's broker does not compete with the client to sell the property; they work together to achieve the sale.

1 CC §1086(f)(1)

Termination of agency by the seller

A seller of real estate enters into an **exclusive listing agreement** with a broker to sell a property within, say, a three-month period. The listing includes a fee provision which contains a *termination-of-agency* clause entitling the broker to a full fee if the seller terminate the broker's employment, without good cause, prior to expiration of the listing period. [See **RPI** Form 102 §3.1(c)]

The broker's listing agent promptly commences a diligent marketing effort to properly present the property for sale and locate a buyer who is willing to acquire the property. However, during the listing period and before a buyer is located, the seller terminates the agency by cancelling the listing.

The broker makes a demand on the seller for a full listing fee, claiming the termination-of-agency clause in the fee provision of the listing calls for payment of a fee as earned when the seller prematurely terminates the agency. The seller claims the broker is not entitled to a full brokerage fee, but only to money losses based on an accounting for their time, effort and costs incurred to market the property since a seller may legally terminate a broker's agency at any time.

Is the broker entitled to collect a full fee from the seller upon the seller's exercise of their legal right to terminate the agency?

Yes! While a seller may terminate the broker's agency at any time, the seller cannot both terminate the agency during the listing period and avoid payment of a fee if a termination-of-agency clause exists. The **termination-of-agency clause** in the listing agreement couples the permissible cancelling of the listing with the obligation to pay a fee.

Documenting the cancellation

When a seller, by word or by conduct, clearly indicates they no longer desire to sell the property, the agent prepares a *Release and Cancellation of Employment Agreement* form for the seller to review and sign. [See Form 121 accompanying this chapter]

The **release and cancellation** agreement may call for immediate payment of the full brokerage fee agreed to in the listing in exchange for mutually agreeing to cancel the listing agreement.

Alternatively, it may call for payment at a later date when the property is sold, placed again on the market, exchanged, optioned, refinanced (if the broker was retained to arrange new financing) or leased to anyone within a specified time period (for example, one year) after the date of the agreement. A compromise might be the payment of a partial fee with the balance due if the property is sold during the cancellation period.

This release and cancellation agreement is also used when a buyer wants to cancel an *exclusive right-to-buy listing*. On cancellation, the broker is deprived of the opportunity acquired under the listing to earn a contingency fee.

Form 121

Lease and Cancellation of Employment Agreement

RELEASE AND CANCELLATION OF EMPLOYMENT AGREEMENT

Waiver of Rights

NOTE: This form is used by an agent when employed by a client under an existing listing agreement that has been terminated by mutual agreement, to document the agreed-to termination of the employment, cancel the listing agreement and liquidate any claims that may have arisen due to the employment.

DATE: ______________, 20______, at ____, California.
Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This mutual release and cancellation agreement with waiver of rights pertains to the following employment agreement:

a. ☐ Seller's Listing Agreement [**RPI** Form 102]
b. ☐ Loan Broker Listing [**RPI** Form 104]
c. ☐ Exclusive Authorization To Lease [**RPI** Form 110]
d. ☐ Property Management Agreement [**RPI** Form 590]
e. ☐ Buyer's Listing Agreement [**RPI** Form 103]
f. ☐ Trust Deed Listing [**RPI** Form 112]
g. ☐ Exclusive Authorization To Locate Space [**RPI** Form 111]
h. ☐ ______________________________

1.2 dated ____________________, 20______, at ____, California,
1.3 entered into by ____, as the Broker,
1.4 and ____, as the Client,
1.5 regarding property or real estate services referred to as ______________________________
____.

2. AGREEMENT:

2.1 Broker and Client hereby cancel and release each other and their agents from all claims and obligations of any kind, known or unknown, arising out of the employment agreement.
2.2 In consideration of Broker's accptance, Client to pay Broker a brokerage fee of $ ____________________.
2.3 In consideration of Broker's acceptance of this cancellation, Client to pay the brokerage fee set forth in the employment agreement if Client enters into an agreement for any of the following checked events within _____ months after the date of this cancellation agreement:

a. ☐ The property is sold, exchanged or otherwise transferred.
b. ☐ An option to buy or sell the property is created.
c. ☐ The property is relisted with another broker.
d. ☐ The property is refinanced or further financed.
e. ☐ The property is leased.
f. ☐ The property is acquired.
g. ☐ ____.

3. WAIVER:

The parties hereby waive any rights provided by Section 1542 of the California Civil Code which states:
"A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor."

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: ______________, 20 __________	☐ See attached Signature Page Addendum. [**RPI** Form 251]
Broker: __________________ CalBRE#: __________	Date: ______________, 20 __________
	Client's Signature: ______________________________
By: ______________________________	Client's Signature: ______________________________
Phone: ______________ Cell: ______________	Phone: ______________ Cell: ______________

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Exclusive right-to-buy listings

For brokers and their agents, an exclusive **right-to-buy listing** creates a positive collaborative activity which is to be matched up to agents who list and market property for sale. A buyer's listing agreement employs the broker and their agents to locate qualified properties to be purchased by the buyer represented under an exclusive right-to-buy listing.

As with an exclusive **right-to-sell listing,** the right-to-buy variation has provisions for a brokerage fee to be paid by the buyer, if not the seller, when the buyer acquires property during the listing period of the type described in the buyer's listing.

Also, the exclusive right-to-buy listing provides greater incentive for brokers and their agents and imposes a duty to work *diligently and continuously* to meet their buyers' objectives.

The buyer benefits under an exclusive right-to-buy listing due to the greater likelihood the broker will more likely find the particular type of property sought. Brokers have continuous access to all available properties and will investigate and qualify properties as suitable before they are presented to the buyer, and will advise the buyer on the pros and cons of each property presented.

open listing
An employment entered into by a broker to render real estate services on a best-efforts basis under which a fee is due to the broker if they achieve the client's objective of the employment before the client or another broker separately first meet the objective, such as the sale or locating of a property.

A buyer's broker locating properties listed by other brokers does not become a dual agent or lose their status as the buyer's exclusive agent merely because the broker works with seller's brokers. The fee received by a buyer's broker is typically paid by the seller, directly or through the seller's broker, and does not create a dual agency.

A broker who seeks out and locates properties at the buyer's request negotiates the purchase terms as the buyer's agent regardless of who pays the fee (which is nearly always paid by the seller from the proceeds of the sales price paid by the buyer).

Exclusive agency variations

The **exclusive agency listing** is a hybrid of the open and the exclusive listings. The variation is rarely used by brokers as a practical matter and seems best suited to academic discussion.

Under an exclusive agency listing, the client employs the broker as their sole agent, as in an exclusive listing. Also, the broker is entitled to a fee on any transaction in which the broker, a finder or another broker produces a buyer. (A finder is an unlicensed agent with no authority to negotiate.)

However, under the exclusive agency listing, an owner retains the right to sell the property to any buyer the owner locates without becoming obligated to pay the broker a fee. This is the same for a buyer under an exclusive agency listing who finds the property on their own.

As with open listings, brokers are reluctant to spend much time and energy under exclusive agency arrangements.

Open listings

An **open listing**, sometimes called a **nonexclusive listing**, does not grant exclusive rights to the seller's broker and their agents to be the sole representative of the client. This is true whether the client is a buyer, tenant, borrower, seller, landlord or lender. Also, the client may enter into open listings with as many brokers as they chose to without becoming obligated to pay more than one fee.

A brokerage fee under an open listing to sell real estate is due a broker only if the broker or agent procures a ready, willing and able buyer and presents the owner with an offer from the buyer to purchase the listed property.

The terms contained in the offer submitted by the broker will be substantially the same as the terms sought by the owner under the listing to earn a fee whether or not the seller accepts it, called a **full listing offer**. If other terms are offered by a buyer and accepted by the owner, the broker earns their fee.

full listing offer
A buyer's or tenant's offer to buy or lease on terms substantially identical to the employment terms in the owner's listing agreement with the broker. [See **RPI** Form 556]

For a broker to be entitled to a fee under an open listing, the broker or agent needs to present the offer to the owner before the property is sold to some other buyer located by another broker or the owner. Also, the offer will be submitted before the listing expires or is revoked by withdrawal of the property from sale or by the termination of the agency.[1]

A unilateral contract

The broker employed under an open listing is not obligated to use diligence in their efforts to locate a buyer. The broker only has a best-effort obligation since the broker does not "accept" the employment until they locate a buyer interested in the property. Thus, an open listing is legally classified as a **unilateral contract**.

However, the agency duties of a fiduciary exist at all times under an open listing. Further, on locating a buyer the broker will perform their due diligence efforts to make disclosures and close the transaction.

The first broker to submit an offer during this open listing period from a ready, willing and able buyer to purchase property on the listed terms, or on other terms accepted by the owner, has earned the agreed fee. None of the other brokers holding open listings from the owner are entitled to a fee.

On the other hand, an open listing allows the owner to market the property themselves. Thus, the owner may compete against the seller's brokers to locate buyers. If the owner locates a buyer, the owner does not become obligated to pay a fee under any open listing.

A broker may also represent a buyer to locate property under an open listing agreement. A broker assisting a buyer to locate a suitable property among *multiple listing service (MLS)* listings held by other brokers will at least consider asking the buyer to sign an open listing if the broker chooses not to solicit an exclusive representation.

An open listing does not need to contain an expiration date, unlike an exclusive agency or exclusive right-to-sell/buy listing which is to have an *expiration date*.

Cancellation of an open listing

The owner revoking an open listing that contains an expiration date owes a fee to the broker if:

- the owner closes a sale with a prospective buyer located by the broker before the listing is revoked; or
- the owner revokes the listing in an attempt to escape payment of the agreed fee.[2]

1 CC §1086(f)(3)

2 **Heffernan** v. **Merrill Estate Co.** (1946) 77 CA2d 106

Conversely, an open listing without an expiration date may be terminated by the owner at any time without becoming obligated to pay a fee. Also, no fee is due under an open listing on:

- the good-faith withdrawal of the property from the market; or
- the premature termination of the employment before the broker has submitted a full listing offer.[1]

However, an open listing may contain a provision calling for the owner to pay the seller's broker a set amount, at an agreed time, for services other than procuring a buyer, such as the preparation of disclosure documents.

Net listings

A **net listing** is used only with sellers, not buyers, and can be structured as either an open or an exclusive type of listing. The net listing is distinguishable from all other listing arrangements due to the way compensation is calculated.

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.

In a net listing, the broker's fee is not based on a percentage of the selling price.

Instead, the seller's net sales price (excluding brokerage fees and closing costs) the seller is to receive on closing is stated in the listing agreement. The broker's fee equals whatever amount the buyer pays in excess of the seller's net figure and closing costs.

However, the broker will disclose to the seller the full sales price paid by the buyer and the amount of the broker's residual fee before the seller accepts an offer on a net listing. Failure to disclose to the client those benefits the broker receives on a transaction leads to loss of the entire fee.[2]

Claims of misrepresentation and unfair dealings

Net listings tend to be unpopular with the DRE and consumer protection organizations. They have been outlawed in some states.

Net listings are particularly prone to claims from buyers and sellers that the broker has been involved in misrepresentations and unfair dealings. These claims are generally based on an improper valuation of the property at the time of the listing or a failure to disclose the fee received by the broker when the property sells.

If the seller thinks the broker's fee is excessive, the seller is likely to complain they were improperly advised about the property's *fair market value* when employing the broker or pricing changes since then.

Option listing variation

An **option listing** is normally a variation of the exclusive right-to-sell listing.

1 **Tetrick** v. **Sloan** (1959) 170 CA2d 540
2 Bus & P C §10176(g)

Its unique feature is the additional element of a grant to the broker of an *option to buy* the property at a predetermined price, if the property does not sell during the listing period.

option listing
A variation of the exclusive right-to-sell listing in which the seller grants the broker an option to buy the property at a predetermined price, if the property does not sell during the listing period. [See **RPI** Form 102 §10]

The broker wears two hats when holding an option listing: one as an agent for the seller, the other as a principal acting for the broker's own account.

The temptation for or a claim of *misrepresentation* is quite apparent. The concurrent status of agent and principal is a conflict of interest for the broker which is fully disclosed. But as a result of the conflict, the seller's broker might fail to market the property as aggressively as they might otherwise do, with a view toward buying it themselves and reselling it at a profit. Likewise, the broker might neglect to inform the seller about all inquiries into the listed property by potential buyers.

As always, brokers are required to disclose any outstanding offers or other factors affecting the seller's decision to sell when the broker exercises the option.[3]

The broker's exercise of a purchase option contained in a listing agreement requires the broker to disclose to the seller the full amount of the broker's earnings (profit) and obtain the seller's written consent to the earnings before or on the broker's exercise of the option.[4]

Guaranteed sale variation

A **guaranteed sale listing** is distinct from a regular, exclusive right-to-sell listing. It is the broker who grants an option to their seller to sell, called a *put*. The *seller* is given the right to call on the broker to buy the property at a predetermined price if the property does not sell during the listing period.

guaranteed sale listing
A variation of the exclusive right-to-sell listing in which the broker agrees to buy the property if the property does not sell during the listing period.

Thus, the guaranteed sale listing establishes a reverse role for the seller from the option listing when the property fails to sell during the listing period.

The difference with the guaranteed sale listing is that the seller, not the broker, has the right to exercise the option by accepting the broker's promise to buy the listed property.

As with the option listing, the broker may tend not to work the listing vigorously when the price they will pay under the guarantee is much lower than the amount the seller will net on a sale at current market prices. Thus, the broker stands to acquire the property at a bargain price if it does not sell during the listing period.

In practice, if a buyer is not produced during the listing period, a desperate seller may have no choice but to sell to the broker since the seller delegated complete control to the broker to locate a buyer.

The broker's advantage, however, is lessened by a DRE regulation which prohibits the inclusion of advance fee provisions in a guaranteed sale listing.[5]

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3 **Rattray** v. **Scudder** (1946) 28 C2d 214

4 Bus & P C §10176(h)

5 Department of Real Estate Regulations §2970(b)(5)

As always, the broker is to disclose all offers and the status of potential offers during the listing period and at the time the seller exercises their option to sell to the broker.

Other listings

Other listing variations contain provisions for the broker to:

- obtain a tenant for a landlord;
- lease a property for a tenant;
- arrange a mortgage on behalf of a borrower who owns real estate or holds a trust deed note; and
- find a borrower for a lender seeking to make such a mortgage.

Unimproved real estate, business opportunities and mobile homes can also be the subject of the employment. All of these employment variations can be used with the open or exclusive type of listing agreements.

Chapter 24 Summary

A listing agreement is a written employment contract between a client and a licensed real estate broker. The listing agreement creates an employment relationship and an agency relationship between the client and broker.

There are several variations of listing agreements, each classified as either open or exclusive listings. An open listing does not grant exclusive rights to the seller's broker to be the sole representative of the client. Conversely, an exclusive listing gives the broker the sole right to represent the client. The broker discloses all offers and the status of potential offers to the seller under any type of listing agreement.

Chapter 24 Key Terms

Quiz 6 Covering Chapters 24-30 is located on page 611.

Chapter 25

Operating under a buyer's listing

Learning Objectives

After reading this chapter, you will be able to:

- appreciate the need for a buyer's broker to enter into a written employment agreement with their buyer; and
- advise a buyer on the benefits of entering into an exclusive right-to-buy listing agreement with a broker.

Key Terms

bilateral employment agreement

exclusive right-to-buy listing agreement

real estate owned (REO) property

safety clause

unilateral employment agreement

For a further discussion of this topic, see Chapter 15 of Real Estate Practice.

A prerequisite to representation

Most brokers realize a signed *buyer's listing agreement* produces the maximum financial return for the effort, money and talent an agent invests when representing an individual interested in buying property.

Real estate services have great value to members of the public. This is evident by the fact that nearly all buyers and sellers use an agent to assist them to meet their real estate objective. Often, members of the public are allowed to exploit the time and talent of agents without payment. Prospective buyers learn what they need to know about MLS properties, and fail to return when they decide to buy.

So, when you counsel a potential buyer before giving advice or commencing efforts to locate qualifying properties, ask the buyer to enter into a **written**

commitment retaining you to work with them as their *exclusive agent*. In exchange, you agree to diligently engage yourself to the best of your abilities to do what is necessary to meet their objectives.

The exclusive right-to-buy

exclusive right-to-buy listing agreement
A written employment agreement by a broker and a prospective buyer of real estate employing and entitling the broker to a fee when property is purchased during the listing period. [See **RPI** Form 103]

An **exclusive right-to-buy listing agreement** is used by brokers and their agents to prepare and submit to prospective buyers their **offer to render services** on their behalf as the buyer's real estate agent. Under it, you are employed to locate property sought by the buyer in exchange for the buyer's assurance you will be paid a fee when the buyer acquires the type of property they seek. [See Form 103 accompanying this chapter]

A buyer who refuses to enter into a written listing agreement with a broker and their agent demonstrates a clear intention the buyer does not want them as their representative. What this unlisted buyer likely wants is an agent to act as a *locator* or *finder* of properties, providing valuable information without any obligation to compensate them for the assistance. Possibly, the buyer has not yet committed themselves to buy a property; "just looking, thank you very much."

Without the buyer's written promise to pay a fee, you're entitled to nothing when your buyer "goes around" you and acquires property on which you provided them with information.

Without the buyer's written promise, no fee has been earned which is collectable from anyone, unless you arranged a fee-sharing agreement with the seller's broker documenting the buyer as your client, a condition which presents other risks. [See Figure 1, **RPI** Form 103]

The fee-payment bargain

Various working relationships and compensation arrangements may be struck between a prospective buyer and their agent.

Writings, by their nature, are intended by all who enter into them to be enforced. This includes a signed buyer's listing calling for payment of a fee when the buyer's objective of acquiring property is met.

Editor's note — All assurances of a brokerage fee on a real estate transaction are required by contract law (Statute of Frauds) to be in writing and signed by the person who agreed a fee will be paid, regardless of whether the fee will be paid by that person or by another party to the transaction.[1]

The following situations demonstrate the various likelihoods of *collecting a fee* for assisting a buyer:

1. *No listing exists.* Neither the seller nor the buyer has formally employed a broker. Usually, the seller acting without a broker is an experienced real estate investor, subdivider, land speculator, **real estate owned property (REO)** lender or other well-seasoned owner capable of negotiating a real estate transaction without representation.

real estate owned (REO) property
Property acquired by a mortgage holder through foreclosure.

1 Phillippe, *supra*

Form 103

Buyer's Listing Agreement

BUYER'S LISTING AGREEMENT

Exclusive Right to Buy, Exchange or Option

Prepared by: Agent ____________________ **Phone** ____________________

Broker ____________________ **Email** ____________________

NOTE: This form is used by a buyer's agent when employed by a prospective buyer as their sole agent, to prepare an offer to render services on behalf of the buyer to locate and acquire property for a fixed period of time.

DATE: ____________, 20_____, at ________________________________, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Buyer hereby retains and grants to Broker the exclusive right to locate real property of the type described below and to negotiate the terms and conditions for its purchase, lease or option, acceptable to Buyer, for the period beginning on ____________, 20_____ and terminating on ____________, 20_____.

2. BROKER'S OBLIGATIONS:

2.1 Broker to use diligence in the performance of this employment.

3. GENERAL PROVISIONS:

3.1 Buyer acknowledges receipt of the Agency Law Disclosure. [See **RPI** Form 305]

3.2 Buyer authorizes Broker to cooperate with other brokers and divide with them any compensation due.

3.3 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.

3.4 The prevailing party in any action on a dispute will be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.

3.5 This agreement will be governed by California law.

4. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between Client and Broker.

4.1 Buyer agrees to pay Broker ☐ __________% of the purchase price, or ☐ ______________, IF:

a. Buyer, or any person acting on Buyer's behalf, purchases, leases, exchanges for or obtains a purchase option on real property sought under this agreement during the retainer period.

b. Buyer terminates this employment of Broker during the listing period.

c. Within one year after termination of this agreement, Buyer enters into negotiations which result in Buyer's acquisition of an interest in any property Broker has solicited information on or negotiated with its owner, directly or indirectly, on behalf of Buyer prior to this agreement's termination. Broker to identify prospective properties by written notice to Buyer within 21 days after termination. [See **RPI** Form 123]

4.2 Buyer's obligation to pay Broker a brokerage fee is extinguished on Broker's acceptance of a fee from Seller or Seller's Broker of property acquired by Buyer.

4.3 In the event this agreement terminates without Broker receiving a fee under §4.1 or §4.2, Buyer to pay Broker the sum of $____________ per hour of time accounted for by Broker, not to exceed $____________.

TYPE OF PROPERTY SOUGHT:

GENERAL DESCRIPTION ________________________________

LOCATION ________________________ SIZE ______________

RENTAL AMOUNT/TERM ________________________________

I agree to render services on the terms stated above.

Date: ________, 20_____

Buyer's Broker: ____________________

Broker's CalBRE #: ____________________

Buyer's Agent: ____________________

Agent's CalBRE #: ____________________

Signature: ____________________

Address: ____________________

Phone: ____________ Cell: ____________

Email: ____________________

I agree to employ Broker on the terms stated above.

☐ See attached Signature Page Addendum. [**RPI** Form 251]

Date: ________, 20_____

Buyer's Name: ____________________

Signature: ____________________

Buyer's Name: ____________________

Signature: ____________________

Address: ____________________

Phone: ____________ Cell: ____________

Email: ____________________

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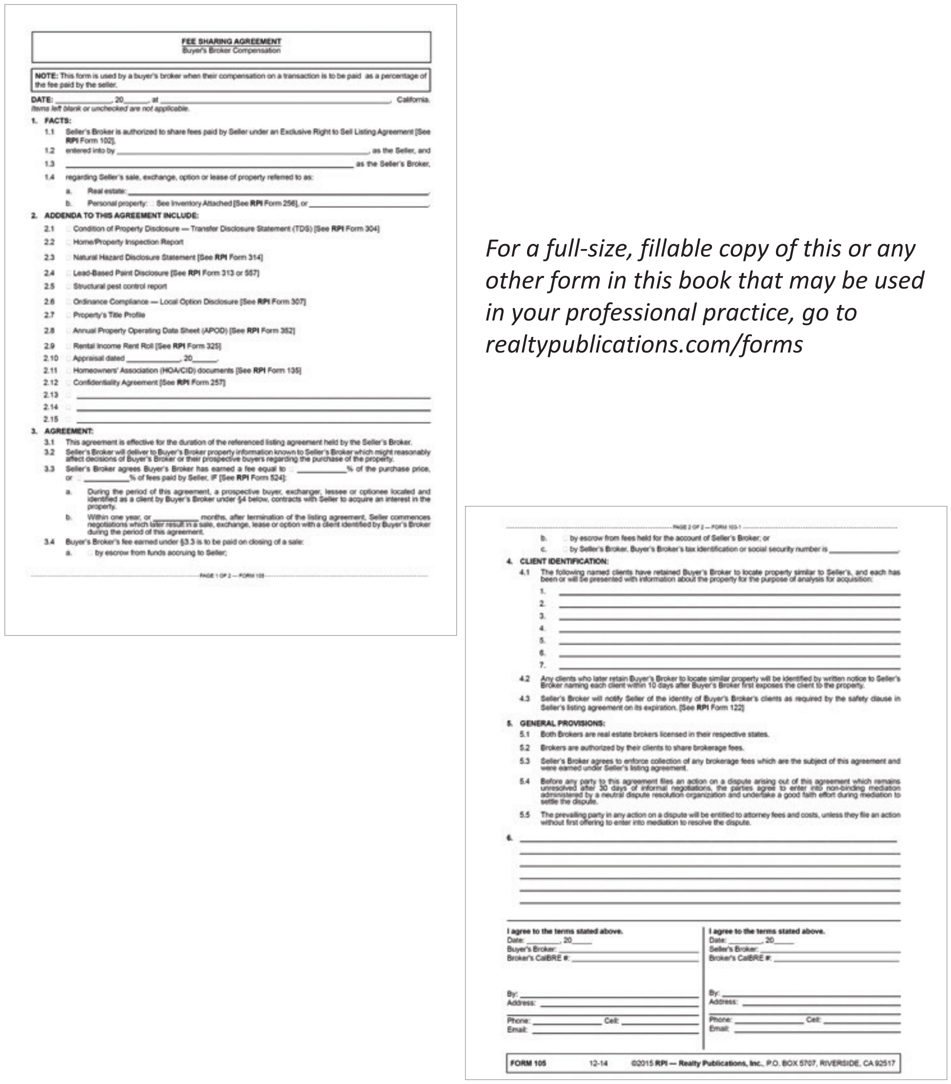
2. *A* "one-shot" seller's listing exists. A buyer is willing to make an offer through an agent who located an unlisted property (and other properties) at the buyer's request and brought it to the buyer's attention. [See **RPI** Form 103-1]

The agent fails to have the buyer enter into an *exclusive right-to-buy listing*. Before preparing and submitting an offer from the buyer, the agent solicits the seller for and obtains a "one-shot" right-to-sell listing containing a promise to pay a fee. On getting the listing, the agent prepares and submits an offer from the buyer.

Figure 1

Form 105

Fee Sharing Agreement



FEE SHARING AGREEMENT
Buyer's Broker Compensation

NOTE: This form is used by a buyer's broker when their compensation on a transaction is to be paid as a percentage of the fee paid by the seller.

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

1. FACTS:
1.1 Seller's Broker is authorized to share fees paid by Seller under an Exclusive Right to Sell Listing Agreement [See **RPI** Form 102],
1.2 entered into by ______________________________, as the Seller, and
1.3 ______________________________ as the Seller's Broker,
1.4 regarding Seller's sale, exchange, option or lease of property referred to as:
a. Real estate: ______________________________.
b. Personal property: ☐ See Inventory Attached [See **RPI** Form 256], or ______________.

2. ADDENDA TO THIS AGREEMENT INCLUDE:
2.1 ☐ Condition of Property Disclosure — Transfer Disclosure Statement (TDS) [See **RPI** Form 304]
2.2 ☐ Home/Property Inspection Report
2.3 ☐ Natural Hazard Disclosure Statement [See **RPI** Form 314]
2.4 ☐ Lead-Based Paint Disclosure [See **RPI** Form 313 or 557]
2.5 ☐ Structural pest control report
2.6 ☐ Ordinance Compliance — Local Option Disclosure [See **RPI** Form 307]
2.7 ☐ Property's Title Profile
2.8 ☐ Annual Property Operating Data Sheet (APOD) [See **RPI** Form 352]
2.9 ☐ Rental Income Rent Roll [See **RPI** Form 325]
2.10 ☐ Appraisal dated ____________, 20_____.
2.11 ☐ Homeowners' Association (HOA/CID) documents [See **RPI** Form 135]
2.12 ☐ Confidentiality Agreement [See **RPI** Form 257]
2.13 ☐ ______________________________
2.14 ☐ ______________________________
2.15 ☐ ______________________________

3. AGREEMENT:
3.1 This agreement is effective for the duration of the referenced listing agreement held by the Seller's Broker.
3.2 Seller's Broker will deliver to Buyer's Broker property information known to Seller's Broker which might reasonably affect decisions of Buyer's Broker or their prospective buyers regarding the purchase of the property.
3.3 Seller's Broker agrees Buyer's Broker has earned a fee equal to ☐ __________% of the purchase price, or ☐ __________% of fees paid by Seller, IF [See **RPI** Form 524]:
a. During the period of this agreement, a prospective buyer, exchanger, lessee or optionee located and identified as a client by Buyer's Broker under §4 below, contracts with Seller to acquire an interest in the property.
b. Within one year, or __________ months, after termination of the listing agreement, Seller commences negotiations which later result in a sale, exchange, lease or option with a client identified by Buyer's Broker during the period of this agreement.
3.4 Buyer's Broker's fee earned under §3.3 is to be paid on closing of a sale:
a. ☐ by escrow from funds accruing to Seller;

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b. ☐ by escrow from fees held for the account of Seller's Broker; or
c. ☐ by Seller's Broker. Buyer's Broker's tax identification or social security number is ______________.

4. CLIENT IDENTIFICATION:
4.1 The following named clients have retained Buyer's Broker to locate property similar to Seller's, and each has been or will be presented with information about the property for the purpose of analysis for acquisition:
1. ______________________________
2. ______________________________
3. ______________________________
4. ______________________________
5. ______________________________
6. ______________________________
7. ______________________________
4.2 Any clients who later retain Buyer's Broker to locate similar property will be identified by written notice to Seller's Broker naming each client within 10 days after Buyer's Broker first exposes the client to the property.
4.3 Seller's Broker will notify Seller of the identity of Buyer's Broker's clients as required by the safety clause in Seller's listing agreement on its expiration. [See **RPI** Form 122]

5. GENERAL PROVISIONS:
5.1 Both Brokers are real estate brokers licensed in their respective states.
5.2 Brokers are authorized by their clients to share brokerage fees.
5.3 Seller's Broker agrees to enforce collection of any brokerage fees which are the subject of this agreement and were earned under Seller's listing agreement.
5.4 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.
5.5 The prevailing party in any action on a dispute will be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.

6. ______________________________

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: ________, 20_____	Date: ________, 20_____
Buyer's Broker: ______________	Seller's Broker: ______________
Broker's CalBRE #: ______________	Broker's CalBRE #: ______________
By: ______________	By: ______________
Address: ______________	Address: ______________
Phone: __________ Cell: __________	Phone: __________ Cell: __________
Email: ______________	Email: ______________

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3. *Customer turned client.* An agent employed by a broker in an office with numerous listed properties is contacted by a prospective buyer. The buyer is exposed to all the relevant "in-house" listings, none of which are of immediate interest to the buyer. Having exhausted the in-house inventory of property for sale by clients, the agent may choose to see the buyer off. Or, the agent might better consider making arrangements with the buyer to locate qualifying properties listed by other brokers and unlisted properties (For Sale By Owners (FSBOs)), and present them to the buyer.

   If the buyer agrees, the agent is to locate qualifying properties, the agent needs to first ask for and obtain a signed buyer's listing agreement. If the agent is to be assured payment of a fee when the buyer acquires property, the buyer needs to enter into a buyer's listing agreement.

4. *A buyer's listing agreement exists*. The agent's broker is employed by the buyer in a signed **exclusive right-to-buy** listing agreement to represent the buyer by locating and negotiating the purchase of suitable property of the type sought by the buyer.

   A *seller* of suitable property may or may not have signed a seller's listing agreement with another broker. Either way, the buyer's broker controls the amount and destiny of their fee to be paid when their buyer buys.

Agency duties owed to buyers

Special agency duties are owed to a buyer when a broker and their agents undertake to locate property on the buyer's behalf. The duty to the buyer first arises when the broker:

- *enters* into an exclusive right-to-buy agreement with the buyer; or
- *presents* property information to an unlisted buyer who they have agreed to assist by locating qualifying properties suitable to the buyer.

When representing a buyer under a written exclusive right-to-buy employment agreement, the broker (and their agents) has entered into a **bilateral employment agreement**. Such an employment obligates the broker, through their agents, to exercise *due diligence* by way of a constant and continuing search to locate qualifying properties, while keeping the buyer informed of their progress.

bilateral employment agreement
A written exclusive employment agreement obligating the broker to exercise due diligence to fulfill the client's real estate objectives in exchange for the promise to pay a fee under various circumstances.

Without an exclusive right-to-buy listing, the brokerage duties which exist to locate properties for a buyer are *best-effort obligations* created by an oral (or written) open listing, called a **unilateral employment agreement**. A best-effort obligation requires no affirmative action (diligence) on the part of the broker's office to locate property.

unilateral employment agreement
An oral or written employment agreement obligating the broker to use their best-efforts to fulfill the client's real estate goals without imposing a due diligence duty on the broker until a match is located, commonly called an open listing.

However, under a buyer's listing, be it a written exclusive or oral open, the act of delivering property information to the buyer they are assisting obligates the broker and agents to use due diligence in their efforts to:

- *gather readily available data* on the property under review;
- *assist in the analysis* and *consequences* of the property data gathered; and
- *advise the buyer* regarding the property and any proposed transaction in a conscientious effort to act honestly, and to care for and protect the buyer's best interests.

When acting as the buyer's agent regarding the acquisition of a particular property, due diligence includes:

- disclosing facts about the integrity of the property; and

Marketing for new buyers and sellers through technology

Real estate marketing evolves as technology improves. Social networking through the internet has sparked a relatively new approach some agents are using to reach potential clients. From posting pictures and videos of properties on YouTube to advertising on Facebook, agents are reaching out to the world's population through the use of the internet.

For agents, one of the most appealing aspects of using social networking websites to conduct business is the fact most are entirely free. This form of free advertising allows agents to keep clients — be they past, present or potential —informed through quick status updates (or "Tweets" if using Twitter).

Homebuyers are able to follow the updates of an agent if they so choose, and receive notifications whenever an update is made – effectively allowing those who this technology to reach out to untold numbers of owners, buyers, lenders and tenants, all at once.

Another important aspect of social networking sites to consider is the access it grants to friends, family and acquaintances. If an agent does not solely use their internet page as a means of advertising, but instead uses it as their own personal page, then their family and friends, both past and current, can be plugged-in to the life of the agent, and will be far more prone to contact them or give their name as a reference when they or others need to be represented in the real estate market.

The internet has evolved into a very powerful tool readily at the disposal of all agents and brokers. They cannot only advertise and network on these newly available sites, but they can inform their friends and followers about the current status of the real estate market in a more efficient manner. Providing useful, interesting and relevant market information via their tweets and status updates, agents can demonstrate their own authority and prowess.

- recommending investigative activity which the agent knows might influence the buyer's conduct in negotiations.

Without an exclusive employment with a buyer on whose behalf the agent is locating properties, the agent is reduced to a mere "locator" or "finder." Worse, the buyer's agent is burdened with affirmative agency duties of utmost care and protection owed their buyer when reviewing properties listed with other brokers even if they are not acting under a written exclusive right-to-buy listing agreement with that buyer.

Provisions for payment of a fee

An exclusive right-to-buy agreement contains the same operative provisions found in exclusive right-to-sell agreements. [See Form 103]

In exchange for the broker's promise to use *due diligence* while rendering services to comply with their end of the employment bargain, the buyer promises in the exclusive right-to-buy listing agreement to pay the broker a specific fee.

Fees are either a fixed dollar amount or a percentage of the price paid, but may be set as an hourly rate. Fixed and percentage fees are contingent fees.

They are earned when the buyer enters into a binding purchase agreement during the (buyer's) listing period to acquire the type of property described in the buyer's listing.

However, buyers, like sellers, often do not enter into a purchase agreement during the period of employment. Thus, on expiration of the listing, the buyer's broker has not earned a fee. An event triggering payment of the promised fee has not yet occurred.

safety clause
A provision in an exclusive listing agreement earning the broker a fee during an agreed safety period after expiration of the employment for marketing efforts with identified buyers, tenants or property, if the client sells the listed property to an identified buyer or purchases or leases an identified property during the safety period. [See **RPI** Form 102 §3.1(d), 103 §4.1(c) and 110 §3.1(d)]

The fee provisions in a buyer's listing agreement include a **safety clause** which provides added protection against a lost fee for services rendered in regard to specific properties during the listing period. [See Form 103-1 §5.1(c)]

Under the *safety clause*, the buyer's broker is entitled to collect a fee if, within an agreed-to period after the expiration of the buyer's listing:

- information specific to the property was provided to the buyer by the buyer's agent during the listing period;
- on expiration of the buyer's listing, the buyer is handed an itemized list which identifies those properties the buyer's agent brought to the buyer's attention needed to *perfect* the broker's right to a fee [See **RPI** Form 123];
- the buyer entered into negotiations with the owner of a registered property; and
- the safety-period negotiations ultimately resulted in the buyer acquiring an interest in the property.

Buyer's liability for the brokerage fee

The buyer under a listing agreement promises to pay a full brokerage fee on the acquisition of property. However, in practice the buyer will nearly always close the purchase without directly paying the promised brokerage fee. It is the seller who typically pays the fee the buyer has promised their agent.

Further, when the property purchased is listed with another broker, the buyer's broker will typically accept a lesser amount for their fee than the fee amount the buyer agreed to pay under the buyer's listing.

Can the broker enforce the fee arrangement in the buyer's listing and recover the balance of the agreed-to fee from the buyer when the buyer's broker accepts a lesser fee from the seller or the seller's broker?

No! The buyer's obligation to pay the brokerage fee is *fully satisfied* when the buyer's broker agrees to accept a fee from the seller or the seller's broker, which is nearly always the case. [See Form 103§4.2]

Chapter 25 Summary

Most brokers realize a signed buyer's listing agreement produces the maximum financial return for the effort, money and talent an agent invests when representing an individual interested in buying property. Without the buyer's written promise to pay a fee, the broker is entitled to nothing when your buyer "goes around" the broker and acquires property on which the broker provided them with information.

All assurances of a brokerage fee on a real estate transaction are required by contract law to be in writing and signed by the person who agreed a fee will be paid, regardless of whether the fee will be paid by that person or by another party to the transaction.

The fee provisions in a buyer's listing agreement include a safety clause which provides added protection against a lost fee for services rendered in regard to specific properties during the listing period.

Chapter 25 Key Terms

Quiz 6 Covering Chapters 24-30 is located on page 611.

Chapter 26

Finders: a nonlicensee referral service

Learning Objectives

After reading this chapter, you will be able to:

- determine the conduct permitted of a finder; and
- distinguish the exceptions under which referral fees are allowed under the Real Estate Settlement Procedures Act (RESPA).

Key Terms

fee-splitting	**finder's fee**
fiduciary duty	**Real Estate Settlement Procedures Act (RESPA)**
finder	

For a further discussion of this topic, see Chapter 20 of Real Estate Practice.

Agency relationships in real estate transactions

Licensed brokers and sales agents employed by principals owe **fiduciary duties** to the principals they represent. *Fiduciary duties* require licensees to perform on behalf of their clients with the utmost care and diligence.

However, an **unlicensed finder** has no such fiduciary duty and does not act in the same capacity as a licensed agent or broker. A finder is someone who identifies and refers potential real estate clients or participants to a broker, agent or principal in exchange for a fee.

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.

Limitations are placed on the *conduct* of a finder. A finder lacks legal authority to participate in any aspect of property information dissemination or other transactional negotiations.[1]

Further, though California statute and case law have in the past permitted finders to *solicit* prospective buyers, sellers, borrowers, lenders, tenants or landlords for *referral* to real estate licensees or principals, the Department

1 Calif. Business and Professions Code §§10130 et seq.

of Real Estate (DRE), as the regulatory agency, prohibits finders from continually soliciting lead information on behalf of another. Thus, a finder is only permitted to — occasionally and not as a business practice — *provide the contact information* of an individual who may become a participant in a real estate transaction.[2]

Finding and introducing parties

finder
An unlicensed individual who locates, identifies and refers potential clients to brokers, agents or principals in exchange for the promise of a fee. [See **RPI** Form 115]

A **finder** in California may only:

- *introduce parties*;
- provide referrals on an *occasional* and nonrecurring basis; and
- enter into a *Finder's Fee Agreement* with principals or brokers for compensation. [See **RPI** Form 115]

For example, a past client of a real estate broker may act as a finder by providing the broker with the contact information of a prospective buyer known to the *finder*, and entering into an agreement with the broker for a finder's fee.

However, a finder may not:

- solicit participants to a real estate transaction;
- take part in any negotiations;[3]
  discuss the price;
- discuss the property; or
- discuss the terms or conditions of the transaction.[4]

Thus, continuing the above example, though the finder may provide the broker with contact information of a prospective client they happen to know, the finder may not seek out prospective clients for the broker. Further, their involvement is limited to introducing the buyer to the broker — the finder may not participate in the transaction or carry out activities requiring a real estate license.

A finder who crosses into any aspect of negotiation which leads to the creation of a real estate transaction needs a real estate license as they are both *soliciting* and *negotiating*. Unless licensed, an individual who enters into negotiations (supplying property or sales information) cannot collect a fee for services rendered — even if they call it a **finder's fee**.

The finder is subject to a penalty of up to $20,000 and/or a six-month jail term for engaging in brokerage activities without a license.[5]

In addition, a broker who permits an unlicensed employee to solicit clients or perform any other type of "licensed" work may have their license suspended or revoked.[6]

2 Tyrone v. Kelley (1973) 9 C3d 1; 78 Attorney General Opinion 71 (1995)
3 Bus & P C §10131(a)
4 **Spielberg** v. **Granz** (1960) 185 CA2d 283
5 Bus & P C §§10137, 10139
6 Bus & P C §§10131, 10137

RESPA limits authority to split fees

The **Real Estate Settlement Procedures Act (RESPA)** prohibits brokers from giving or accepting a referral fee if the broker or their agent is already acting as a *transaction agent* in the sale of a one-to-four unit residential property which is being funded by a purchase-assist, federally-related loan. However, there are two major exceptions.[7]

Real Estate Settlement Procedures Act (RESPA)
Legislation prohibiting brokers from giving or accepting referral fees if the broker or their agent is already acting as a transaction agent in the sale of a one-to-four unit residential property which is being funded by a purchase-assist, federally-related consumer mortgage.

A broker and their agents are *not* involved in a *RESPA* transaction when negotiating the sale, lease, or encumbrance of any of the following types of properties:

- apartment buildings with five or more units;
- commercial buildings;
- agricultural properties;
- business opportunities;
- vacant land (other than those involving one-to-four unit residential construction loans);
- properties containing 25 or more acres;
- leases and rental agreements;
- all-cash transactions; and
- seller carryback transactions where no federally-related loan is originated.[8]

Business development and RESPA

A broker and their agents need to develop methods for *generating business*. If not, their business model will produce insufficient numbers of clientele to provide enough earnings to keep them from being driven out of the real estate brokerage profession.

Many methods for finding and soliciting clientele exist. The source of clients most often discussed is the *referral*. In fact, agents not employed by media/franchise brokers are said to live by referrals alone.

Brokers also cooperate among themselves, as in broker-to-broker referrals between different segments of the brokerage community. For example, a property manager refers a homebuyer to an MLS sales agent, or an MLS agent refers a prospective tenant to a property manager.

Brokers and agents in single family residence (SFR) sales rarely develop a client base of homebuyers large enough to sustain a decent standard of living from sales fees generated solely by transactions handled on behalf of these prior clients. Thus, a *business model* for finding and locating clients on a regular basis needs to include sources other than clients personally located by the broker.

Many methods exist to generate new clients. Advertising through printed and electronic/digital media to solicit clients is fundamental promotion and expected by all.

7 12 United States Code §2607(a); 24 Code of Federal Regulations §3500.14(b)
8 12 USC §2606(a)(1); 24 CFR §3500.5(b)(1)

Fees through personal solicitation

On the other hand, finding and locating a client becomes a more focused and arduous task when a broker's business model expands beyond exclusive use of media, into the time consuming but rewarding task of *personally soliciting* clients.

Licensed agents place themselves directly between their employing broker and the prospective client when:

- the employing broker "refers" clients directly to their agent;
- an agent takes "floor time" to solicit new clients who call in response to media advertising and the "brand name" the broker has established;
- an agent canvasses a neighborhood or section of the community in a classic on-going *farming operation* to find and solicit new clientele (for their broker, but brand themselves in the process); or,
- an agent extends their reach to potential buyers and sellers of SFRs by inducing both licensed and unlicensed individuals to be "team members" who locate and solicit clientele for the agent (and the broker), activities which are permitted by both RESPA and DRE regulations.

The employment of unlicensed *finders/locators* of buyers and sellers will extend the agent's business to bring earnings to a level sufficient to sustain their sought-after standard of living. This is permissible. State and federal regulations on this arrangement are straightforward and compliance is relatively easy.

State and federal regulations

These regulations address the *relationship* between:

- the finder/locator and the broker/agent; and
- members of the public and finders/locators acting on behalf of brokers/agents.

All employees of a broker need to be hired under *written contracts* of employment. This includes licensed agents, administrative staff and finders. Written contracts are entered into to delineate the responsibilities each has undertaken. Provisions limit their conduct to what regulations allow for their licensed or unlicensed status.

These employments, the finder included, are not casual relationships since a fee is paid by the broker. Casual relationships the broker/agent develop with friends, neighbors, past clientele, social contacts, are a word-of-mouth network of *good will* and "viral adverts" which generate referrals for which no fee is paid.

Employed individuals *generate business* for the broker/agent and thus are paid. However, the employed finder is limited to locating new clientele for the broker/agent.

Fee sharing by a broker under RESPA

RESPA's goal is to prohibit activity which artificially drives up the cost buyers and sellers pay for services needed to close a sale. Artificial costs include duplicate fees charged for services implicitly covered by the provider's basic fee. *Double dipping* is the concern.

RESPA, like conditions stated in a title insurance policy, initially sets out a blanket rule as the starting point for arriving at the final conditions. RESPA's opening statement of purpose holds that no **referral fee** can be paid or received by a settlement service *provider* (broker/escrow/lender) who will be rendering transactional services in exchange for compensation in a RESPA sale (concurrent origination of mortgage financing as part of a one-to-four unit residential sale).

Likewise, a title insurance policy's initial statement proclaims no encumbrance of any type exists on the title being insured. The policy provisions then proceed to list exclusions, exceptions, and conditions which nearly neuter the initial general statement.

Here too, RESPA codes provide several exceptions allowing fee sharing by a broker in a mortgage financed home sale. These exceptions permit the broker to conduct orderly *business development* for their brokerage income which does not violate the RESPA principle of avoiding double dipping (referrals among providers within a sales transaction) or *surcharges*.

Two RESPA exceptions go to the heart of sourcing new clientele and sharing fees by brokers:

- referral fees paid to or received from other brokers, known as a *horizontal disbursement* from one broker to another, but only if neither broker is involved as a loan broker or lender in the home sale transaction;[9] and
- fees paid by the broker to the broker-employed licensed sales agent or *unlicensed finder*, known as a *vertical disbursement* within the broker's office, not paid to providers or third parties connected to the home sale transaction.[10]

DRE further limitations

While both of these exceptions to RESPA permit payment of fees under federal law, DRE regulations limit the conduct of these individuals when actually rendering services for a fee permitted by RESPA.

While the RESPA exceptions allow **fee splitting** activity, DRE regulations require *fee splitting* to be limited exclusively to:

- payments between brokers (who then may split the fee vertically with agents they employ); or
- payments by a broker to their employees, licensed or unlicensed.

fee-splitting
When fees made to a broker are split vertically with employed agents or split horizontally among other brokers.

9 24 CFR §3500.14(g)(1)(v)
10 24 CFR §3500.14(g)(1)(vii)

Thus, while RESPA allows agents and finders who are employed by a broker to receive fees from the broker for *generating business*, DRE regulations and statutory/case law set forth the *limits of conduct* each type of employee may undertake with the clientele.

To satisfy RESPA, the employment of a finder needs to be under an agreement where the employee-finder is obligated to report to the broker every prospect located of the sort the broker is looking for. The employee-finder's sole purpose is to generate business for their broker and the finder does not have the freedom, by contract, to refer a prospect to just any broker.[11] [See Form 115]

Three classes of finders with different expectations for a referral fee exist under RESPA:

- *friends* or *past customers* who pass on tips to brokers and/or sales agents;
- *individuals* who sell "lead lists" to brokers; and
- *bona fide employees* of brokers who generate business for their employing broker, classified as **financial services representatives (FSRs)**.[12]

Entitlement to a fee under RESPA

Finders are also entitled to a fee for referrals under RESPA, depending on the type of finder they are.

A friend or past customer type of unlicensed finder who is not under contract and thus not employed by a broker is not entitled to a finder's fee when the transaction contemplated is RESPA-controlled. If RESPA did not control, this type of finder would be entitled to a fee under California law if agreed to by a broker.

A *bona fide employee* of a broker, such as an FSR, is not barred from collecting a fee or salary from their employer-broker since employed individuals are exceptions to RESPA.

A person who sells lead lists is also able to legally collect a fee under both RESPA and non-RESPA transactions. Lead lists are considered "goods" and are perfectly legal in California, as well as under the RESPA exception for goods and services actually furnished.[13]

The finder's fee bargain

Generally, a **finder's fee** is a lump sum amount or a percentage of the fee received by the broker on a transaction which is closed due to the finder's referral. Only sound economics control the amount of the fee a broker, agent or principal should pay a finder for a lead. Also, no limit is placed on the volume of referral business conducted by a finder.

finder's fee
The fee paid to an individual who located, identified or referred a client to a broker, agent or principal. [See **RPI** Form 115]

11 24 CFR §§3500.2(b), 3500 Appendix B, examples 11 and 12; **Zalk** v. **General Exploration Co.** (1980) 105 CA3d 786
12 24 CFR §3500 Appendix B, example 12
13 24 CFR §3500.14(g)(1)(iv); see BRE Real Estate Bulletin, Spring 2006

Form 115

Finder's Fee Agreement

FINDER'S FEE AGREEMENT

(California Business and Professions Code §§10130, 10139)

NOTE: This form is used by an agent when they employ an unlicensed individual to locate, solicit and refer or identify persons who need the services of the broker, to document the terms of the employment.

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

Items left blank or unchecked are not applicable.

1. In consideration for services to be rendered by ______________________________, as the Finder, Broker contracts with Finder to refer to Broker a prospective client in need of services as a:

☐ Buyer. ☐ Lender. ☐ Borrower.
☐ Owner/Seller. ☐ Tenant. ☐ Landlord.

2. Finder agrees not to participate in or conduct any negotiations with the prospective client or solicit loans on behalf of the prospective client.

2.1 Finder is not licensed by the California Bureau of Real Estate (CalBRE).

The prospective client is identified as:
Name ______________________________
Address ______________________________
Telephone ______________________________

3.1 Further referrals of other prospective clients may be included in this agreement by an addendum signed by both Broker and Finder. [See **RPI** Form 250]

4. The real estate involved, if any, is referred to as
Common address ______________________________
Legal description/Assessor's parcel number ______________________________
____

5. As compensation for each referral by Finder, Broker agrees to pay Finder the following amount:
a. $____________ for each prospective client.
b. ______ % of Broker's fee received on the first transaction with each prospective client.
c. ______ % of the purchase price paid on the first transaction with each prospective client on which Broker receives a fee.
d. Other: ______________________________

6. Finder's compensation is earned and payable:
a. ☐ On close of the first transaction involving each prospective client.
b. Other time of payment ______________________________
c. If the prospective client does not enter into a commissionable transaction through Broker within ________ months after the date that prospective client is identified in writing to Broker, Broker will owe Finder no compensation.

7. Additional terms and conditions: ______________________________
____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: ______________, 20 ____	Date: ______________, 20 ____
Broker: ______________________	Finder's name: ______________________
CalBRE #: ______________________	
By: ______________________	Signature: ______________________
Address: ______________________	Social Security #: ______________________
______________________	Address: ______________________
	______________________
Phone: ____________ Cell: ____________	Phone: ____________ Cell: ____________
Fax: ______________________	Fax: ______________________
Email: ______________________	Email: ______________________

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Further, while brokers may collect advance fees from principals, finders may not. *Advance-fee operators*, masking themselves as finders for principals, sometimes collect fees "up front," a prohibited activity for an unlicensed individual.[14]

14 Bus & P C §10131.2

Entitlement to a fee under California law

A finder is entitled to a fee as an unlicensed individual if the finder locates, places, introduces, or delivers up names of prospective clients to a broker or principal.[15]

A finder's fee agreement entered into between a finder and a principal regarding the finder's referral services needs to be *evidenced in a writing* signed by the principal who employed the finder. If not, the finder cannot enforce their fee agreement with the principal.[16] [See Form 115]

However, the principal's *use and benefit* of a finder's referral under an oral finder's fee agreement, such as closing a sale with an individual referred by the finder, will substitute for a written agreement.[17]

Conversely, oral fee agreements between a broker (or their agents) and a finder are *enforceable*. No written agreement is required between a broker (or their agents) and a finder. However, a writing memorializes the agreement as documentation against memories to the contrary, and is in conformance with DRE regulations. [See Form 115]

15 Tyrone, *supra*
16 Calif. Civil Code §1624(a)(4)
17 **Tenzer** v. **Superscope, Inc.** (1985) 39 C3d 18

Chapter 26 Summary

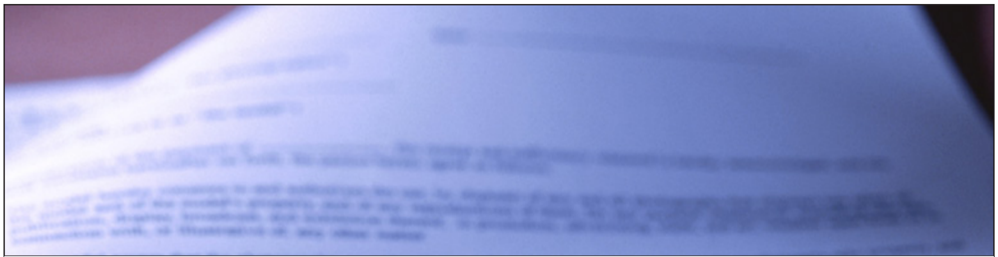
A finder's function as an "agent" is limited to locating, identifying, and referring potential real estate clients or participants to brokers, agents, or principals in exchange for the promise of a fee. A finder lacks legal authority to participate in any aspect of property information dissemination or other transactional negotiations.

The employment of unlicensed finders/locators of buyers and sellers is one method a broker or their agents may use to extend business to bring earnings to a level sufficient to sustain the agent's sought-after standard of living.

To satisfy RESPA, the employment of a finder needs to be under an agreement where the employee-finder is obligated to report to the broker every prospect located of the sort the broker is looking for. Finders are also entitled to a fee for referrals under RESPA, depending on the type of business relationship they have to the broker or agent.

Chapter 26 Key Terms

Quiz 6 Covering Chapters 24-30 is located on page 611.



Chapter 27

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**

For a further discussion of this topic, see Chapter 51 of Real Estate Practice.

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;
- commercial 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

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]

is a **purchase agreement** form. Different types of properties each require a different variety of *purchase agreement*. Various purchase agreement comprise provisions necessary to negotiate the sale of a particular type of property.

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 commercial 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, **RPI** Form 150];
- 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 brokerage fees paid each broker by their client [See **RPI** Form 151];
- negotiating the government insured financing (FHA/VA) of the purchase price [See **RPI** Form 152 and 153];
- negotiating the sale of an owner-occupied residence-in-foreclosure to an investor, called an **equity purchase 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** Form 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 down payment 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** Form 158 and 158-1 through 158-6]

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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; see Chapter 30]

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

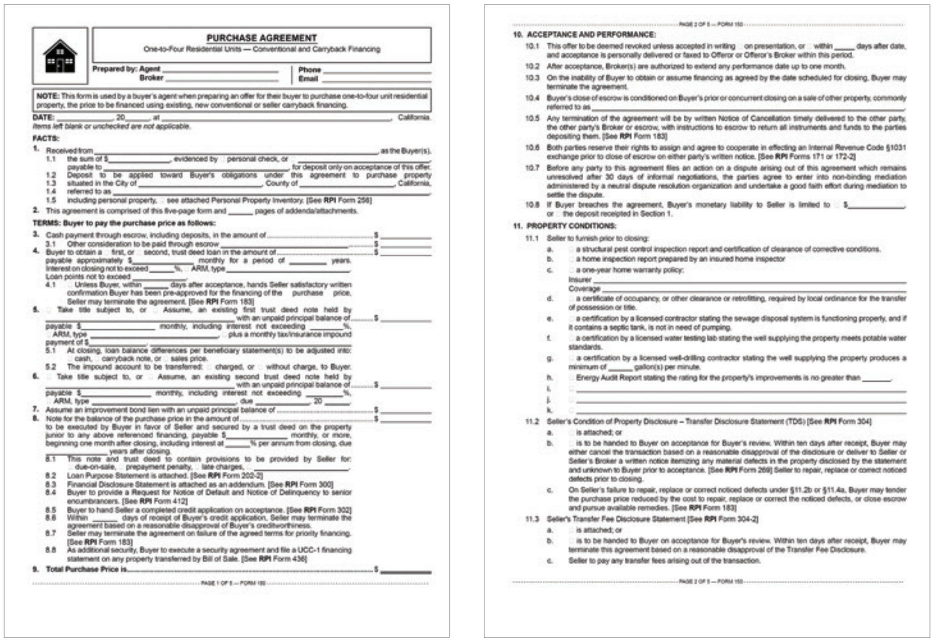
A buyer's agent uses the **Purchase Agreement (One-to-Four Residential Units – Conventional and Carryback Financing)** to prepare and submit the buyer's *written offer* to purchase a one-to-four unit residential property.

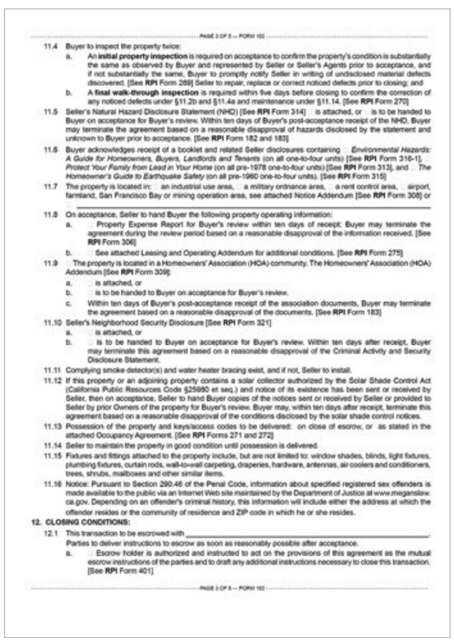
The pricing and terms for performance are limited to conventional financing, a takeover of existing mortgages, a carryback note or a combination of some of these arrangements. This *purchase agreement* is also properly used by sellers when confronted with a counteroffer situation. The seller's agent 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 (One-to-Four Residential Units — Conventional and Carryback Financing)





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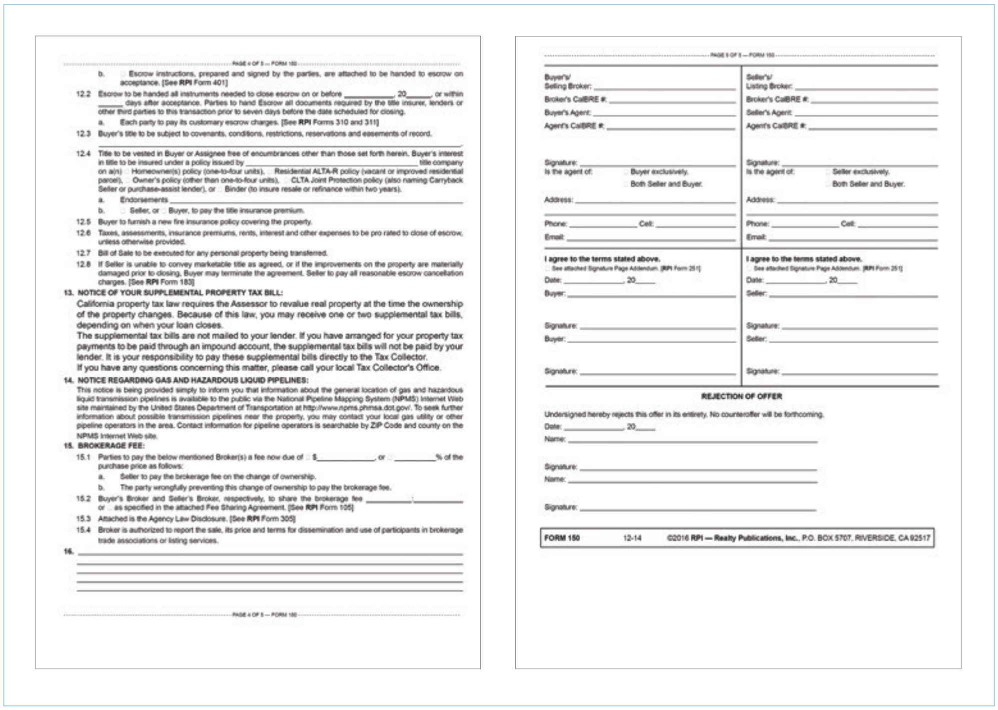
On acceptance, the purchase agreement becomes a *binding written contract* between the buyer and seller. To be enforceable, the price and terms for performance need to be clear, concise and complete to prevent misunderstandings. To this end, a comprehensive purchase agreement includes as "boilerplate" 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, **RPI** Form 150]


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

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: ______________________

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Figure 1

Form 150 Cont'd

Purchase Agreement (One-to-Four Residential Units — Conventional and Carryback Financing)

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 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 contained in sections 1 and 2 to establish the facts for negotiating the agreement.
2. *Price and terms*: All the typical variations for payment of the price by conventional purchase-assist financing or a takeover of existing financing are set forth in sections 3 through 9 as a checklist of provisions for consideration. On making an offer (or counteroffer using this form), the terms for payment and financing of the price are selected by checking boxes and filling blanks in the desired provisions.
3. *Acceptance and performance*: Aspects of the formation of a contract, excuses for nonperformance and termination of the agreement are provided for 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.
4. *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 11 by the seller's delivery of reports, warranty policies, certifications, disclosure statements, an environmental, lead-based paint and earthquake safety booklet, any operating cost

and income statements, and any homeowners' association (HOA) documents not handed to the 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 to confirm the seller has eliminated defects known, but not disclosed, prior to acceptance.

5. *Closing conditions*: The escrow holder, escrow instruction arrangements and the date of closing are established in section 12, as are title conditions, title insurance, hazard insurance, prorates and mortgage adjustments.
6. *Notice of supplemental property tax:* 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, as set forth in section 13.
7. *Notice regarding 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.
8. *Brokerage and agency*: The release of sales data on the transaction to trade associations is authorized, the brokerage fee is set and the delivery of the agency law disclosure to both 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.
9. *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.

*Editor's note — For specific instructions covering the preparation of the Purchase Agreement — One-to-Four Residential Units, **RPI** Form 150, see Real Estate Practice Chapter 51.*

Observations

As a policy of the publisher to provide users of **RPI (Realty Publications, Inc.)** 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; and
- a *liquidated damages provision*, since they **create wrongful** expectations of windfall profits for sellers and are nearly always forfeitures and unenforceable.

Chapter 27 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 commercial income properties and owner-occupied business/farming properties; and
- land acquisition transactions.

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; and
- the down payment note financing of the purchase price.

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.

Each part of the purchase agreement has a separate purpose and need for enforcement. These parts include:

- identification;
- price and terms;
- acceptance and performance;
- property conditions;
- closing conditions;
- notice of supplemental property tax;
- notice regarding gas and hazardous liquid pipelines;
- brokerage and agency; and
- signatures.

Chapter 27 Key Terms

Quiz 6 Covering Chapters 24-30 is located on page 611.

Chapter 28

Agency confirmation provision

Learning Objectives

After reading this chapter, you will be able to:

- identify the arrangements in which an agency confirmation provision is mandated; and
- properly use the agency confirmation provision in transactions that require it.

Key Terms

agency confirmation provision

associate licensee

double-end

dual agent

For a further discussion of this topic, see *Agency* Chapter 3 of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Mandated for purchase agreements

The agency relationship of brokers and their agents to their principals is required to be disclosed to all parties in *targeted transactions*. This includes the sale, exchange or long-term lease of a one-to-four unit residential property, commercial property, mobilehome and more.[1]

This relationship is disclosed in the **agency confirmation provision** located in all written negotiations to purchase or lease and lease agreements.[2] [See Figure 1]

agency confirmation provision
A provision in all purchase agreements and counteroffers disclosing the agency of each broker in the transaction.

The *agency confirmation provision* states the existence or nonexistence of each broker's *fiduciary agency* with the various parties to the transaction. Each broker identifies the party they are acting on behalf of as their agent in the transaction. Thus, one broker does not state the agency relationship of

1 Calif. Civil Code §2079.17(d)

2 CC §2079.17

Figure 1

Excerpt from Form 150 Purchase Agreement

Seller's Broker: ____________	Buyer's Broker: ____________
Broker's DRE #: ____________	Broker's DRE #: ____________
is the broker for: ☐ Seller ☐ both Buyer and Seller (dual agent)	is the broker for: ☐ Buyer ☐ both Buyer and Seller (dual agent)
Seller's Agent: ____________	Buyer's Agent: ____________
Agent's DRE #: ____________	Agent's DRE #: ____________
is ☐ Seller's agent (salesperson or broker-associate) ☐ both Buyer's and Seller's agent (dual agent)	is ☐ Buyer's agent (salesperson or broker-associate) ☐ both Buyer's and Seller's agent (dual agent)
Signature: ____________	Signature: ____________
Address: ____________ ____________	Address: ____________ ____________
Phone: ________ Cell: ________	Phone: ________ Cell: ________
Email: ____________	Email: ____________

any other broker involved in the transaction. For example, the buyer's broker does not include the seller's broker's agency in the agency confirmation and broker identification provisions in the purchase agreement form.[3] [See **RPI** Form 150]

Further, an *Agency Law Disclosure* is provided each time any broker prepares a purchase agreement. The separate disclosure confirms the broker's specific agency in the transaction, and is attached as a referenced addendum. [See Chapter 2 and 3]

The Agency Law Disclosure is an explanation of the duties owed to each party in a sales transaction by the broker and agents involved.[4]

The Agency Law Disclosure is signed by the buyer then signed by the seller on an acceptance of the offer or submission of a counteroffer.

Statutory jargon

The contents of the agency confirmation provision requires the broker and their agents to first understand the statutory definitions of:

- agent;
- seller's agent, also referred to as a *listing agent*;
- buyer's agent, also referred to as a *selling agent*;
- subagent; and
- dual agent.

The statutory definitions of these agency terms and their meanings are oftentimes different from the jargon used among brokers and agents in the multiple listing service (MLS) environment.

For example, by statutory definition, an agent retained by a client is always a broker. This broker is usually represented through the efforts of licensed sales agents employed by the broker. In the jargon of the real estate industry, a sales agent employed by the broker is always called an "agent." In practice, a licensed broker never refers to themselves or other brokers as an agent.

3 CC §2079.17(a)

4 CC §2079.17(d)

By statute, the agent employed by a broker is defined as an **associate licensee** — an *agent of the agent,* not an agent of the client.[5]

associate licensee
A sales agent employed by a broker.

Only the broker can be an agent of a client. Sales agents are not permitted to have clients. Sales agents are always employees of the *client's agent* — the broker. However, for income tax purposes, agents may be classified in employment contracts with their broker as **independent contractors.**[6] [See **RPI** Form 506]

Just who is the "selling agent"?

A buyer's agent, previously referred to as a **selling agent** in the Agency Law Disclosure, by definition is a legal hybrid with four distinct personalities. Each of the four is a different type of agency relationship a broker can have with a buyer. The common thread among the legal types is *direct contact* with the buyer.[7]

By legal definition, a buyer's agency includes the following four types of broker relationships with buyers:

1. The *seller's broker,* also known as the listing broker, when acting as the seller's exclusive agent, has direct contact with the buyer when no broker is acting on behalf of the buyer. [See Figures 2 and 4]
2. Another broker collaborating with the seller's broker on behalf of the seller to locate a buyer, acting not as an employee of the seller's broker but independently as a subagent of the seller. [See Figure 5]
3. Buyer's brokers locating property on behalf of a buyer, often referred to as *fee-splitting (cooperating) brokers*. [See Figure 3]
4. Brokers locating buyers for an unlisted property, such as a For Sale by Owner (FSBO) transaction in which the seller will not employ the broker and the broker does not represent the buyer.[8]

For example, a broker who is employed by a buyer to locate *qualifying properties* is said to have *listed the buyer* or been retained by the buyer.

The **buyer's broker** confirms their agency in the purchase agreement as "the agent of the buyer exclusively" — even though no oral **fee arrangements,** much less a written exclusive right-to-buy listing, may exist with the buyer. [See Figure 1; see Chapter 27]

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

The buyer's broker might find their agency confirmation complicated by also having a listing with the seller of the property their buyer is making an offer on. Thus, the broker becomes a **dual agent.** [See Figures 1 and 4; see **RPI** Form 117]

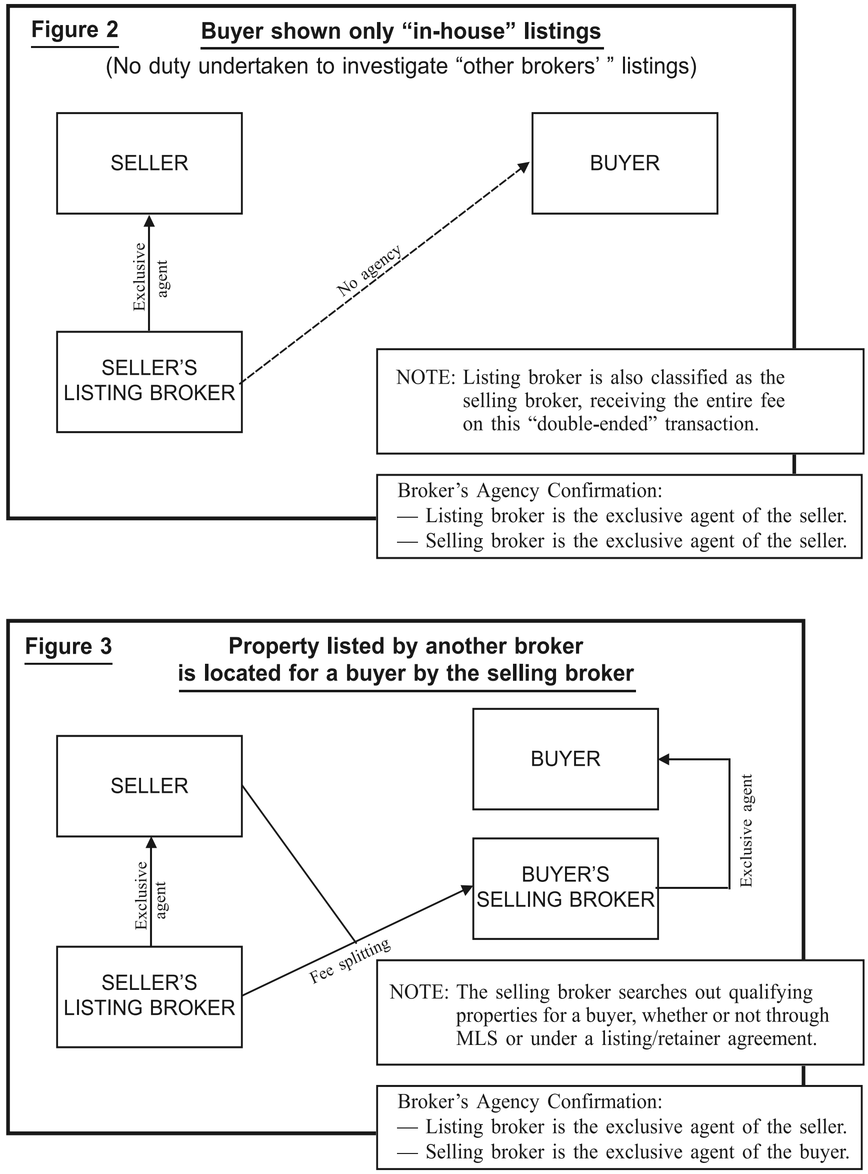
Use of the agency confirmation provision

Both the agency confirmation provision and the separate Agency Law Disclosure are required to be part of a purchase agreement on all offers and acceptances negotiated by brokers on targeted transactions. [See Chapter 3]

5 CC §2079.13(a), 2079.13(b)
6 Calif. Business and Professions Code §10132
7 CC §2079.13(n)
8 CC §2079.13(n)

Figure 2 & 3

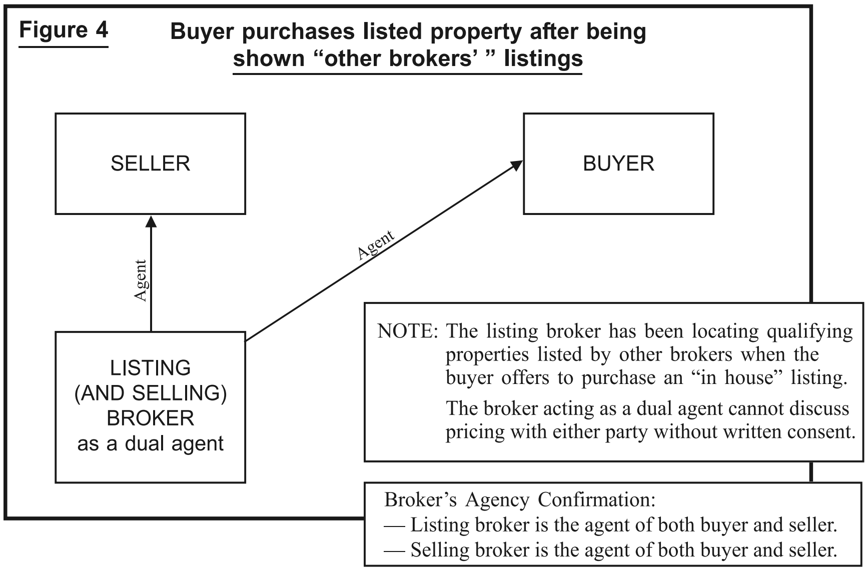
Listing Arrangements



In practice, the buyer's agent is the broker who prepares and presents a purchase agreement to the buyer for their signature.

Thus, the buyer's broker of their agent, will:

- attach the Agency Law Disclosure as an addendum to the purchase agreement;
- fill out the buyer's agent's agency confirmation provision in the purchase agreement; and
- obtain the buyer's signature on the agency law disclosure and the purchase agreement.



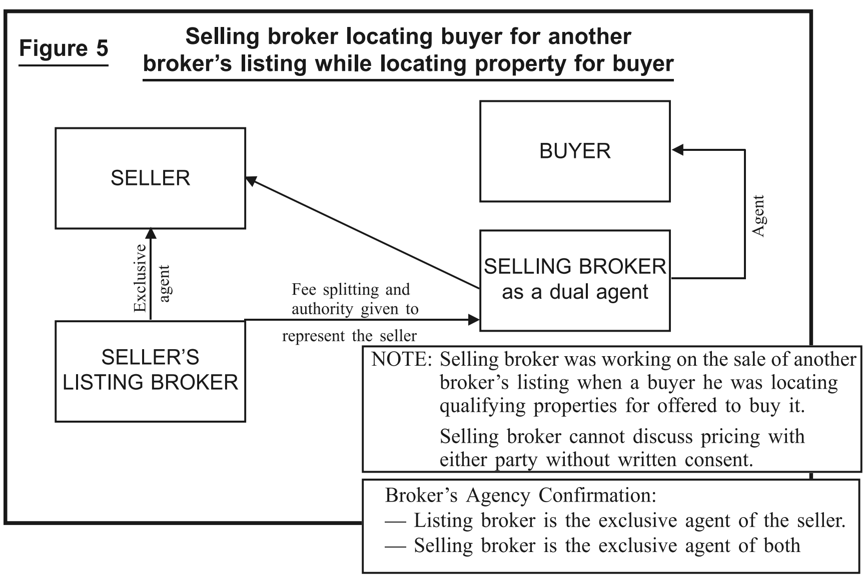


Figure 4 & 5

Listing Arrangements

Before submitting the buyer's purchase agreement to the seller, the seller's broker confirms their agency with the seller. The seller's broker does so by filling out the seller's broker confirmation, noting the agency relationship established by their conduct with the seller.

Double-ending codified

The seller's broker or their agents are occasionally the only persons acting as agents in a transaction and working directly with a buyer. As the seller's agent, they do not owe a *fiduciary duty* to the buyer.

If they do act to become the buyer's agent, the listing broker becomes a *dual agent*. As a dual agent, the agent agrees to locate the most suitable property available for the buyer to purchase in the entire MLS inventory, not limited to the seller's property. [See Chapter 5]

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.

However, if the seller's broker and their agents do not expose the buyer to properties other than their "in-house" listings, they do not become the buyer's agent by their conduct. Thus, they are not dual agents. [See Figure 2]

Alternatively, a broker is said to have "double-ended" a deal when only one broker is involved and is paid a fee. When a transaction is **double-ended**, no cooperating buyer's broker is involved with whom they split the fee.

In this instance, no dual agency is created. Thus, the seller's broker includes the standard agency law disclosure and confirms their agency as the "exclusive agent of the seller." [See Figure 1]

Chapter 28 Summary

The agency confirmation provision is contained in all purchase agreements for the sale, exchange or long-term lease of targeted properties such as a one-to-four unit residential property, commercial property or mobilehome. The provision lays out the agency relationships of brokers and their agents to their principals and third-parties to the transaction.

By statutory definition, an agent retained by a client is always a broker. However, the broker is usually represented by licensed sales agents employed by the broker to provide services agreed to by the broker. The agent employed by a broker is acting on their broker's behalf when providing brokerage services for the client, and is thus an agent of the broker.

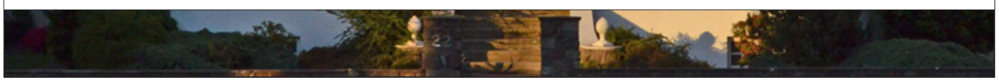
A transaction is double-ended when the seller's agent receives the entire fee as no buyer's agent exits to split the fee with.

Chapter 28 Key Terms

Quiz 6 Covering Chapters 24-30 is located on page 611.

Chapter 29

The appraisal report



Learning Objectives

After reading this chapter, you will be able to:

- understand the purpose and function of an appraisal to provide an opinion of a property's value on a specific date;
- recognize the six steps of the appraisal process, concluding with the creation of an appraisal report;
- differentiate the three appraisal approaches used to analyze the property data collected;
- advise on the elements of a completed appraisal report;
- discuss appraiser licensing requirements; and
- avoid activities which violate appraisal independence.

Key Terms

appraisal	**cost approach**
appraisal report	**fair market value (FMV)**
comparison approach	**income approach**

An opinion of value

An **appraisal** is an individual's *opinion or estimate* of a property's value on a specific date, reduced to writing in an **appraisal report**.

appraisal
An individual's opinion of a property's value on a specific date, documented in an appraisal report.

appraisal report
Documentation of an appraiser's findings, including the purpose and scope of the appraisal.

The *appraisal report* contains data collected and analyzed by the appraiser which substantiates the appraiser's opinion of the property's value. The value of a parcel of real estate, given as a dollar amount, is the *present worth* to an owner of the future flow of net operating income (NOI) generated by the property.

Factors used in the appraisal process to determine a property's value include:

- **demand** – the number of buyers for the property;
- **utility** – the property's possible uses;

- **scarcity** – the availability of similar properties; and
- **transferability** – the seller's ability to transfer good title to a buyer clear of all encumbrances itemized in a title insurance policy.

Collectively, these are known as the **elements of value** and can be memorized with the acronym of **DUST**.

Further, there are forces that influence value, including:

- **physical considerations** – the property's proximity to commercial amenities, access to transportation, the availability of freeways, beaches, lakes, hills, etc;
- **economic considerations** – rents in the area, vacancies and the percentage of homeownership, as well as employment opportunities lost or gained;
- **government considerations** – property taxes, zoning, building codes, and local services such as police and fire protection; and
- **social considerations** – crime rates, school ratings, shopping and recreational opportunities.

These **forces that influence value** can be memorized with the acronym of **PEGS**.

Factors not used to determine a property's value include the present owner's:

- acquisition cost;
- listing price;
- mortgage financing; and
- equity in the property.

fair market value (FMV)
The price a reasonable, unpressured buyer would pay for property on the open market.

There are many different types of values assigned to a property. In real estate appraisal, the most common type of value used is **market value**, also called **fair market value (FMV)**.

The *FMV* of a property is the highest price on the date of valuation a willing seller and buyer would agree to, both having full knowledge of the property's various uses.[1]

Economic principles in appraisal

Several economic concepts are used in the appraisal of real estate. These principles are referred to as *principles of appraisal* and include:

1. The **principle of supply and demand**: For appraisal purposes, the principle of supply and demand holds that once the supply of available homes decreases, the value of homes increase since more people are demanding the decreased supply of available homes. This principle correlates to the density of the population and its level of income.

1 Calif. Code of Civil Procedures §1263.320

Economic principles in appraisal, cont'd

2. The **principle of change**: The principle of change holds that property is constantly in a state of change. The change a property experiences is seen in its **life-cycle**. The *life-cycle* of a property has four stages: **development**, **stability, decline** and **old age**.

    Development of the property includes the subdivision of lots, improvements constructed and the start of a neighborhood community.

    The *stability stage* of a property, such as a home built within a community, occurs when the property reaches a level of completion where changes are only made to it to maintain an appropriate level of condition.

    The *decline stage* starts when the oldest buildings begin to deteriorate, lower social or economic groups move into the community and larger homes are converted into multiple family use.

    The *revitalization* or *gentrification stage* occurs when the neighborhood is recognized as suitable for renewal. This most often occurs in more urban areas where high-costs force younger and first-time buyers to create value through the renewal process.

3. The **principle of conformity**: The principle of conformity holds that when similarity of improvements is maintained in a neighborhood, the maximum value of a property can be realized on a sale. Zoning regulations and conditions, covenants and restrictions (CC&Rs) tend to protect homeowners by narrowing the uses and excluding nonconforming uses of the property.

    The *principle of conformity* is further categorized under the principle of:

    regression: The principle of regression holds that the value of the best property in a neighborhood will be adversely affected by the value of other properties in the neighborhood. For example, this principle applies to over-improved homes. When an owner makes extensive renovations, such as adding additional rooms and landscaping, and the other neighbors do not, the house is no longer as similar to the others. On the sale of the over-improved home, the owner will not receive the full value of the cost of over-improvements.

    progression: The principle of progression is the opposite of the principle of regression, holding that a smaller and lesser maintained property in a well-kept neighborhood will sell for more than if the home were in an area of comparable properties.

4. The **principle of highest and best use:** The principle of highest and best use holds that the greatest value of the property is realized when its use is maximized. The test for highest and best use requires that the use be physically possible, legally permissible, economically feasible, and achieve the maximum productivity (memorized by the acronym **PLEM**).

5. The **principle of contribution**: The principle of contribution holds that the value of one component (improvement) is measured in terms of its contribution to the value of the whole property rather than its cost. For example, a property's FMV may increase if additions, such as a swimming pool, are added.
6. The principle of **substitution**: The principle of substitution holds that a buyer will not pay more for a property if it will cost less to buy a similar property of equal desirability. The principle of substitution is the most basic principle of appraisal as it is used in each of the three approaches to value.

Steps in the appraisal process

The appraisal process consists of six steps:

- identifying and defining the appraisal effort to be undertaken by the appraiser;
- data collection;
- analyzing the data;
- applying the three appraisal approaches;
- reconciliation and final valuation of the property; and
- producing the complete report.

Defining the appraisal effort

The first step in the appraisal process is the identification of the questions to be answered during the appraisal.

The questions to be answered include:

- What is the purpose of the appraisal?
- What interest in the property is being appraised?
- What is the description and location of the property to be appraised?
- Who owns or holds an interest in the property being appraised?
- What is the highest and best use of the property in light of zoning and CC&Rs?
- What encumbrances affect the condition of title to the property?
- Are there any facts that the appraiser needs to clarify?
- What is the appraiser's fee?

Gathering data

The background information gathered on the property to conduct an appraisal is divided into two categories:

1. **General data**: Information on the region, city and neighborhood surrounding the property; and
2. **Specific data**: Information on the location, lot and improvements.

The *general data* gathered are to provide an overview of the property. Data on the local and regional economy are included since it affects property within the local real estate market.

Regional considerations include geography. Also, a growing city or county where jobs are available is desirable. Other features to consider include the quality of school systems and public facilities.

The collection of *specific data* about a property includes information on the size of the parcel, lot type, the improvements on the property and the uses permitted.

Types of lots

Lot types include:

1. **Cul-de-sac lot**: a lot facing the rounded turn-around portion of a dead-end street. A cul-de-sac property is private since it is not subject to through traffic. Unlike rectangular lots, the cul-de-sac lot has a small front yard which is offset by a larger backyard.
2. **Corner lot**: a lot located at the intersection of two streets. A corner lot does not have a great deal of privacy due to traffic on the streets it intersects. However, the corner lot may be more desirable since access to the sideyard and backyard for vehicles is available from the side street.
3. **Key lot**: a lot bordered by three or more lots on the sides and the back. The biggest disadvantage of the key lot is the lack of privacy due to numerous neighbors abutting all sides of the lot except the frontage.
4. **T-intersection lot**: a lot at the end of a dead-end street. The biggest disadvantage of the T-intersection lot is noise and lack of privacy.
5. **Interior lot**: a lot surrounded by lots on all three sides. This is the most common type of lot. An interior lot is usually rectangular in shape with a large backyard. However, privacy is limited since the lot is adjoined on all sides by neighbors.
6. **Flag lot**: a lot located behind other lots with a long and narrow access driveway to a public street. Flag lots generally have a reduced value due to the lack of privacy that results from being surrounded by other homes' backyards. Flag lots also lack curb appeal.

The physical aspects of a lot include:

- size and shape;
- slope, drainage and soil;
- view, exposure to sun and weather; and
- improvements.

Analyzing the data

The third step in the appraisal process is analyzing the data collected to determine what further research will be necessary.

The fourth step in the appraisal process is to consider and perform the three appraisal approaches, which are:

1. The **market comparison approach** (also known as the *sales comparison approach*);

2. The **cost approach** (also known as the *replacement* or *reproduction method*); and
3. The **income approach** (also known as the *gross rent multiplier* or *capitalization income method*).

Market comparison approach

The *market comparison approach* is the most commonly used approach to establish the FMV of real estate. Applying the market comparison approach, the appraiser looks at the current selling prices of *similar properties* to help establish the comparable value of the property appraised. Adjustments are made for any differences in the similar properties, such as their location, obsolescence, lot size and condition.

comparison approach
A method for comparing a given property with similar or comparable surrounding properties; also called market comparison.

For example, a property owner's neighbor recently sold their residence for $345,000. The neighbor's house is of a similar age, size and condition as the owner's house, except it has a fireplace worth $3,000 which the owner does not have. Adjusting for the difference in the improvements (the fireplace) between the owner's and neighbor's house would establish the value of the owner's house at $342,000.

To produce a more reliable appraisal, it is better to gather data on comparable sales, frequently called "**comps**." The appraiser then compares each against the property being appraised for their similarities. Sales information can be obtained from the multiple listing service (MLS), tax records, electronic databases on recordings and title insurance companies.

Cost approach

Appraisers setting value using the *cost approach* calculate the current construction cost to replace the improvements. From the replacement cost, appraisers subtract their estimate of the accrued **depreciation** of the existing improvements due to *obsolescence* and *deterioration* to get the current replacement value of the improvements.

Added to this is the value of the land as though it was vacant. Thus, the appraised market value under the cost approach is the result of totaling the value of the lot plus the cost to replace the improvements minus obsolescence and physical deterioration (depreciation).

cost approach
An appraisal method used by an appraiser to arrive at a property's value based on the present cost of constructing the present improvements and acquisition of the land.

The cost approach is best used when valuing *new buildings* and *special* or *unique structures,* such as churches and factories.

Also, an appraiser places more emphasis on the cost approach when recent comparable sales are not sufficient or the property has no income.

Estimating the cost of improvements which would be incurred today to construct the improvements as they exist on the property involves the calculation of **direct** and **indirect** costs.

Direct costs include labor and materials used to construct the improvements.

Indirect costs include expenditures other than labor and materials, including permits and other governmental fees, insurance, taxes, administrative costs and financing charges.

Estimated replacement cost under the cost approach

The estimated replacement cost of the existing improvements is determined using one of four methods:

- **comparative-unit method**: estimates the cost in terms of dollars per square foot or per cubic foot based on known costs of similar structures, adjusted for physical differences;
- **unit-in-place method**: estimates the unit costs for building components such as foundations, floors, walls, windows and roofs, as well as labor and overhead;
- **quantity survey method**: the most comprehensive and accurate method for estimating the cost of the labor and materials a general contractor would use to build an identical structure, such as lumber, cement, plumbing, electrical, roofing, stucco, glazing, drywall, insulation and labor costs; and
- **index method**: the method designed for use in updating historic costs or backdating current costs such as in probate valuations where it is required to establish a number at an earlier date.

After the appraiser estimates the replacement costs, the next step is to estimate and deduct depreciation.

Estimated depreciation cost under the cost approach

Depreciation reflects any value-related loss in the property due to use, decay and improvements that have become outdated.

There are three types of depreciation:

1. **Physical deterioration** is the loss in the property's value due to wear and tear. Physical deterioration can be curable or incurable. Examples include damage from termites or damage resulting from deferred maintenance and negligent care.
2. **Functional obsolescence** is any loss in the property's value due to outdated style or non-usable space. Examples include antique fixtures, a one-car garage or an outdated kitchen.
3. **Economic obsolescence** is the loss in property value due to changes in the property's neighborhood. Economic obsolescence is external to the property. For example, a property's value may decrease due to increased noise and traffic if a freeway is built next to it.

The income approach

There are two methods of calculating the property's value under the **income approach**:

- the **gross rent multiplier (GRM)** method; and
- the **capitalization method**.

income approach
One of three methods of the appraisal process applied to income producing property to develop the appraiser's opinion of value.

Property appraised using the income approach includes:

- apartments;
- offices;
- industrial buildings;
- commercial units; and
- other income-producing property.

The *GRM method* uses the market rent (determined by a survey of similar properties) of the subject property which is then multiplied by a factor, the GRM, to arrive at a value for the subject property. The GRM factor is determined by comparing the subject property to similar properties that have recently been sold.

The *capitalization method* determines the property's value based on the property's future income and operating expenses.

The first step to establish value using the capitalization approach is to determine the property's **effective gross income**. A property's *effective gross income* is its gross income minus vacancies and collection losses. [See **RPI** Form 352]

Determine the net operating income

The second step is to deduct **operating expenses** from the effective gross income to determine the property's *net operating income* (NOI). Operating expenses include such items as:

- property taxes;
- insurance;
- security;
- management fees;
- utilities; and
- maintenance.

Operating expenses that vary, such as utilities and repairs, are called **variable costs**. Operating costs that remain constant, such as property taxes, security services and insurance, are called **fixed costs**.

Net operating income divided by cap rate

The third step is to mathematically divide the property's NOI by the appropriate **capitalization rate (cap rate)**. The cap rate is comprised of a prudent investor's expected annual *rate of return* on monies invested in this type of property (adjusted for inflation and risk premiums), and a *rate of recovery* of their invested monies allocated to the improvements, also called *depreciation*.

Thus, the FMV of the property is determined by dividing the NOI by the cap rate. For example, if a property's NOI is $100,000 annually, and a cap rate of 10% is used, the property's value under the income approach would be $1,000,000.

The rate of interest paid on mortgages and the amount or terms of mortgage debt on a property have no bearing on a property's market value. The property is viewed as being clear of any monetary encumbrances.

Correlation of values

The next step in the appraisal process is the correlation or reconciliation of the values arrived at under each of the three approaches described previously.

The process selects the most appropriate value from the values arrived at by using the three approaches.

The appraisal report

The final step in the process is the creation of the complete appraisal report. It is the documentation of the appraiser's findings. The types of appraisal reports include:

- *short summary report* – a filled-in form using checks and explanations;
- *letter form* – a brief written report; and
- *self-contained* or *narrative* – an extensive written report.

The following information is included in the appraisal report:

- the property's description;
- the purpose and scope of the appraisal;
- description of the neighborhood;
- the date on which the value is estimated;
- qualifying conditions and assumptions;
- factual data, photos and maps with analyses;
- the estimate of value; and
- the name, address, type of license and signature of the appraiser.

Appraiser licensing

All appraisers are required to hold a license or certification issued by the **California Bureau of Real Estate Appraisers (BREA)**.

The license/certification categories are:

- **Trainee appraiser** – allows the trainee to work on the appraisal of properties under the direct supervision of an appraiser licensed to appraise those properties.
- **Residential appraiser** – allows the appraisal of one-to-four residential units up to $1 million and nonresidential property up to $250,000.
- **Certified residential appraiser –** allows the appraisal of one-to-four residential units of any dollar amount and nonresidential property up to $250,000.
- **Certified general appraiser** – allows the appraisal of any type of real estate and transaction value or complexity.

Justifying the buyer's price is another matter

When a buyer locates a property and contracts to pay a price to buy it, the property needs to be qualified as *collateral* which will provide adequate security for the repayment of the mortgage amount in the event of a default.

This task of valuation falls to third-parties in the transaction, parties that are indirectly hired by the lender. However, the buyer has an even greater interest in knowing they have paid the right price than does the lender. A buyer is unable to contact or discuss the price with the third-party appraiser. The buyer is permitted to receive a copy of the appraisal report and may appeal the results based on factual information that is found to be in error, such as amenities not considered in the report.

Appraisals under federal law

It is unlawful to violate appraisal independence, including:

- coercing, extorting, colluding with, instructing, bribing or intimidating any appraisal professional into appraising property at a value based on any factor other than the independent judgment of the appraiser;
- mischaracterizing the appraised value of a property to secure a mortgage;
- influencing or encouraging an appraiser to meet a targeted value for a property; and
- withholding or threatening to withhold payment for an appraisal report or service.[1]

This does not prohibit anyone with an interest in the transaction from asking an appraiser to:

- consider *additional relevant property information*, including information regarding comparable properties;
- provide *further explanation* for the valuation;
- *correct errors* in the appraisal report; or
- obtain *multiple valuations* in order to assure reliability in value assessment.

No interest in property appraised

No appraiser or appraisal company may have an interest, financial or otherwise, in the property being appraised.

If a lender is aware of a violation of appraisal independence, they are prohibited from using that appraisal report to make a mortgage, unless the lender has confirmed that the appraisal does not misrepresent the value of the property.

Lenders and their agents need to compensate *fee appraisers* at a rate that is reasonable in the market area of the property being appraised. A fee appraiser may charge a fee for complex assignments that reflects the increased time, difficulty and scope of the work performed.

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1 15 United States Code 1631 §129E

Chapter 29 Summary

An appraisal is an individual's opinion of a property's value on a specific date, reduced to writing in an appraisal report. The appraisal report contains data collected and analyzed by the appraiser which substantiates the appraiser's estimate of the property's value.

The appraisal process consists of six steps:

- identifying and defining the appraisal effort to be undertaken by the appraiser;
- data collection, including both general data on the area surrounding the property, and specific data on the improvements and property lot;
- analyzing the data;
- applying the three approaches to value;
- reconciling the approaches and determining the final value of the property; and
- creating the complete appraisal report.

When applying the data collected, each of the three appraisal approaches are used:

- the comparative market approach;
- the cost approach; and
- the income approach.

Under the market comparison approach, the appraiser looks at the current selling prices of similar properties to establish the comparable value of the property appraised. Adjustments are made for any differences in the similar properties, such as their location, amenities and condition.

Under the cost approach, the appraiser sets a property's value by calculating the construction cost to replace the improvements at today's prices.

Under the income approach, the appraiser determines the property's value based on future income and operating expenses of the property.

As part of the appraisal process, the appraiser reconciles of values arrived at under each of the three appraisal approaches, selecting the most appropriate value based on the property and objective of the appraisal.

As the final step in the process, the appraiser creates a complete appraisal report.

All appraisers are required to hold a license or certification issued by the California Bureau of Real Estate Appraisers (BREA).

Appraisers are required to maintain independence. It is unlawful to violate appraisal independence by:

- coercing any appraisal professional into appraising property at a value based on any factor other than the independent judgment of the appraiser;
- mischaracterizing the appraised value of a property to secure a mortgage;
- influencing or encouraging an appraiser to meet a targeted value for a property; and
- withholding or threatening to withhold payment for an appraisal report or service.

Chapter 29 Key Terms

appraisal .... **pg. 199**
appraisal report .... **pg. 199**
comparison approach .... **pg. 204**
cost approach .... **pg. 204**
income approach .... **pg. 206**
fair market value (FMV) .... **pg. 200**

Quiz 6 Covering Chapters 24-30 is located on page 611.

Chapter 30

Escrow, the way to perform

Learning Objectives

After reading this chapter, you will be able to:

- understand the steps escrow takes to facilitate the closing of a real estate sale;
- distinguish the various services rendered by escrow and the duties of an escrow officer;
- appreciate how the purchase agreement and the escrow instructions work in tandem to create and close a transaction;
- recognize how agents ensure the escrow instructions conform to the purchase agreement and the intent of the buyer and seller;
- calculate prorations and adjustments for the buyer and the seller in a transaction; and
- advise on who has the right to receive the buyer's funds held in escrow when escrow fails to close.

Key Terms

escrow	**good faith deposit**
escrow instructions	**proration**
escrow officer	**Statute of Frauds**

The execution of a purchase agreement

Escrow is a process employing an independent agent to manage and coordinate the closing of a real estate transaction through the exchange of documents and money between two parties such as a buyer and seller. *Escrow* activities are typically based on a primary agreement, such as a *purchase agreement*.[1]

In mortgage situations, escrow references the accounting by the lender for its management of the receipt and disbursement of funds received from the property owner for the annual payment of property taxes and insurance

1 Calif. Financial Code §17003(a)

premiums (TI) owed by the owner of the secured property. Typically, these funds are collected monthly with the regular principal and interest (PI) payment. Collectively, the mortgage principal, interest, property taxes and insurance premiums are referred to as **PITI**.

escrow
The depository process employed to facilitate the gathering of instruments and funds for use to transfer real estate interests between two persons.

Escrow activity employed to close a real estate transaction consists of:

- *one person*, such as a seller or buyer of real estate, who delivers written documents or money, called **instruments**, to an escrow company for the purpose of fully performing their *obligations owed another person* under an agreement entered into before the escrow is opened for a sale, a mortgage origination or leasing of real estate; and
- *the escrow company*, who receives and delivers the documents and money *to another person*, such as the buyer, seller or third parties, on the occurrence of a specified event or the performance of prescribed conditions, such as the receipt of reports or the issuance of a title insurance policy.[2]

Escrow companies and escrow officers

An individual engaged in the business of acting as an *escrow agent* is called an **escrow officer**. The officer is employed by an **escrow company** and needs to be licensed. Likewise, the *escrow company* is licensed by the Department of Financial Protection and Innovation (DFPI), unless exempt.[3]

escrow officer
An individual licensed and employed as an agent of an escrow company or other escrow service provider to perform escrow services.

Individuals exempt from the escrow licensing requirements include:

- a *licensed real estate broker*, either individual or corporate, who represents a person in the real estate transaction in which the broker will be performing escrow services;
- a *licensed attorney* who does not hold themselves out as an escrow agent;
- a *bank,* trust company, or insurance company; and
- a *title insurance company* whose principal business is preparing abstracts or making searches of title used for issuing title insurance policies.[4]

The services rendered by the escrow officer typically include:

- receiving funds and collecting necessary documents, such as property reports, disclosure statements and title reports called for in the **escrow instructions** [See **RPI** Form 401];
- preparing documents necessary for conveyancing and mortgaging a property required for escrow to close;
- calculating prorations and adjustments; and
- disbursing funds and transferring documents when all conditions for their release have been met.[5]

escrow instructions
Directives an escrow officer undertakes, as given by buyer and seller, or lender and borrower to coordinate the closing on a purchase agreement or mortgage origination. [See **RPI** Form 401]

2 Fin C §17003(a)
3 Fin C §17200
4 Fin C §17006
5 Fin C §17003(a)

The specific duties of the escrow officer, outlined in the *escrow instructions*, vary according to local real estate custom. [See **RPI** Form 401]

Escrow basics

Consider a buyer and seller who enter into a purchase agreement for the sale of the seller's one-to-four unit residence. As provided in the purchase agreement, escrow is opened to handle the closing of the transaction.

In modern real estate practice, *opening escrow* simply means establishing a depository for the **instruments** (deeds, money and other items) with accompanying instructions for their use. Escrow instructions are signed by all necessary persons (the buyer and seller in the case of a sale), each authorizing escrow to transfer or hand their instruments to the other person or third parties on closing.[6]

Before accepting any instruments as an escrow holder for a transaction, an agent of the buyer or seller *dictates instructions* to the escrow officer. The purpose for this communication is to establish precisely when and under what circumstances the documents and monies deposited with escrow are to change hands.

When receiving instructions from an agent, the escrow officer prepares a "**take sheet**" noting all the tasks they are to undertake to handle and close escrow. When drafting escrow instructions, the officer relies on the *take sheet* as a checklist to determine the contents of the instructions.

Increasingly, agents simply email a copy of the purchase agreement to the named escrow company. The escrow officer then drafts escrow instructions as needed for the buyer and seller to comply with their obligations under the purchase agreement. When prepared, the officer sends the written instructions to the agent to verify they conform to the intent of the persons in the transaction.

As a checklist for "going to escrow," a worksheet helps the seller's and buyer's agents to organize the collection of facts and supporting papers the escrow officer needs to draw instructions, clear title conditions and close escrow. [See **RPI** Form 403]

Escrow instructions

An escrow officer will perform only as instructed. *Escrow instructions* are prepared by the escrow officer based on the information received from the seller's agent about the transaction.[7] [See **RPI** Form 401]

In practice, the escrow officer prepares the instructions on forms adopted for this use. Once completed, the instructions are forwarded to the agents of the persons in the transaction for their signatures and return to escrow. When returned, escrow is then *open* for the person who signed and returned the instructions.

6 **Montgomery** v. **Bank of America National Trust & Savings Association** (1948) 85 CA2d 550

7 **Moss** v. **Minor Properties, Inc.** (1968) 262 CA2d 847

Two types of escrow instructions are used in California:

- **bilateral**; and
- **unilateral** instructions.

Throughout most of California, escrow instructions used in real estate sales transactions are *bilateral* in nature. As bilateral escrow instructions, they are entered into by both the buyer and seller. Each signs a copy of the same instructions and hands them to escrow. [See **RPI** Form 401]

In some areas of Northern California, separate sets of *unilateral* escrow instructions are prepared, usually waiting until the transaction is ready to close. Each set of instructions contain only the activities to be performed by or on behalf of one person; one set being the buyer's instructions, the other set the seller's instructions. When escrow determines it has all documents necessary to call for funding and closing the transaction, the officer prepares the separate instructions for signatures of the respective buyers and sellers.

The documents work together

Most modern real estate sales transactions depend on both the purchase agreement and the escrow instructions working in tandem to close a transaction.

Both the purchase agreement and the escrow instructions are *contracts* regarding interests in real estate. Both documents are required to be in writing to be enforceable under the **Statute of Frauds**.[8]

Statute of Frauds
California state law requiring specific types of contracts to be in writing and signed by the person to be charged with performance before they will be enforceable by a court, e.g., purchase agreements and lease agreements for a term of more than one year.

A *purchase agreement* sets forth the:

- sales price;
- terms of payment; and
- conditions to be met before closing. [See **RPI** Form 150]

Escrow instructions constitute an additional agreement entered into by the buyer and seller with an escrow company. Under the instructions, escrow facilitates the completion of the performance required of the buyer and seller in the underlying purchase agreement.

Escrow instructions do not replace the purchase agreement. Instead, the instructions function as directives an escrow officer undertakes to coordinate a closing intended by the terms of the purchase agreement.[9]

Escrow instructions occasionally add exactness and completeness, providing the enforceability sometimes lacking in purchase agreements prepared by brokers or their agents.

A written and signed purchase agreement typically is the primary underlying document in a real estate sales transaction. All further agreements, including the escrow instructions, need to comply with the primary document, unless the parties *intend to modify* the terms of that original agreement.

8 Calif. Civil Code §1624

9 **Claussen** v. **First American Title Guaranty Co.** (1986) 186 CA3d 429

The agents negotiating a transaction are responsible for ensuring the escrow instructions conform to the purchase agreement. This is done by reviewing the instructions prepared by the escrow officer to ensure the intentions of the buyer and seller are clear. Thus, the escrow instructions are reviewed by both agents prior to submitting them to their clients for their review and signatures.

In some instances, the buyer and seller orally negotiate the sale and go directly to escrow, without first memorializing their understandings in a written purchase agreement. In this instance, there is no underlying written purchase agreement generated prior to opening escrow.

Here, the buyer and seller intend the escrow instructions to function as the binding contract documenting the sale. In this situation, in addition to providing closing instructions, the escrow instructions constitute a binding contract between the buyer and seller, satisfying the *Statute of Frauds*.[10]

To provide for a timely closing, the agent dictating instructions collects and hands to the escrow officer all of the information necessary to prepare the instructions and documents.

Modifying escrow instructions

If a dispute between the buyer and seller arises over a point not addressed in the underlying purchase agreement or escrow instructions, the agents need to mediate an agreeable solution.

The negotiated resolution then needs to be added to the escrow instructions by amendment and signed by the buyer and the seller. Signed amended instructions bind the buyer and seller to the terms agreed to in the amended instructions as part of their contractual obligations in the transaction.[11]

Escrow instructions which **modify** the intentions stated or implied in the purchase agreement need to be *written, signed and returned* to escrow by both the buyer and seller. Proposed modifications signed by some but not all parties are not binding on a party who has not agreed to the modifications.[12]

Required escrow disclosures

All written escrow instructions signed by a buyer or seller are to include:

- the escrow agent's name; and
- the name of the California state agency issuing the license or granting the authority under which the escrow agent is operating.[13] [See **RPI** Form 401]

In addition, all escrow transactions for the purchase of real estate where a policy of title insurance will not be issued are to include an **advisory notice** prepared in a separate document and signed by the buyer.

10 **Amen** v. **Merced County Title Co.** (1962) 58 C2d 528

11 **U.S. Hertz, Inc.** v. **Niobrara Farms** (1974) 41 CA3d 68

12 **Louisan** v. **Vohanan** (1981) 117 CA3d 258

13 CC §1057.7

Finally, escrow has a duty to advise the buyer in writing of the *Franchise Tax Board (FTB)* requirements for withholding 3 1/3% of the price paid the seller, unless the seller certifies they are exempt from state income tax withholding.[14]

Prorations

On the close of escrow, buyers and sellers receive a credit or a charge for their proportionate share of income or expenses involved in the ownership or operations of the property being conveyed, called **prorations.**

proration
Provisions entitling the seller to a credit for the portion of prepaid sums which have not accrued on obligations a buyer assumes on the day escrow closes, or entitling the buyer to a credit for amounts assumed which accrued unpaid through the day prior to the close of escrow. [See **RPI** Form 401 §10]

Prorations are usually calculated based on the date escrow closes. However, they may be set based on any date agreed to by the buyer and seller. For calculating prorations based on the date of closing, the entire day of closing is the first day of the buyer's ownership, unless the escrow instructions specify otherwise.

Items which the buyer takes over and are prorated include:

- property taxes;
- interest on mortgages/bonds assumed;
- rent; and
- service contracts assumed by the buyer.

Prorations are initially agreed to in the purchase agreement. Proration provisions entitle the seller to a credit for the portion of prepaid sums which have not fully accrued by the day of closing on items the buyer takes over or receives on the sale. Prorations are based on a 30-day month or a 360-day year.

Conversely, the buyer receives a credit for unpaid amounts assumed by the buyer which accrued through the day prior to the close of escrow. [See **RPI** Form 150 §12.6]

Property taxes are levied for the fiscal year which begins July 1st and ends June 30th of the following calendar year. To prorate property taxes, the beginning of the fiscal year – July 1st – is the starting point for accrual.

Property taxes are paid in one or two installments. The first installment is payable no later than December 10th for the first half of the fiscal year. The second payment is due no later than April 10th for the second half of the fiscal year.

For interest on mortgages, improvement bonds or other debts assumed by the buyer, the seller is charged and the buyer receives a credit for the interest accrued and unpaid during the seller's ownership of the property through the day before the close of escrow.

14 Calif. Revenue and Taxation Code §18662(e)(3)(B)

Prorations on the purchase of income property

On the purchase of income property, the buyer is entitled to a credit for the **prepaid rents** collected by the seller which have not accrued for the remaining days of the month beginning with the day of the close of escrow.

All **security deposits** held by the seller are credited to the buyer as a lump sum adjustment, not a proration. After closing, the buyer is responsible to account to the tenants for the deposits on termination of their tenancies. [See **RPI** Form 585]

The seller is credited for any delinquent unpaid rents which have accrued prior to closing and are to be collected by the buyer, unless otherwise agreed in the purchase agreement and escrow is so instructed.

Funds held in escrow on cancellation

When escrow fails to close, a buyer's **good faith deposit** toward the payment of the purchase price of a one-to-four unit residential property is returned within 30 days after the person entitled to the funds demands them. If disputed by the other party, the issue becomes who has the right to receive the funds deposited in escrow.[15]

A seller or buyer who wrongfully refuses to release the buyer's good faith escrow deposit is liable for a money penalty of three times the amount wrongfully withheld, called **treble damages**. *Treble damages* need to be greater than $100 but less than $1,000, plus attorney's fees.[16]

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]

Usually the dispute arises on the seller's claim they are entitled to the deposit under a *forfeiture-of-deposit* provision in the purchase agreement. However, the seller is not entitled to any of the buyer's funds unless the seller has suffered **out-of-pocket money losses** due to a breach by the buyer.

Unless escrow receives mutual instructions to disburse the funds held in escrow when escrow fails to close, the escrow company deposits the funds with the court. This relieves escrow of any further responsibility to account for the funds, called an **interpleader**. Thus, escrow can close out its trust account on this escrow file.[17]

Good faith dispute over deposits

Release of deposited funds is not required if a legitimate **good faith dispute** exists between the buyer and the seller over entitlement to the funds.[18]

Neither the buyer nor seller will be entitled to any penalty or statutory attorney's fees on resolution of a *good faith dispute*.

The good faith standard for an individual's refusal to release escrowed funds requires a *reasonable belief* by the individual of their right to the funds.[19]

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15 CC §1057.3
16 CC §1057.3
17 Calif. Code of Civil Procedure §386; **Security Trust & Savings Bank** v. **Carlsen** (1928) 205 C 309
18 CC §1057.3(f)(2)
19 CC §1057.3(c)

Chapter 30 Summary

Escrow is a process employed to facilitate the closing of a transfer of real estate interests by two parties. Escrow activity consists of:

- one person, such as a seller or buyer of real estate, delivering written documents or money to an escrow company for the purpose of fully performing their obligations owed another person under an agreement; and
- the escrow company delivering the documents and money to the other person on the occurrence of a specified event or the performance of prescribed conditions.

The services rendered by escrow agents typically include:

- receiving funds and gathering necessary documents, called instruments;
- preparing documents necessary for conveyancing and mortgaging a property required for escrow to close;
- calculating prorations and adjustments; and
- disbursing funds and transferring documents when all conditions for their release have been met.

Most modern real estate sales transactions depend on both the purchase agreement and the escrow instructions working in tandem to close a transaction. Both the purchase agreement and the escrow instructions must be in writing to be enforceable under the Statute of Frauds.

Agents negotiating a transaction are responsible for ensuring the escrow instructions conform to the purchase agreement and the intent of the parties.

On the close of escrow, buyers and sellers receive a credit or a charge for their proportionate share of income or expenses, called prorations.

When escrow fails to close, a seller or buyer who wrongfully refuses to release the buyer's good faith escrow deposit is liable for a money penalty of three times the amount wrongfully withheld. Release of deposited funds is not required if a legitimate good faith dispute exists between the buyer and the seller over entitlement to the funds.

Chapter 30 Key Terms

Quiz 6 Covering Chapters 24-30 is located on page 611.

Chapter 31

Basics of California real estate law

Learning Objectives

After reading this chapter, you will be able to:

- understand the origins of California real estate law; and
- discuss the four main constitutional powers of the California legislature to enact laws regulating real estate activities.

Key Terms

administrative agencies	**eminent domain**
civil law	**police power**
common law	

For a further discussion of this topic, see Chapter 1 of Legal Aspects of Real Estate.

The English and Spanish influence

Historically, California real estate law has been influenced by two key sources of human conduct:

- the English legal system, or **common law**; and
- the Spanish legal system, or **civil law**.

The *common law* of England has been the predominate influence on California real estate law. This legal frame work was officially adopted by California soon after obtaining statehood in 1850. [1]

common law
An English legal system in which disputes are decided on a case-by-case basis before a judge applying codes and prior cases.

Under the common law, legal disputes are decided on a case-by-case basis before a judge. Even today, the common law is often called "judge-made" law. When similar legal disputes arise, the judges refer back to earlier decisions to decide current cases. The reliance on an earlier decision to decide a current case is called **stare decisis**. The earlier case relied on is called precedent.

1 Calif. Civil Code §22.2

Similarly, the *civil law* of Spain, while less influential, has nevertheless had a significant impact on California real estate law. Civil law attempts to settle legal disputes by establishing elaborate statutes to address the issues in advance of the disputes, rather than on a case-by-case basis.

American rule

Many land titles in California are based on Spanish and Mexican land grants, as are water rights.

civil law
A Spanish legal system in which an elaborate system of statutes address permissible conduct of the people in advance of disputes.

The Mexican-American War ended with the signing of the Treaty of Guadalupe Hidalgo. Under the treaty, the United States agreed to acknowledge the existing land grants conveyed by the Spanish and Mexican governments.

The United States set up a **land commission** to document the validity of the land grants. The land commission established land titles and created the chain of title still used for all California real estate today.

After confirmation of a valid land grant, the land was surveyed by the federal government and conveyed to the rightful owner by a United States **patent deed**.

All land not under a valid claim became part of the public domain of the United States.

In 1850, the United States granted part of the unclaimed real estate to the State of California. The balance was retained by the federal government.

Authority to legislate

The federal and state legislatures and local governments only enact laws they have been given the power to by the **United States Constitution** or the **California Constitution**.[2]

The authority of the California legislature to enact laws regulating real estate activities comes from four main constitutional powers:

- police power;
- power of eminent domain;
- power to tax; and
- *escheat,* the reverting of property to the state when the owner dies and there are no capable heirs to inherit it.

These four powers can be memorized using the mnemonic device **PETE**.

The United States Constitution confers on California the right to enact laws to protect the public health, safety and welfare.[3]

police power
The basis for enacting local ordinances such as zoning, traffic, health and safety regulations and rent control.

The California Constitution confers an equal power to local cities and counties to likewise protect the public good.[4]

This power to protect the public well-being is called **police power**. *Police power* is the source of the state or local government's authority to act.

2 U.S. Const., Art. I
3 U.S. Const., Amend. X
4 California Constitution, Article XI §7

Police power is the basis for laws governing such things as:

- highway construction and maintenance;
- rent control;
- zoning; and
- traffic.[5]

A statute or ordinance passed under the state or local government's constitutional police power and affecting real estate related activity is valid as long as the law:

- is fair and reasonable;
- addresses a legitimate state interest;
- does not unreasonably burden the flow of interstate commerce; and
- does not conflict with related federal law.

Eminent domain

The second key power of the state to regulate real estate is the power of **eminent domain**.[6]

Eminent domain is the right of the government to take private property for public use.

However, the government is required to pay the owner the fair market value (FMV) of the property taken.[7]

The process of using the power of eminent domain is called **condemnation**.

eminent domain
The right of the government to take private property for public use on payment to the owner of the property's fair market value.

Examples of eminent domain include condemning property to:

- provide highways and roads;
- establish parks;
- construct flood control levees; and
- provide land for redevelopment.

The power to tax

State and local governments also regulate the crucial **power to tax** real estate activities to generate revenue and fund state and local governmental functions under their police power.[8]

For example, a city passes an ordinance which imposes an *inspection fee* on all landlords renting residential properties. The fee charged is based on a flat rate per unit, not on current property values.

A landlord subject to the ordinance claims the ordinance is unenforceable since the city needs to have voter approval before adopting an ordinance imposing a regulatory fee on their property.

5 **Village of Euclid, Ohio** v. **Ambler Realty Co.** (1926) 272 US 365
6 Calif. Const., Art. 1 §19
7 **Loretto** v. **Teleprompter Manhattan CATV Corp.** (1982) 458 US 419
8 Calif. Const., Art. XIII D §6

The city claims the ordinance is enforceable without voter approval since the fee is imposed on a *use* of the property — renting — not on the mere ownership of the property, which would require voter approval.

Here, the ordinance imposing the inspection fee on residential landlords based on a flat rate is enforceable. Voter approval is only required when fees and taxes are imposed on owners simply because they own real estate. Fees and taxes imposed on the owner's exercise of their use and rights which come from owning the property do not require voter approval.[9]

When federal and state law conflict

States have the sovereignty to regulate within their own borders. At the same time, the federal government has the right to regulate local activities affecting commerce.

Thus, it is possible for federal and state law to regulate the same real estate activity. Generally, the more restrictive rule controls.

For example, there are federal and state *fair housing laws* prohibiting discrimination. Both the state and federal governments can regulate fair housing. The state may provide more but cannot afford less protection than the federal law.[10] [See Chapter 7]

A federal law will **preempt** state and local statutes and ordinances when:

- the federal interests outweigh local interests;
- the federal law is so pervasive as to exclude inconsistent state law; and
- inconsistent treatment nationwide would result if state law controls.

Administrative agencies

administrative agencies
A government entity created by the state or federal legislature and local governing bodies to oversee specialized matters. Most have legislative, executive and judicial authority.

As general real estate law becomes more specialized, the role of **administrative agencies** become increasingly important.

Many administrative agencies are given the powers of all three branches of the government:

- legislative;
- executive; and
- judicial.

For example, consider a rent control board established by a local city council under **rent control ordinances**. The board is given authority to enact regulations to implement the *rent control ordinance*. This enactment of regulations is a legislative activity.

The board is also given the power to hear disputes between tenants and landlords, and dispense penalties for a landlord's failure to comply with the law. This is a judicial activity.

9 Apartment Association of Los Angeles v. City of Los Angeles (2001) 24 C4th 830
10 CC §51

In this way, the administrative rent control board has the authority to enact regulations (entailing legislative authority) and hear disputes and administer penalties for noncompliance (entailing judicial authority).

A landlord can always challenge the board in court to determine whether the board has overstepped its power.

The trend with the courts is to continue to give administrative agencies the necessary powers to judge cases involving their own regulations. Thus, the courts themselves are relieved of processing and resolving these disputes.

Chapter 31 Summary

Historically, California real estate law has been influenced by the English legal system (common law) and the Spanish legal system (civil law). Under common law, legal disputes are decided on a case-by-case basis before a judge. Civil law attempts to settle legal disputes by establishing elaborate statutes to address the issues in advance of the disputes.

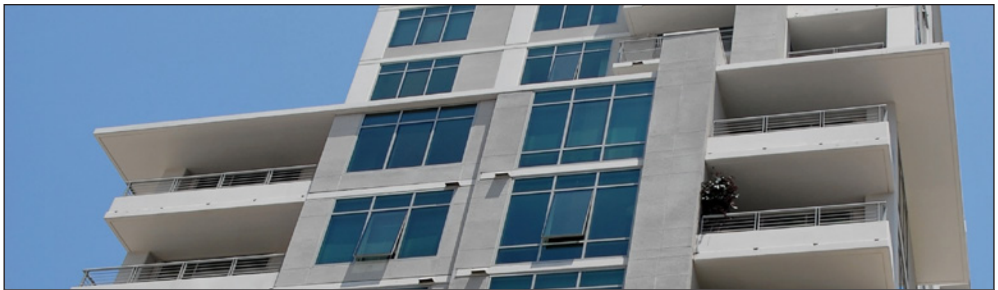
The authority of the California legislature to enact laws regulating real estate activities comes from four main constitutional powers:

- police power, the source of the state or local government's authority to act;
- power of eminent domain, the right of the government to take private property for public use;
- power to tax, the right of the government to impose taxes to generate revenue and fund state and local governmental functions; and
- escheat, the reverting of property to the state when the owner dies and there are no capable heirs to inherit it.

Chapter 31 Key Terms

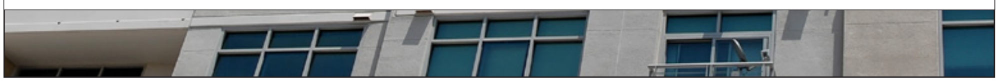
Quiz 7 Covering Chapters 31-36 is located on page 612.

Notes:



Chapter 32

The real estate exists



Learning Objectives

After reading this chapter, you will be able to:

- distinguish between personal property and real estate;
- comprehend the physical characteristics of real estate;
- understand a property's appurtenant and riparian rights; and
- determine whether an item is a property fixture or trade fixture.

Key Terms

appurtenant rights

common interest development (CID)

mechanic's lien

fixture

lien

personal property

profit a prendre

real estate

riparian right

trade fixture

For a further discussion of this topic, see Chapter 3 of Legal Aspects of Real Estate.

Physical and legal aspects of real estate

For most people, the term "**property**" means a physical or tangible *thing*. However, property can be more broadly defined, focusing on the *rights* which arise out of the object. Thus, property is referred to as a **bundle of rights** in a thing, which for the purposes of this material, is real estate.

Further, property is anything which can be owned. In turn, *ownership* is the right to possess the property owned and use it to the exclusion of others.[1]

The *right to possess* and use property includes the right to:

- occupy;
- sell or dispose;

1 Calif. Civil Code §654

- encumber; or
- lease the property.

real estate
Land and anything permanently affixed or appurtenant to it.

personal property
Moveable property not classified as part of real estate, such as trade fixtures.

Property is divided into two primary categories:

- **real estate**, also called *real property* or *realty*; and
- **personal property**, also called *personalty*.[2]

Real estate is characterized as **immovable**, whereas personal property is **movable**.[3]

Personal property is defined, by way of exclusion, as all property which is not classified as real estate.[4]

While the distinction between real estate and personal property seems apparent at first glance, the difference is not always so clear.

Cutting up the real estate

Real estate can be physically cut up by **severance** of a part of the earth (i.e., removal of minerals). Title to real estate can also be cut up in terms of time, providing sequential ownership.

For example, fee ownership can be conveyed to one person for life, and on their death, transferred by the fee owner to another. Time sharing is another example of the allocation of ownership by time, such as the exclusive right to occupy a space for only three weeks during the year.

Title to real estate can also be *fractionalized* by concurrently vesting title in the name of co-owners, such as tenants-in-common who each hold an undivided (fractional) ownership interest in the real estate.

Possession to real estate can be cut out of the fee ownership for a period of time. For instance, the fee owner of real estate acting as a landlord conveys possession of the property to a tenant under a lease agreement for the term of a *lease*. When the tenancy expires or is terminated, possession of the property will *revert* to the landlord. The landlord retains fee title to the real estate at all times.

Possession can also be cut up by creating *divided interests* in a property, as opposed to undivided interests. For example, an owner can lease a portion of their property to a tenant. The tenant, in turn, can sublease a portion of their space to yet another person, known as a *subtenant*.

lien
Interests in real estate which secure payment or performance of a debt or other monetary obligation.

Other interests in real estate can be created, such as **liens**. *Liens* are interests in real estate which secure payment or performance of a debt or other monetary obligation, such as a:

- trust deed lien; or
- a local property tax lien.

2 CC §657
3 CC §§659, 657
4 CC §§658, 663

On nonpayment of a lien amount, the lienholder can force the sale of the real estate to pay off and satisfy the lien.

Thus, an owner's rights in a parcel of real estate extend beyond the mere physical aspects of the land, airspace and improvements located within the legally described boundaries of the property.

Real estate components

The **physical components** of real estate include:

- the raw land;
- anything affixed to the land;
- anything appurtenant (incidental rights in adjoining property) to the land; and
- anything which cannot be removed from the land by law.[5]

Real estate includes buildings, fences, trees, watercourses and easements within a parcel's horizontal and vertical boundaries. Anything below the surface, such as water and minerals, or above the surface, such as crops and timber, is part of the real estate.

For example, the rental of a boat slip includes the water and the land below it, both of which comprise the total of the rented real estate. Thus, landlord/tenant law controls the rental of the slip.[6]

In the case of a condominium unit, the air space enclosed within the walls is the real estate. The structure itself, land and air space outside the unit are the property of the association or all the owners of the separate parcels within the condominium project, creating what is called a **common interest development (CID)**.[7]

common interest development (CID)
Condominium projects, cooperatives or single family residences in a planned unit development. [See **RPI** Form 135]

The boundaries of real estate

A parcel of real estate is located by defining its **legal description** on the face of the earth. Using the property's *legal description*, a surveyor locates and sets the corners and *horizontal boundaries* of the parcel.

The legal, horizontal boundary description of real estate is documented in numerous locations, such as:

- trust deeds;
- public records of the county where the parcel is located;
- subdivision maps; and
- government surveys relating to the property.

Real estate is three dimensional and reaches perpendicular to the horizontal boundary. In addition to the surface area between boundaries, the classic definition of real estate consists of the soil below to the core of the earth as well as the air space above to infinity.

5 CC §658
6 **Smith** v. **Municipal Court** (1988) 202 CA3d 685
7 CC §4125(b)

All permanent structures, crops and timber within this *inverse pyramid* are also a part of the parcel of real estate. The three dimensional aspect of real estate has its source in the English common law.[8]

Land

The first component of real estate is **land**. *Land* includes:

- soil;
- rocks;
- other materials of the earth; and
- the reasonable airspace above the earth.[9]

The soil and solid materials, such as ores and minerals, are considered land while they remain undisturbed as a part of the earth. For example, unmined gold dormant in the earth is real estate.

However, when the gold is mined, it becomes *personal property* since it is no longer embedded in the earth. The gold has been converted from something immovable — part of the rock below the soil — to something movable.

Minerals in the soil are *severable* from the earth. Also, fee ownership to the soil and minerals can be conveyed away from the ownership of the remainder of the land.

When ownership of minerals in a parcel of land is transferred, the transfer establishes two fee owners of the real estate located within the same legal description — an owner of the *surface rights* and an owner of the mineral rights beneath the surface.

These parties are not co-owners of the real estate, but individual owners of separate vertically located portions of the same real estate. Both fee owners are entitled to reasonable use and access to their ownership interest in the real estate.

Right to extract minerals

For example, an owner sells and conveys the right to extract minerals to a buyer. On conveyance, there now exists:

- a surface owner; and
- a mineral rights owner.

Later, the surface owner conveys the real estate to a developer. The developer subdivides the parcel of real estate and plans to construct homes on the lots.

The mineral rights owner objects to the construction, claiming the homes, if built, would interfere with their right to enter the property and remove their minerals.

Is the mineral rights owner entitled to enter the property to remove the minerals?

8 CC §659
9 CC §659

Yes! But only as necessary to use their mineral rights. The rights of the surface owner and the mineral rights owner are thus balanced to determine the precise surface location to be used to extract the minerals.[10]

profit a prendre
The right to remove minerals from another's real estate.

The right to remove minerals from another's real estate is called a **profit a prendre**.

Oil and gas

Unlike solid minerals which are stationary, oil and gas are mobile. Oil and gas are referred to as being **fugacious matter** as they are transitory.

Oil and gas are perpetually percolating under the earth's surface. Due to their fleeting nature, a real estate owner does not hold title to the physical oil and gas situated under the surface of their real estate. At any given time, a real estate owner will have more or less oil or gas depending on the earth's movements. The ownership interest in unremoved oil and gas referred to as a **corporeal hereditament**.

In California, oil and gas are incapable of being owned until they are actually possessed. Once they have been removed, they become personal property.[11]

A fee owner has the exclusive right to drill for oil and gas on their premises, unless that right has been conveyed away to others for consideration.

Rather than owning the physical oil and gas, the fee owner has a right, called an *incorporeal hereditament,* to remove the oil or gas for their purposes.[12]

A land owner has the right to extract all the oil and gas brought up from their real estate even if it is taken from an underground pool extending into an adjoining owners' real estate.[13]

However, an owner cannot slant drill onto another's property to reclaim the oil or gas that has flowed from their property.[14]

Airspace

Land also includes the *airspace* above the surface of a property. Under traditional English common law, the right to airspace continued to infinity. However, modern technological advances have altered the legal view on airspace.

For example, an owner runs a farm near a military airport with heavy air traffic. The government expands the military base by extending the runway to accommodate larger (and louder) aircraft. The aircraft, on their approach to the airport, now fly directly over the farmer's barn, scaring the animals and causing the farmer financial loss.

The farmer sues the government for trespass on their real estate since the airspace is being occupied by others — the military.

10 Callahan v. Martin (1935) 3 C2d 110
11 Callahan, supra
12 **Gerhard** v. **Stephens** (1968) 68 C2d 864
13 **Alphonzo E. Bell Corporation** v. **Bell View Oil Syndicate** (1938) 24 CA2d 587
14 Alphonzo E. Bell Corporation, supra

Can the owner keep the aircraft from flying into their real estate?

No! The common law doctrine regarding the ownership of airspace to the edge of the universe is obsolete. The owner only owns the airspace necessary to allow them a *reasonable use* of their real estate. The owner's real estate extends only so far above the surface of the earth as can be reasonably occupied or used in connection with the land.[15]

However, when the flight of airborne vehicles intrudes upon an owner's *use and enjoyment* of their real estate below, the intrusive entry may constitute a **taking** of the real estate. The continued noise and disturbance of low-flying aircraft has effectively *taken* something from the owner – the quiet use and enjoyment of their property. Thus, the owner is to be compensated for their loss.[16]

Other blue sky to be sold

The *airspace* portion of land has also been modernized with the concept of the **condominium**. An owner of a *condominium* unit legally owns the right to occupy the *parcel of airspace* they have acquired which is enclosed between the walls, ceilings and floors of the structure.

Included in these ownership rights are incidental rights of *ingress* and *egress*, called **appurtenances**. Also included is the *exclusive right* to use other portions of the real estate for storage and parking, plus an undivided fractional interest in the common areas, directly or through a homeowners' association (HOA).[17]

Also, the installation of **active solar collectors** has led to the right of access to sunlight and air which passes through airspace above property owned by others. This right of access to the sun for a solar collector is considered an *easement*.[18]

Water

Water in its natural state is considered land since it is part of the material of the earth. While water is real estate, the right to use water is an *appurtenant* (incidental) right to the ownership of real estate. [See Chapter 36]

Three key rights in water include:

- the right to **use water**;
- the right to take water by **appropriation**; and
- the right to take water by **prescriptive rights**.

The right to use water is called a **riparian right**. *Riparian rights* refer to the rights of a real estate owner to take surface water from a running water source contiguous to their land, such as a river or stream.[19]

riparian right
The right of a real estate owner to take surface water from a running water source contiguous to their land.

15 United States v. Causby (1946) 328 US 256
16 Causby, supra
17 CC §4125
18 Calif. Public Resources Code §§25980 et seq.; CC §801.5(a)(1)
19 Calif. Water Code §101

The right to take water can be acquired by *appropriation*. The appropriator of water diverts water from a river or watercourse to their real estate for reasonable use.[20]

Also, an individual may obtain *prescriptive rights* in water by wrongfully appropriating nonsurplus water openly and adversely under a claim of right for an uninterrupted period of at least five years.[21]

However, all water in the state of California belongs to the people based on a *public trust* doctrine. Riparian, appropriation, and prescriptive rights are subject to the state's interest in conserving and regulating water use.[22]

Affixed to the land

Real estate includes things which are affixed to the land. Things may be affixed to the land by:

- roots (e.g., shrubs and trees);
- embedment (e.g., walls);
- permanently resting (e.g., structures); or
- physically attached (e.g., by cement or nails).[23]

Things attached to the earth naturally are real estate. Natural fixtures to the land, called **fructus naturals**, include:

- trees;
- shrubs; and
- grass.

However, natural items planted and cultivated for human consumption and use are fruits of labor, called **fructus industriales,** also known as **emblements**.

Fructus industriales include such things as crops and standing timber. Crops and timber are ordinarily considered real estate. However, industrial crops and standing timber sold under a purchase agreement and scheduled to be removed are considered personal property.[24]

fixture
Personal property permanently attached to real estate and conveyed with it.

Fixtures

A **fixture** is personal property which has become *permanently attached* to real estate. As it is permanently attached, it effectively becomes part of the real estate and is conveyed with it.[25]

Factors which determine whether an item is a fixture or removable improvement include:

- manner of attachment
- agreement between the parties;

20 In re Water of Hallett Creek Stream System (1988) 44 C3d 448
21 **City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224
22 Wat C §101
23 CC §660
24 Calif. Commercial Code §9102(a)(44)
25 CC §660

- relationship of the parties;
- intention of the parties; and
- adaptability of attachment to the real estate's use.[26]

These factors can be memorized using the mnemonic device **MARIA**.

The most important factor when determining whether an item is a fixture or improvement is the **intent of the parties**.

Intent to make an item a permanent part of the real estate as a fixture is determined by:

- the manner of attachment; and
- the use and purpose of the item in dispute.

For example, when an item is attached to real estate by bolts, screws, cement or the like, the item is a fixture and part of the real estate. An item need not be attached to the real estate in this manner to be a fixture. Items of such weight and size that gravity maintains them in place are sufficient to give the item the character of permanence and affixation to be real estate.

Also, the item may be *constructively attached* when the item is a necessary, integral or working part of improvements on the real estate.

Trade fixtures

Fixtures which are used to render services or make products for the trade or business of a tenant are called **trade fixtures**.

trade fixture
A fixture used to render services or make products in the trade or business of a tenant.

Trade fixtures are to be removed by the tenant on termination of the tenancy, unless agreed to the contrary with the landlord. The removal cannot unduly damage the real estate.[27]

Thus, trade fixtures are considered *personal property*.

To be considered a trade fixture, a fixture needs to be an essential part of the tenant's business and its removal cannot substantially damage the real estate.

In the instance of a beauty salon, trade fixtures would include:

- mirrors;
- dryers; and
- sink bowls and installed wash stations.[28]

Appurtenant rights

Real estate also includes any **incidental rights** which are not located on the real estate nor reflected on its title, called **appurtenant rights**. *Appurtenant rights* include the right of ingress and egress (entry and exit) across adjoining properties.[29]

26 **San Diego Trust & Savings Bank** v. **San Diego County** (1940) 16 C2d 142
27 CC §1019
28 **Beebe** v. **Richards** (1953) 115 CA2d 589
29 CC §662

An *appurtenant easement* is an interest held by an owner of one parcel of real estate to use adjoining real estate. [See Chapter 40]

appurtenant rights
Incidental property rights which are not located on a parcel of real estate nor reflected on its title, including the right of ingress and egress across adjoining properties.

Under an appurtenant easement, an owner's **right to use** adjoining real estate is part of their real estate, although it is not reflected on the title to the real estate. This right to use adjoining property *runs with the land* and is automatically conveyed with the real estate when the owner sells it. Appurtenant rights remain with the real estate they benefit and do not transfer from person to person.

Other appurtenant rights to real estate include the right to the *lateral and subjacent support* provided by the existence of adjoining real estate. For example, the owner of real estate cannot remove soil from their land if doing so causes the adjoining real estate to subside or collapse.

Appurtenant rights held by an owner of one property are a recorded encumbrance on title to the adjacent property burdened by the appurtenant rights, such as an easement.

Chapter 32 Summary

Property is divided into two primary categories: real estate and personal property. Real estate is immovable whereas personal property is movable.

The first component of real estate is land, which includes materials of earth and reasonable airspace above the earth. Oil and gas are incapable of being owned until they are actually possessed. Once they have been removed, they become personal property. While water is considered real estate, the right to use water is an appurtenant (incidental) right to the ownership of real estate

Real estate also includes objects which are affixed to the land, such as fixtures. A fixture is personal property which has become permanently attached to real estate and is conveyed with it. Fixtures which are used to render services or make products for the trade or business of a tenant are trade fixtures. Trade fixtures are to be removed by the tenant on termination of the tenancy, unless agreed to the contrary with the landlord or the removal would cause undue damage the real estate.

Real estate also includes incidental rights, such as an appurtenant easement held by an owner of one parcel of real estate to use adjoining real estate.

Chapter 32 Key Terms

Quiz 7 Covering Chapters 31-36 is located on page 612.

Chapter 33

Fee vs. leasehold

Learning Objectives

After reading this chapter, you'll be able to:

- identify the different interests held in real estate; and
- distinguish the different types of leasehold interests.

Key Terms

estate	**master lease**
fee estate	**parcel**
fixed-term tenancy	**periodic tenancy**
ground lease	**profit a prendre**
leasehold estate	**sublease**
legal description	**tenancy-at-sufferance**
life estate	**tenancy-at-will**

For a further discussion of this topic, see Chapter 4 of Legal Aspects of Real Estate.

A matter of possession

Real estate, sometimes legally called **real property** or **realty,** consists of:

- the land;
- the improvements and fixtures attached to the land; and
- all rights incidental or belonging to the property.[1]

A **parcel** of real estate is located by circumscribing its **legal description** on the "face of the earth." Based on the legal description, a surveyor locates and sets the corners and surface boundaries of the *parcel*. The *legal description* is contained in deeds, subdivision maps or government surveys relating to the property.

parcel
A three-dimensional portion of real estate identified by a legal description.

legal description
The description used to locate and set boundaries for a parcel of real estate.

1 Calif. Civil Code §658

All permanent structures, crops and timber are part of the parcel of real estate. The parcel of real estate also includes buildings, fences, trees, watercourses and easements within the parcel's boundaries.

A parcel of real estate is three dimensional. In addition to the surface area within the boundaries, a parcel of real estate consists of:

- the soil below the parcel's surface to the core of the earth, including water and minerals; and
- the air space above it to infinity.

In the case of a statutory condominium unit, the air space enclosed within the walls is the real estate conveyed and held by the fee owner of the unit. The structure, land and air space outside the unit are the property of the *homeowners' association (HOA)*.

Possessory interests in real estate

estate
The ownership interest a person may hold in real estate.

The ownership interests a person may hold in real estate are called **estates**. Four types of *estates* exist in real estate:

- **fee estates,** also known as *fee simple estates, inheritance estates, perpetual estates*, or simply, *the fee*;
- **life estates**;
- **leasehold estates**, sometimes called *leaseholds*, or *estates for years*; and
- **estates at will**, also known as *tenancies-at-will.*[1]

In practice, these estates are separated into three categories: *fee estates*, *life estates* and *leasehold estates*. Estates at will are considered part of the leasehold estates category. Leasehold estates are controlled by landlord/tenant law.

Fee estates: unbundling the rights

fee estate
An indefinite, exclusive and absolute legal ownership interest in a parcel of real estate.

sublease
A leasehold interest subject to the terms of a master lease.

A person who holds a *fee estate* interest in real estate is a fee owner. In a landlord/tenant context, the fee owner is the landlord.

Editor's note — If a sublease exists on a commercial property, the master tenant is the "landlord" of the subtenant. [See Chapter 76]

A fee owner has the right to possess and control their property indefinitely. A fee owner's possession is exclusive and absolute. Thus, the owner has the right to deny others permission to cross their boundaries. No one can be on the owner's property without their consent, otherwise they are trespassing. The owner may recover any money losses caused by the trespass.

1 CC §761

Exclusive right to use and enjoy

A fee owner has the exclusive right to use and enjoy the property. As long as local ordinances such as building codes and zoning regulations are obeyed, a fee owner may do as they please with their property. A fee owner may build new buildings, tear down old ones, plant trees and shrubs, grow crops or simply leave the property unattended.

A fee owner may *occupy*, *sell*, *lease* or *encumber* their parcel of real estate, give it away or pass it on to anyone they choose on their death. The fee estate is the interest in real estate transferred in a real estate sales transaction, unless a lesser interest such as an easement or life estate is noted. However, one cannot transfer an interest greater than they received.

A fee owner is entitled to the land's surface and anything permanently located above or below it.[2]

The ownership interests in one parcel may be separated into several fee interests. One person may own the mineral rights beneath the surface, another may own the surface rights, and yet another may own the rights to the air space. Each solely owned interest is held in fee in the same parcel. [See Case in point, "Separation of fee interests"]

In most cases, one or more individuals own the entire fee and lease the rights to extract underground oil or minerals to others. Thus, a fee owner can convey a leasehold estate in the oil and minerals while retaining their fee interest. The drilling rights separated from the fee ownership are called **profit a prendre**.[3]

profit a prendre
The right to remove minerals from another's real estate.

Profit a prendre is the right to remove profitable materials from property owned and possessed by another. If the profit a prendre is created by a lease agreement, it is a type of easement.[4]

Life estates and the life tenant

A *life estate* is an interest in a parcel of real estate lasting the lifetime of an individual, usually the *life of the tenant*. *Life estates* are granted by a deed entered into by the fee owner, an executor under a will or by a trustee under an inter vivos trust.

Life estates are commonly established by a fee owner who wishes to provide a home or financial security for another person (the life tenant) during that person's lifetime, called the controlling life.

life estate
An interest in a parcel of real estate lasting the lifetime of the life tenant.

Life estates terminate on the death of the controlling life. Life estates may also be terminated by agreement or by merger of different ownership interests in the property. The holder of a life estate may not impair the fee interest.[5]

Leasehold estates held by tenants

Leasehold estates, or *tenancies*, are the result of rights conveyed to a tenant by a fee owner (or by the life estate tenant or master lessee) to possess a parcel of real estate.

2 CC §829
3 **Rousselot** v. **Spanier** (1976) 60 C3d 238
4 **Gerhard** v. **Stephens** (1968) 68 C2d 864
5 CC §818

leasehold estate
The right to possess a parcel of land, conveyed by a fee owner (landlord) to a tenant.

Tenancies are created when the landlord and the tenant enter into a rental or lease agreement that conveys a possessory interest in the real estate to the tenant.

The tenant becomes the owner of a leasehold with the right to possess and use the entire property until the lease expires. The ownership and title to the fee interest in the property remains with the landlord throughout the term of the leasehold. The landlord's fee interest is subject to the tenant's right of possession, which is carved out of the fee by the lease agreement.

In exchange for the right to occupy and use the property, the landlord is entitled to rental income from the tenant during the period of the tenancy.

Types of leaseholds

fixed-term tenancy
A leasehold interest which lasts for the specific lease period set forth in a lease agreement. A fixed term tenancy automatically terminates at the end of the lease period. [See **RPI** Form 550 and 552]

periodic tenancy
A leasehold interest which lasts for automatic successive rental periods of the same length of time, terminating upon notice from either party. [See **RPI** 551 and 552-5]

tenancy-at-will
A leasehold interest granted to a tenant, with no fixed duration or rent owed. A tenancy-at-will can be terminated at any time by an advance notice from either party.

Four types of leasehold estates exist and can be held by tenants. The interests are classified by the length of their term:

- a **fixed-term tenancy**, simply known as a *lease* and legally called an *estate for years*;
- a **periodic tenancy**, usually referred to as a *rental*;
- a **tenancy-at-will**, previously introduced as an *estate at will*; and
- a **tenancy-at-sufferance**, commonly called a *holdover tenancy*.

A *fixed-term tenancy* lasts for a specific length of time as stated in a lease agreement entered into by a landlord and tenant. On expiration of the lease term, the tenant's right of possession automatically terminates unless it is extended or renewed by another agreement, such as an option agreement. [See Figure 1, Form 552 §3.1]

Periodic tenancies also last for a specific length of time, such as a week or a month. Under a periodic tenancy, the landlord and tenant agree to automatic successive rental periods of the same length of time, such as in a month-to-month tenancy, until terminated by notice by either the landlord or the tenant.

In a **tenancy-at-will** (also known as an *estate at will*) the tenant has the right to possess a property with the consent of the fee owner. Tenancies-at-will can be terminated at any time by an advance notice from either the landlord or the tenant or as set by agreement. Tenancies-at-will do not have a fixed duration, are usually not in writing and a rent obligation generally does not exist.

A **tenancy-at-sufferance** occurs when a tenant retains possession of the rented premises after the tenancy granted terminates. [See Chapter 34]

Leaseholds conveying special uses

In addition to the typical residential and commercial leases, you will find *special use* leases.

Oil, gas, water and *mineral leases* convey the right to use mineral deposits below the earth's surface.

The purpose of an oil lease is to discover and produce oil or gas. The lease is a tool used by the fee owner of the property to develop and realize the wealth of the land. The tenant provides the money and machinery for exploration, development and operations.

The tenant pays the landlord rent, called a **royalty**. The tenant then keeps any profits from the sale of oil or minerals the tenant extracts from beneath the surface of the parcel.

tenancy-at-sufferance
A leasehold condition created when a tenant retains possession of the rented premises after the tenancy has terminated. [See **RPI** Form 550 §3.3]

A **ground lease** on a parcel of real estate is granted to a tenant in exchange for the payment of rent. In a *ground lease*, rent is based on the rental value of the land in the parcel, whether the parcel is vacant or improved. Fee owners of vacant, unimproved land use leases to induce others to acquire an interest in the property and develop it.

An original tenant under a ground lease constructs their own improvements. Typically, the tenant encumbers their possessory interest in a ground lease with a trust deed lien to provide security for a construction loan.

ground lease
A leasehold interest for which rent is based on the rental value of the land, whether the parcel is improved or unimproved.

Master leases benefit fee owners who want the financial advantages of renting fully improved multi-tenant property, but do not want the day-to-day obligations and risks of managing the property.

For instance, the fee owner of a shopping center and a prospective owner-operator agree to a master lease.

master lease
A leasehold interest granted to a master tenant with the right to sublease the property in exchange for rent paid to the fee owner.

Another type of special-use lease is the **farm lease**, sometimes called a *cropping agreement* or *grazing lease*. Here, the tenant operates the farm and pays the landlord either a flat fee rent or a percentage of the value of the crops or livestock produced on the land.

The rights of others in a property

Easements and **use licenses** are not real estate but they give a holder of the rights a limited and nonexclusive use of someone else's property. [See Chapter 40]

An *easement* is a *right to use* another's property for a specific purpose. An easement is an interest held in someone else's real estate. It grants its holder the right to limit the activities of others on the property burdened by the easement, including the owner of the burdened property.[1]

For example, a landowner holds an easement allowing them to construct and have access to a pipeline across their neighbor's property. The neighbor's right to develop their own property is limited since the neighbor may do nothing to interfere with the easement owner's access to the pipeline.

A **license** grants its holder a personal privilege to use property, but no possessory right to occupy it to the exclusion of others. Unlike easements, *licenses* are not exclusive rights — an owner may give many licenses to perform the same or different activity in the same area.

Unlike an easement, a license may be revoked at the will of the person who grants it, unless agreed to the contrary or it has become irrevocable.

1 CC §§801 et seq.

Binding on all future owners

Covenants, conditions and restrictions (CC&Rs), collectively called **encumbrances**, are recorded against title to a property and limit an owner's right to use their property. By recording restrictions against the title to real estate on a sale, a seller may prohibit certain uses of the property, or require the property be used for specific purposes only. [See Chapter 37]

Regulations governing how a condominium owner may use their unit and the rights and responsibilities of the common interest development (CID) are typically contained in a declaration of CC&Rs filed with the condominium subdivision plan.

The CC&Rs bind all future owners to comply with the CC&Rs since the use restrictions they contain run with title to the land. [See Chapter 37]

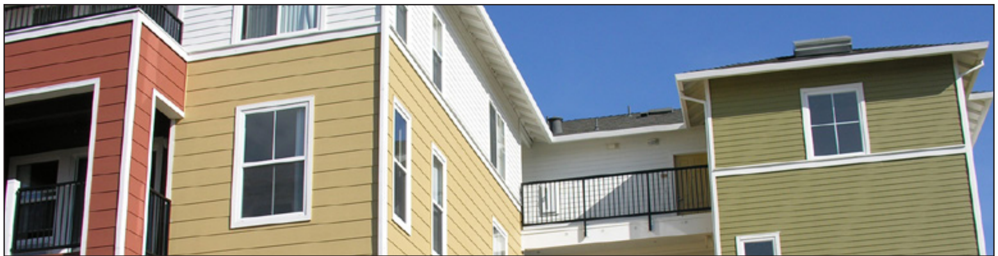
Chapter 33 Summary

Four types of estates exist in real estate: fee estates, life estates, leasehold estates and estates at will. In practice, estates at will are considered leasehold estates. Leasehold estates are controlled by landlord/tenant law.

Four types of leasehold interests exist and can be held by tenants: fixed-term tenancies, periodic tenancies, tenancies-at-will and tenancies-at-sufferance. In addition, several special use leases exist, including ground leases, master leases and subleases.

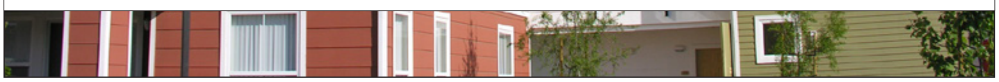
Chapter 33 Key Terms

Quiz 7 Covering Chapters 31-36 is located on page 612.



Chapter 34

The tenancies in real estate



Learning Objectives

After reading this chapter, you'll be able to:

- differentiate between the different types of tenancies; and
- understand how each tenancy is established and terminated.

Key Terms

holdover rent	**rental agreement**
holdover tenant	**trespasser**
lease agreement	**unlawful detainer (UD)**

For a further discussion of this topic, see Chapter 2 of Landlords, Tenants and Property Management.

Tenancies as leasehold estates

Different types of tenancies and properties trigger different termination procedures for the landlord, and different rights and obligations for the tenant.

Leasehold estates, or tenancies, are possessory interests in real estate. Four types of **tenancies** exist:

- *fixed-term tenancies*;
- *periodic tenancies*;
- *tenancies-at-will*; and
- *tenancies-at-sufferance*, also called *holdover tenancies*.

To initially establish a tenancy, a landlord transfers to the tenant the right to occupy the real estate. This right is conveyed either in a writing, orally or

Case in point

Extended fixed-term lease is not a periodic tenancy

A landlord and tenant orally enter into a six-month lease agreement. Rent for the period is payable monthly. On expiration of the six month lease, the landlord and tenant orally agree to extend the lease for another six-month period.

At the end of the extended term, the tenant refuses to vacate, claiming the landlord must first serve them with a notice to vacate.

Here, the tenant is not entitled to any further notice beyond the agreed-to termination date. The oral occupancy agreement did not create a periodic tenancy, even though it called for monthly rent payments. Instead, the agreement to extend the occupancy created a fixed-term lease with a set expiration date.

*Thus, the tenant's right of possession terminated without further notice on expiration of the orally conveyed six-month period of occupancy, the rent for which was payable monthly. The oral lease agreement was enforceable since it was for a term less than one year. [**Camp** v. **Matich** (1948) 87 CA2d 660]*

trespasser
A person who occupies a property without the owner's transfer of the right to occupy.

by the landlord's conduct, called a *grant*. If the landlord does not transfer by grant the right to occupy, the person who takes possession as the occupant is a **trespasser**.

Fixed-term tenancies, periodic tenancies and tenancies at will have agreed-to termination dates, or can be terminated by notice.

unlawful detainer (UD)
The unlawful possession of a property. [See **RPI** Form 575 -578]

A *holdover* tenancy occurs when a tenant continues in possession of the property after their right to occupy has expired. This holdover of possession without a contractual right is called an **unlawful detainer (UD)**.

A landlord needs to file a judicial *UD* action to have a holdover tenant evicted. To be evicted, a tenant's right of possession under the tenancy granted is to first be terminated either by service of the proper notice or expiration of the lease. Plainly speaking, the tenant needs to unlawfully retain possession of the property before the tenant can be evicted for unlawful detainer.

The type of notice required to terminate a tenancy, other than a fixed-term lease, depends on the period of the tenancy, length of the occupancy and location of the property (e.g., rent control).[1]

The fixed-term tenancy

A fixed-term tenancy, also called a lease or estate for years, is the result of an agreement between the landlord and the tenant for a fixed rental period, also called the *lease term*. If the rental period is longer than one year, the lease arrangement is required to be in writing and signed by the tenant to be enforceable under the *Statute of Frauds*. The written document which sets the terms for rent and conditions for occupancy creating a fixed-term tenancy is called a lease agreement. A **lease agreement** is required to have a commencement date and an expiration date.[2] [See Form 550 in Chapter 77]

lease agreement
The written document which sets the terms of a fixed-term tenancy. [See **RPI** Form 550 and 552 -- 552-4]

1 **Colyear** v. **Tobriner** (1936) 7 C2d 735

2 Calif. Civil Code §§761, 1624

During the term of the lease, the tenancy can only be terminated and the tenant evicted for good cause. Even then, service of a three-day notice to vacate the property (or if curable to cure the breach) is required. [See **RPI** Form 576]

Without the tenant's exercise of any option to renew or extend, a fixed-term tenancy automatically terminates on the expiration date, no notice required.[3]

If a renewal or extension option exists, the lease is renewed or extended by the tenant's exercise of the option or the landlord's acceptance of rent called for in the option.[4] [See Case in point, "Extended fixed-term lease is not a periodic tenancy"]

A fixed-term tenancy provides a tenant with several advantages:

- the right to occupy for the fixed term;
- a predetermined rental amount; and
- limitations on termination or modification.

However, a fixed-term tenancy also has disadvantages for the fixed-term tenant:

- the tenant is liable for the total amount of rent due over the entire term of the lease (less rent paid by any replacement tenant located by the landlord to mitigate losses); and
- the tenant may not vacate prior to expiration of the rental period and assign or sublet the premises to a new tenant if prohibited by provisions in the lease agreement.

The periodic tenancy

If the landlord finds a fixed-term tenancy too restrictive or inflexible for their requirements, a periodic tenancy may be more suitable.

A periodic tenancy is automatically extended for equal, successive periods of time, such as a week or a month, until terminated by notice. The length of each successive period of time is determined by the interval between scheduled rental payments.

Examples of periodic payment intervals include:

- annual rental payments, indicating a year-to-year tenancy;
- monthly rental payments, indicating a month-to-month tenancy; and
- weekly rental payments, indicating a week-to-week tenancy.

A periodic tenancy is intentionally created by a landlord and tenant entering into a **rental agreement**. A rental agreement is the agreement which sets the terms for payment of rent and conditions for possession under a periodic tenancy.

rental agreement
The written document which sets the terms and conditions of a periodic tenancy. [See **RPI** Form 551 and 552-5]

However, the periodic tenancy can also result due to possession under a defective lease agreement. A tenant who takes possession under an

3 Calif. Code of Civil Procedures §1161(1)

4 CC §1945

unenforceable lease agreement (e.g., oral, or unsigned) and pays rent in monthly intervals that the landlord accepts has entered into a month-to-month periodic rental agreement.

A periodic tenancy continues until terminated by a notice to vacate. This right to terminate a month-to-month tenancy by either the landlord or the tenant giving the other a notice to vacate makes a periodic tenancy flexible.[1] [See **RPI** Form 569 and 572; see Chapter 81]

To terminate a periodic tenancy, the notice period is to be at least as long as the interval between scheduled rental payments, but need not exceed 30 days. A residential property exception exists: a 60-day notice is required to terminate a periodic tenancy in a dwelling if the tenant has occupied the property for more than 12 months.[2] [See **RPI** Form 569-1; see Chapter 81]

On a material breach of the rental agreement, a three-day notice to vacate can also be used to terminate a periodic tenancy. [See Form 577 in Chapter 82]

The tenancy-at-will: consent but no rent

The characteristics of a tenancy-at-will include:

- possession delivered to the tenant with the landlord's knowledge and consent;
- possession for an indefinite and unspecified period; and
- no provision for the payment of rent.

Situations giving rise to a tenancy-at-will include:

- when a tenant is granted the right to indefinitely occupy the property in exchange for services rendered [See **RPI** Form 591];[3]
- when a tenant is given possession of property under an unenforceable lease agreement (e.g., a written lease not signed by either party or on terms orally agreed to) — unless rent is accepted which creates a periodic tenancy;[4] or
- when a tenant is given possession of the property while lease negotiations regarding the rent amount are still in progress and rent is not accepted.[5]

For a tenancy-at-will, a written notice to pay rent or quit is required to implement any change in the right to continue to occupy the premises, e.g., change it to a different kind of tenancy or terminate the tenancy.

A tenancy-at-will is automatically terminated if the tenant assigns or sublets their right to occupy the property to another tenant. The new tenant becomes a holdover tenant. Either form of possession is an unlawful detainer and grounds for eviction without notice.[6]

---

1 **Kingston** v. **Colburn** (1956) 139 CA2d 623; CC §1946
2 CC §1946.1
3 **Covina Manor Inc.** v. **Hatch** (1955) 133 CA2d Supp. 790
4 **Psihozios** v. **Humberg** (1947) 80 CA2d 215
5 **Miller** v. **Smith** (1960) 179 CA2d 114
6 **McLeran v. Benton** (1887) 73 C 329

Case in point

Periodic tenancy or tenancy-at-will?

Consider a property manager who rents an apartment to a tenant under a fixed-term lease. At the end of the leasing period, the tenant retains possession and continues to pay rent monthly, which the property manager accepts.

Later, the tenant is served with an appropriate notice to vacate. On the running of the notice period, the tenant refuses to vacate. The tenant claims the notice to vacate served by the landlord merely terminated the tenant's right of possession and made it a tenancy-at-will on expiration of the notice. As a tenant-at-will, they are entitled to an additional three-day notice to vacate before they are unlawfully detaining the property.

*However, an occupancy agreement for an indefinite term with a monthly rent schedule is a month-to-month tenancy. Thus, a tenant is only entitled to one notice to vacate which must expire before a UD action may be filed to evict them. [**Palmer** v. **Zeis** (1944) 65 CA2d Supp. 859]*

Also, a tenancy-at-will terminates on the death of either the landlord or tenant, unless an agreement to the contrary exists.[7]

The holdover tenancy

When a fixed-term or periodic tenancy terminates by prior agreement or notice, the tenant who remains in possession unlawfully detains the property from the landlord. Likewise, a tenant-at-will who receives the appropriate notice to vacate and who remains in possession of the property also unlawfully detains the property. These scenarios create a tenancy-at-sufferance, commonly referred to as a holdover tenancy.

A holdover tenancy also arises on termination of a resident manager when the resident manager's compensation includes the right to occupy a unit rent-free. When the landlord terminates the employment and the resident manager fails to vacate immediately, the resident manager unlawfully detains the premises as a holdover tenant.[8] [See **RPI** Form 591]

A **holdover tenant** retains possession of the premises without any contractual right to do so. Their tenancy has been terminated. Thus, the landlord is not required to provide a holdover tenant with any additional notice prior to commencing eviction proceedings.[9]

holdover tenant
A tenant who retains possession of the rented premises after their right of possession has been terminated, called a tenant-at-sufferance.

A *holdover tenant* no longer owes rent under the expired lease or terminated rental agreement since they no longer have the right of possession. However, the rental or lease agreement usually includes a **holdover rent** provision which calls for a penalty rate of daily rent owed for each day the tenant holds over.

holdover rent
Rent owed by a holdover tenant for the tenant's unlawful detainer of the rented premises as a tenant-at-sufferance. [See **RPI** Form 550 §3.3]

If the rental or lease agreement does not contain a *holdover rent* provision, the tenant owes the landlord the reasonable rental value of the property. This is a daily rate owed for each day the tenant holds over. [See **RPI** Form 550]

7 **Dugand** v. **Magnus** (1930) 107 CA 243
8 **Karz** v. **Mecham** (1981) 120 CA3d Supp. 1
9 CCP §1161

Holdover rent is not due and is not to be collected by the landlord until the tenant vacates or is evicted. On vacating, the holdover period is known and the amount owed can be determined, demanded and collected. If it is not paid on demand, rent can be collected by deducting it from any security deposit or obtaining a money judgment.

But a caution to landlords: acceptance of any holdover rent prior to a tenant vacating or being evicted by a UD action has unintended consequences.

Changing the type of tenancy

A landlord, on using a proper notice, can create a different tenancy from the one they initially conveyed to the tenant. A tenant's possessory interest in real estate can shift from one type of tenancy to another due to:

- a notice from the landlord
- expiration of a lease; or
- by conduct of the landlord.

A classic example involves a change in the type of tenancy which arises when a holdover tenant under an expired lease agreement becomes a month-to-month (periodic) tenant.

A landlord who accepts any rent from a holdover tenant under an expired lease has elected by their conduct to treat the continued occupancy as a periodic tenancy.[1]

Thus, the prerequisite to filling a UD eviction action when the holdover tenant pays rent for any part of the continued occupancy which the landlord accepts, and thus creates a periodic tenancy, is the service of a proper notice to vacate.[2]

If a landlord accepts rent from a holdover tenant after a fixed-term tenancy expires, the expired lease agreement is renewed on the same terms except for the period of occupancy, which is now periodic – month-to-month.[3]

Continued acceptance of payments

On expiration of a fixed-term lease, the landlord's continued acceptance of rental payments does not renew the tenancy for another term equal to the term of the original lease. Rather, the tenancy is extended as a periodic tenancy for consecutive periods equal to the interval between rent payments — hence, one month if rent on expiration of the lease is paid monthly.[4]

A landlord who wants to terminate a periodic tenancy they created by accepting rent after expiration of a lease is to serve the tenant with the proper notice to vacate and let it expire. On expiration of the notice, the tenant who remains in possession of the premises is unlawfully detaining the premises and the landlord may file a UD action to evict them.

1 **Peter Kiewit Sons Co**. v. **Richmond Redevelopment Agency** (1986) 178 CA3d 435

2 Colyear, *supra*

3 CC §1945

4 CC §1945

A landlord and tenant can by agreement establish a shorter or lengthier notice period than the period of the tenancy. However, the notice period cannot be less than seven days.

Other rules for terminating a tenancy

Overriding rules also exist for different types of properties and situations. For example, in a rent-controlled residential tenancy, terminating the right of possession is restricted by local ordinances.

With a tenancy-at-will in a mobile home park, the tenant needs to be given a 60-day written notice.[5]

Industrial and commercial tenants often provide three months minimum notice before the notice expires due to the time spent in multiple tiers of corporate management for receiving and responding to a notice.[6]

In some instances with foreclosed residential properties, an extended 90-day notice period is required to terminate the tenancies created before the foreclosure sale. [See Chapter 81]

5 CC §798.55(b)

6 CC §1946

Chapter 34 Summary

A fixed-term tenancy is the result of an agreement between the landlord and the tenant for a fixed rental period. A periodic tenancy automatically continues for equal, successive periods of time, such as a week or a month.

In a tenancy-at-will, possession is delivered to the tenant with the landlord's knowledge and consent for an indefinite and unspecified period, usually without requiring rent. A holdover tenancy is the result of a tenant retaining possession of a rented premises without any contractual right to do so.

A tenant's possessory interest in real estate can shift from one type of tenancy to another based on conduct.

The type of notice required to terminate occupancy depends on the period of the tenancy or occupancy and the property type and location.

Chapter 34 Key Terms

Quiz 7 Covering Chapters 31-36 is located on page 612.

Tenant leasehold improvements

Chapter 35

Learning Objectives

After reading this chapter, you will be able to:

- identify the different types of tenant improvements;
- understand the landlord's rights and tenant obligations regarding tenant improvements on termination of the lease; and
- determine the landlord or tenant's obligation to complete or pay for the construction of tenant improvements.

Key Terms

further improvements provision

mechanic's lien

notice of nonresponsibility

permissive improvement

real estate fixture

reversion

tenant improvements

trade fixture

For a more intensive analysis of this topic, see Chapter 4 of Landlords, Tenants, and Property Management.

Ownership rights when a tenant vacates

A retail business owner enters into a commercial lease agreement to occupy commercial space as a tenant. The leased premises do not contain **tenant improvements (TIs)** since the building is nothing more than a shell. [See **RPI** Form 552 through 552-4]

tenant improvements
Improvements made to a leased property to meet the needs of the occupying tenant. [See **RPI** Form 552 §11]

The tenant agrees to make all the tenant improvements needed to occupy the premises and operate a retail business (i.e., interior walls, flooring, ceilings, air conditioning, electrical outlets and lighting, plumbing, sprinklers, telephone and electronic wiring, etc.).

The lease agreement provides for the property to be delivered to the landlord on expiration of the lease "in the condition the tenant received it," less normal wear and tear. However, no lease provision addresses whether, on expiration of the lease, the TIs will remain with the property or the property is to be restored by the tenant to its original condition before the addition of the tenant improvements.

On expiration of the lease, the tenant strips the premises of all of the tenant improvements they placed on the property and vacates. The building is returned to the landlord in the condition it was found by the tenant: an empty shell, less wear and tear. To relet the space, the landlord replaces nearly all the tenant improvements that were removed.

Is the tenant liable for the landlord's costs to replace the tenant improvements removed by the tenant on vacating?

Yes! Improvements made by a tenant that are permanently affixed to real estate become part of the real estate to which they are attached. Improvements remain with the property on expiration of the tenancy, unless the lease agreement provides for the tenant to remove the improvements and restore the property to its original condition.[1]

However, the landlord's right to improvements added to the property and paid for by the tenant depends upon whether:

- the tenant improvements are permanent (built-in) or temporary (free-standing); and
- the lease agreement requires the tenant to remove improvements and restore the premises.

All improvements attached to the building become part of the real estate, except for trade fixtures (as discussed later in this chapter).[2]

further-improvements provision
A commercial lease provision which allows a landlord to retain tenant improvements or require the restoration of the property to its original condition upon expiration of the lease. [See **RPI** Form 552 §11.3]

Examples of improvements that become part of the real estate include:

- built-ins (i.e., central air conditioning and heating, cabinets and stairwells);
- fixtures (i.e., electrical and plumbing);
- walls, doors and dropped ceilings; and
- attached flooring (i.e., carpeting, tile or linoleum).

Leasehold improvement provisions

Commercial lease agreements typically contain a **further-improvements provision** allowing the landlord to either:

- retain tenant improvements and alterations made by the tenant; or
- require restoration of the property to its original condition on expiration of the lease. [See **RPI** Form 552]

Further-improvement provisions usually include clauses stating:

- who will make the construction of improvements (landlord or tenant);

1 Calif. Civil Code §1013
2 CC §660

- who will pay for the construction of the improvements (landlord or tenant);
- the landlord's consent is required before the tenant makes improvements;
- any *mechanic's liens* due to improvements contracted by the tenant will be removed by the tenant;
- the condition of the premises on expiration of the lease; and
- whether and on what conditions the improvements are to remain or be removed on expiration of the lease.

Improvements promised

A landlord under a lease agreement who agrees to make improvements to the rented premises is required to complete the improvements in a timely manner. If the landlord fails to make timely improvements, the tenant may cancel the lease agreement. [See **RPI** Form 552 §10]

Conversely, lease agreement provisions can obligate a tenant to construct or install improvements on the property. The time period for commencement and completion is agreed to in the lease agreement. If not agreed to, a reasonable period of time is allowed.[3]

Further-improvement provisions typically call for the landlord to approve the planned improvements before construction is commenced. Alternatively, some lease agreement provisions allow a tenant to make necessary improvements without the landlord's further consent. These improvements are not specifically mandated, or required to be completed in exchange for a reduction in rent. This non-mandatory type of improvement is called a **permissive improvement**.

Surrender of improvements

All tenant improvements are to remain with the leased property on termination of a lease unless the lease agreement permits or mandates their removal by the tenant as a restoration of the premises.

permissive improvement
A nonmandatory improvement the tenant is authorized to complete without further landlord consent.

Most lease agreements merely provide for the property to be returned in *good condition*, minus ordinary wear and tear for the years of the tenant's occupancy. Thus, the tenant is not required to restore the property to its actual condition when they took possession since tenant improvements are part of the real estate.

A provision calling for the tenant's *ordinary care* of the premises does not also require the tenant to remove their improvements or renovate the premises to eliminate deterioration, obsolescence or normal wear and tear caused by the tenant's permitted use of the property.[4]

If a lease does not require the tenant to restore the property to the condition it was in when received, the tenant may only remove their personal improvements, called **trade improvements** or **trade fixtures**.

3 CC §1657
4 **Kanner** v. **Globe Bottling Co.** (1969) 273 CA2d 559

Form 597

Notice of Nonresponsibility

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF NONRESPONSIBILITY

From Landlord (California Civil Code §3094)

NOTE: This form is used by a property manager or income property owner when a tenant commences construction of improvements on premises leased from the owner, to declare the property owner is not responsible for any claim arising out of the tenant improvements being constructed on the property.

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

NOTICE IS HEREBY GIVEN:

1. ____ is the vested and legal owner of real property located in the County of ______________________________, State of California, identified as

1.1 Common address ____

1.2 Legal description

2. ____ is:

2.1 ☐ The Buyer of the property under a purchase agreement, option or land sales contract, or

2.2 ☐ The Tenant under a lease of the property.

3. Within 10 days before the posting and recording of this notice, the undersigned Owner or Agent of Owner obtained knowledge that a work of improvement has commenced on the site of the property involving ☐ construction, ☐ alteration, or ☐ repair.

4. Owner will not be responsible for any claim arising out of this work of improvement.

5. I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: _____________, 20_______ Name: ____

Signature: ____

☐ Owner, or ☐ Agent of Owner

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 ____

On ________________ before me, ____

(Name and title of officer)

personally appeared ____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature: ____

(Signature of notary public)

(This area for official notarial seal)

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Real estate fixtures vs. trade fixtures

trade fixtures
A fixture used to render services or make products in the trade or business of a tenant.

Two types of fixtures exist for classifying improvements installed in a building:

- **real estate fixtures**; and
- **trade fixtures**.

A *real estate fixture* is personal property that is attached to the real estate. It becomes part of the real estate it is attached to and is conveyed with the property.[5]

5 CC §§660; 1013

For example, a tenant rents an office and builds bookshelves into the wall rather than merely anchoring them to the wall. As a result of the permanence of the bookshelves, they become part of the improvements located on the real estate.

real estate fixture
Personal property attached to the real estate as an improvement, which becomes part of the conveyable real estate.

When the lease expires, real estate fixtures are the landlord's property, not the tenant's who installed them. The landlord takes possession of the real estate fixtures as part of the real estate forfeited or surrendered to the landlord, unless the lease agreement provides for restoration of the property by removal of the TIs by the tenant. The conveyance of real estate fixtures from tenant to landlord on expiration of the lease is called **reversion**.[6]

reversion
The conveyance of real estate fixtures from a tenant to landlord on expiration of a lease.

Conversely, *trade fixtures* do not revert to the landlord on expiration of the lease. A trade fixture is an improvement that is attached to the real estate by the tenant and is unique to the operation of the tenant's business, not the use of the building. Examples include mirrors, salon chairs, wash stations and dryers in a beauty salon.

Removal without damage

A tenant may, at the end of or anytime during the lease term, remove any fixture used for trade purposes if the removal can be done without damaging the premises.[7]

Fixtures that have become an integral part of the building's structure due to the way they are attached or the general purpose they serve cannot be removed. Examples of fixtures which cannot be removed include toilets, air conditioners, vent conduits, sprinkler systems and lowered ceilings.[8]

Lease agreements often contain a default provision prohibiting the tenant from removing the trade fixtures when the agreement is breached. The tenant (and their unsecured creditors) no longer has a right to the trade fixtures under a default provision.

Notice of non-responsibility

Tenants occasionally contract for improvements to be constructed on the premises they have leased. Any **mechanic's lien** by a contractor for nonpayment initially attaches to the tenant's leasehold interest in the property.[9]

However, the mechanic's lien for unpaid labor and materials also attach to the *fee simple interest* held by the landlord if:

- the landlord or the landlord's property manager acquires knowledge the construction is taking place; and
- they fail to post and record a **Notice of Nonresponsibility**. [See Form 597 accompanying this chapter]

mechanic's lien
A lien entitling a contractor or subcontractor to foreclose on a job site property to recover the amount due and unpaid for labor and materials they used.

6 **City of Beverly Hills** v. **Albright** (1960) 184 CA2d 562
7 **Beebe** v. **Richards** (1953) 115 CA2d 589
8 CC §1019
9 CC §8442(a)

notice of nonresponsibility
A notice used by an owner to declare they are not responsible for any claim arising out of the improvements their tenant is constructing on their property. [See **RPI** Form 597]

A *Notice of Nonresponsibility* is a written notice which is to be:

- posted in a conspicuous place on the premises within ten days after the landlord or their property manager first has knowledge of the construction; and
- recorded with the county recorder's office within the same ten-day period.[10]

However, the landlord who becomes aware of the construction and fails to post and record the Notice of Nonresponsibility does not become personally liable to the contractor. Rather, the contractor can only lien the landlord's interest in the real estate and foreclose on their mechanic's lien to collect for unpaid labor and materials delivered to improve the property under contract with the tenant.[11]

Further, if the lease requires the tenant to make *mandatory improvements*, a mechanic's lien attaches to the landlord's interest even when the landlord has posted and recorded a Notice of Nonresponsibility.

10 CC §8444
11 **Peterson** v. **Freiermuth** (1911) 17 CA 609

Chapter 35 Summary

Tenant improvements (TIs) are improvements made to a rented property to meet the needs of the occupying tenant. The landlord's right to tenant improvements depends upon whether the tenant improvements are a real estate fixture or a trade fixture, and whether the further-improvements provision in the lease agreement requires the tenant to remove improvements and restore the premises.

Chapter 35 Key Terms

Quiz 7 Covering Chapters 31-36 is located on page 612.

Chapter 36

Water rights

Learning Objectives

After reading this chapter, you will be able to:

- identify the appurtenant water rights attached to riparian land; and
- understand the extent and terms of riparian rights.

Key Terms

overlying right
prescriptive right
riparian land
riparian right
State Water Resources Control Board

For a further discussion of this topic, see Chapter 8 of Legal Aspects of Real Estate.

Water is used, not owned

Water belongs in one of two categories:

- **surface water**, consisting of watercourses, lakes, springs, marshes, ponds, sloughs, and any other water flowing over the surface of the earth caused by rain, snow, springs or seepage; or
- **ground water**, consisting of percolating, subterranean bodies of water located in underground *basins*.[1]

Holders of rights to withdraw *surface waters* have **riparian rights**. Holders of rights to pump *ground water* have **overlying rights**.

riparian right
The right of a real estate owner to take surface water from a running water source contiguous to their land.

The legal rights to extract and use water are based on priorities and are classified as:

- *landowner's rights* consisting of both riparian and overlying rights;

1 Restatement of the Law 2d Torts §§841, 845, 846

- *appropriative rights* to withdraw water under license from the state; and
- *prescriptive rights* to withdraw water legally entitled to be used by others.

Riparian rights refer to a landowner's appurtenant property right to withdraw water from an adjacent river or lake for beneficial use on their riparian land.

overlying right
The right of a real estate owner to take the ground water below the surface of their land.

Overlying rights refer to a landowner's right to the use of ground water below the surface of their land.

An overlying landowner has rights to an allotment of water which is measured by the ground water in the basin over which their land is located. Overlying landowners have equal rights against other overlying landowners to a basin's ground water percolating underneath their land, subject to their *reasonable use* of the water.

Overlying and riparian rights are legally analogous to one another, except for the limitations placed on overlying landowners to use ground water and riparian landowners to use surface water.[1]

A landowner's use of water in the exercise of their riparian or overlying water rights has *priority* over water rights held by appropriators licensed by the state.

Riparian and overlying water rights are part of the ownership of land, and run with the title to the land when it is sold. Water rights are not personal property which can be assigned or used for the benefit of other property.

Land entitled to water rights

Riparian land is a parcel of real estate located both adjacent to a water source with surface water and within the *watershed* (basin) of the surface water. Similarly, **littoral land** specifically borders a pooled body of water.

A parcel is considered *riparian land* if it:

- touches the surface water; or
- was part of a larger riparian parcel and retained its riparian rights by reassignment when parceled.

riparian land
A parcel of real estate located next to a water source with surface water and within the watershed of the surface water.

The amount of frontage in actual contact with the surface water of a river or lake does not determine whether a parcel is considered riparian land. For example, a 40-acre tract of land, of which only 250 feet abuts a stream, is considered riparian land.[2]

To constitute riparian land, a property needs to also be located within the watershed surrounding the watercourse. If a portion of riparian land extends outside the watershed, only the portion within the watershed is entitled to use the water from the watercourse.

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1 **City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224

2 **Joeger** v. **Mt. Shasta Power Corp.** (1932) 214 C 630

Surface water used on land located within its watershed will eventually return to the watercourse, minus the water consumed, in a natural process called *percolation*. Additionally, rain falling on lands within the watershed of a watercourse feeds the watercourse. Thus, a riparian land owner can only divert water to the portion of their land which will allow the water to return to the watercourse.

Land lying within the watershed of one stream above the point where the two streams unite, called a **confluence**, is not considered to be riparian to the other. Further, the surface flow (river) below the *confluence* of two streams is a new and entirely different watershed, justifying a new name for the river below the confluence, as is the practice in Mexico to distinguish the watershed.[3]

Riparian rights are appurtenant

The right to use riparian water is an **appurtenant** (incidental) right attached to and transferred with the ownership of real estate.[4]

Each riparian landowner is entitled to a *reasonable use* of the natural flow of stream water running through or adjacent to their land. However, the quantity of the water withdrawn is subject to an upstream riparian landowner's *priority right* to first withdraw water for reasonable use on their upstream riparian land.

Additionally, a riparian landowner cannot divert stream water to nonriparian lands, even if they are entitled to use the water on their riparian land, since they are subject to the rules of percolation within the watershed. The landowner's riparian right to use the surface water is appurtenant to the land bordering the stream, not other lands not bordering the stream.[5]

Reasonable use and domestic priorities

Riparian rights are limited by the requirement that water taken from a stream is to be put to a *reasonable and beneficial use*. No one has a protectable interest in the unreasonable use of water.[6]

Reasonable and beneficial uses include:

- domestic uses; and
- agricultural irrigation.

Whether a particular use of water is reasonable and beneficial is determined on a case by case basis.[7]

While riparian landowners hold the same classification of legal rights to water, they are to share the water, giving priority to domestic uses over other uses, including agricultural irrigation.

3 **Anaheim Union Water Co.** v. **Fuller** (1907) 150 C 327
4 Calif. Civil Code §§658, 662
5 **Gould** v. **Eaton** (1897) 117 C 539
6 Calif. Constitution, Article X §2
7 Calif. Constitution, Article X §2

The sharing of water between riparian landowners, with priority to upstream owners, is based on a tiered variety of priority and subordinate uses across the entire group of riparian owners, called **correlative rights**. Each landowner holds *correlative rights* within the riparian class of water rights.

Water rights are usufructuary

Owners of land and water providers (appropriators) who hold water rights do not legally own water. They own rights to the reasonable use of the water. Their right-to-use is subject to change when circumstances controlling the use of water change, called **usufructuary rights.** It is a sort of "here today, gone tomorrow" approach to access and possession.

If a riparian land owner is not using water, downstream riparian land owners are entitled to the full flow of the water, subject to the upstream riparian owner's future reasonable use. Thus, the lack of use of the appurtenant right to water is not lost by mere nonuse alone.

However, an upstream riparian owner who is not using their allotment of water may not divert water to nonriparian land since the water would not percolate into the watershed.[1]

Competing water rights and allotments

In 1943, California established the **State Water Resources Control Board (Board)**. The Board acts as a referee for all disputes over water rights. The Board advises the California courts on the appropriate water allotment each of the disputing parties is entitled to take. Also, on a request from holders of water rights, the board itself may hear legitimate disputes between the parties to determine the water allotment each party is entitled to take.[2]

State Water Resources Control Board
Government entity established to ensure the proper allocation and efficient use of state water resources.

When the Board determines the allotment of water to each holder of riparian rights, the needs of all riparian landowners within the watershed are taken into account. The amount of water allocated to a riparian owner is individually determined based on numerous factors, such as the need for domestic use, irrigation and generating power.

For example, an upstream owner of 66 acres of riparian land suitable for profitable irrigation is entitled to a smaller proportion of the water from a watercourse running through their land than a downstream owner of 96 acres of riparian land also suitable for profitable irrigation.[3]

Termination of riparian rights

Consider riparian land fronting a river or lake which is parceled. One of the parcels created has no frontage on the watercourse. The parcel is later conveyed without a provision in the deed transferring the riparian rights.

Here, the parcel conveyed without reference to its riparian rights loses its riparian land status forever. The conveyance of a parcel, severed from a larger parcel which has riparian rights, terminates the conveyed parcel's riparian rights unless the rights are transferred by the deed which severed the parcel.

1 Gould, *supra*
2 Wat C §§2000, 2501
3 **Half Moon Bay Land Co.** v. **Cowell** (1916) 173 C 543

Even if the severed parcel is eventually conveyed to waterfront owners of portions of the original riparian tract, the severed parcel's status remains nonriparian.[4]

Appropriation and prescriptive rights by non-riparian owners

The right to the use of water located within the state of California may be acquired by **appropriation** by applying for a permit from the Board [5]

On the approval of an application for an appropriation permit by the Board, the permit is issued granting the appropriator the right to use water only to the extent and for the purpose described in the permit.[6]

Waters flowing underground or surface waters flowing in natural channels in excess of the entitlement of riparian, overlying and previously appropriated water rights are considered the public water of the State of California. These excess waters are subject to appropriation by anyone.[7]

Prescriptive rights to the use of water can be established when a person wrongfully appropriates nonsurplus water *openly and adversely* for an uninterrupted period of five years, and does so without documentation or evidence of a legal right.

prescriptive right
The right to use water established by appropriating nonsurplus water openly and adversely for an uninterrupted period of five years without documentation of a legal right.

Riparian and overlying owners may interrupt anyone trying to obtain prescriptive rights by continuing to use their allotment of water.[8]

4 Anaheim Union Water Co., *supra*
5 Wat C §102
6 Wat C §1381
7 Wat C §1201
8 City of Barstow, *supra*

Chapter 36 Summary

Water is characterized as surface water and ground water. Holders of rights to withdraw surface water have riparian rights and holders of rights to pump ground water have overlying rights. A riparian landowner cannot divert water to non-riparian land or bar others from their riparian rights.

Those with riparian rights do not legally own the water, but hold the right to the reasonable use of the water. Riparian water rights cannot be lost by disuse.

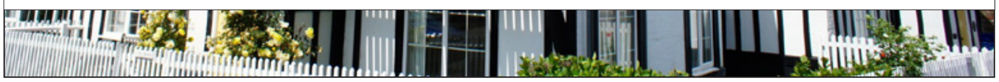
The right to the use of water located within the state of California may be acquired by appropriation, which involves applying for a permit from the State Water Resources Control Board, or by wrongfully appropriating non-surplus water openly and adversely for an uninterrupted period of five years.

Chapter 36 Key Terms

Quiz 7 Covering Chapters 31-36 is located on page 612.

Chapter 37

Covenants, conditions and restrictions (CC&Rs)



Learning Objectives

After reading this chapter, you will be able to:

- understand the limitations and restrictions on use mutually agreed to by all property owners in a subdivision documented in the Covenants, Conditions and Restrictions (CC&Rs);
- distinguish between affirmative and negative covenants;
- determine when a covenant runs with title to the land; and
- understand the circumstances by which CC&Rs may be amended or removed if they pose an unlawful restriction.

Key Terms

affirmative covenant	**negative covenant**
Covenants, conditions and restrictions (CC&Rs)	

For a further discussion of this topic, see Chapter 16 of Legal Aspects of Real Estate.

Recording restrictive covenants

Developers subdivide land into two or more horizontal or vertical sections called lots, parcels or units. Having created a subdivision, developers place *restrictive covenants* on how the *lots* may be used by later owners, called successors.

Use restrictions are usually contained in a document called a **Declaration of Covenants, Conditions and Restrictions (CC&Rs)**. *CC&Rs* are typically recorded with the original subdivision map.

Recorded documents in the chain of title to a parcel of real estate place a buyer on *constructive notice* of their contents.

covenants, conditions and restrictions (CC&Rs)
Recorded restrictions against the title to real estate prohibiting or limiting specified uses of the property.

A prospective buyer of a home in a subdivision protects themselves from unknowingly buying property burdened with unwanted restrictions by reviewing a **preliminary title report (prelim)** prior to acquiring a property. A *prelim* discloses the results of the title company's search of the property's title history. [See Chapter 51]

The prelim functions with the very limited purpose of the title company's revocable offer to issue a title policy. As a customer service, title companies supply copies of any CC&Rs of record to buyers or their agents on request.

Covenants specifying use are affirmative

A recorded restriction can **limit the use** of a property to a specific purpose (e.g., a school, railroad, highway, dwelling or irrigation system). This type of restriction is classified as an **affirmative covenant**.

Another type of recorded restriction prohibits identified uses of the property. Prohibitive restrictions are classified as a **negative covenant.** For example, a typical *negative covenant* prohibits the sale of alcoholic beverages or other activities otherwise allowed to take place on the property.

CC&Rs and future owners

affirmative covenant
A recorded restriction limiting the use of a property to a specific purpose.

negative covenant
A recorded restriction prohibiting identified uses of a property.

Recorded CC&Rs bind future owners of the subdivided lots, a scheme referred to as covenants **running with the land**.

For a covenant to *run with the land* and affect title and future owners, the restriction needs to **directly benefit** the property. Thus, to benefit one lot, all lots within the subdivision need to be burdened by the restriction.[1]

Consider a restriction limiting the use of all subdivision lots to single family residences (SFRs). The use restriction equally *benefits* and *burdens* each lot in the subdivision, assuring consistent and compatible use throughout the subdivision — a benefit with an advantageous effect on each property. Since it benefits every lot, the restriction runs with the title to each lot and affects all future owners.[2]

However, consider a subdivider who sells a beachfront lot while retaining ownership of the surrounding lots in the subdivision. The grant deed conveying the beachfront lot to the buyer contains a use restriction, stating the buyer can only operate a hotel or yachting clubhouse on the lot.

The buyer, unable to develop the property for the purposes set out in the use restriction, sells the lot to a developer who plans to use the property for a ferry landing service. The subdivider seeks to prohibit the developer from conducting a business which violates the restrictive use covenant in the recorded grant deed to the original buyer.

Can the subdivider enforce the covenant entered into by the original buyer and stop the developer from using the lot for a ferry service?

1 Calif. Civil Code §1462

2 **Miles** v. **Hollingsworth** (1919) 44 CA 539

No! The use restriction provides *no benefit* to the beachfront lot since it merely imposes a burden on the original buyer who agreed to limit their use of the property. Enforcement of the restriction is further limited due to its lack of wording binding the buyer's *successors in interest* to the restrictive covenant.

The restriction is only enforceable as long as the original buyer holds title. Thus, it is classified as a **personal covenant.** Since the restriction against use is a *personal* promise, it does not run with the land and cannot be imposed on the developer who reacquired title.

Unenforceable or unreasonable CC&Rs

Restrictions on selling, leasing or encumbrance real estate may not *unreasonably restrict the marketability* of the property, even if the restriction is contained in a trust deed or lease agreement.[3]

However, **due-on-sale clauses** contained in a trust deed are no longer controlled by California law and, under federal mortgage law, are enforceable on the transfer of any interest in the real estate, except:

- short-term leases up to three years not coupled with a purchase option; and
- intra-family transfers of one-to-four unit, owner-occupied residential property on the death of an owner or for equity financing.[4]

CC&Rs on the installation or use of a **solar energy system** are unenforceable if the restrictions significantly increase the cost of the system or decrease its efficiency by:

- resulting in more than a 20% increase in the installation cost of the system; or
- decreasing the operating efficiency of the solar system by more than 20%.[5]

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3 CC §711

4 12 Code of Federal Regulations §591.5(b)

5 CC §714

Chapter 37 Summary

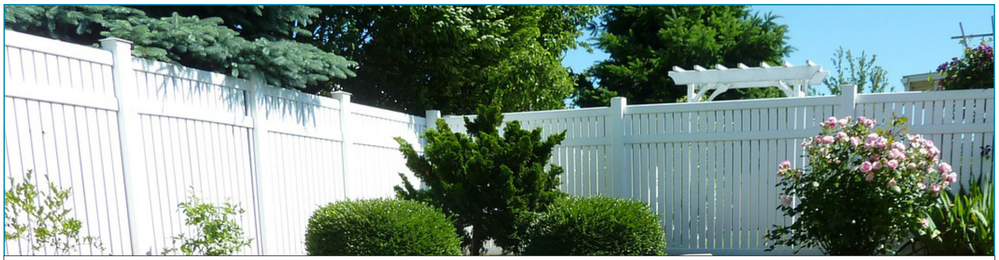
Restrictive use covenants are contained in a subdivision's Declaration of Covenants, Conditions and Restrictions (CC&Rs). A recorded restriction limiting the use of a property to a specific purpose is referred to as an affirmative covenant. A recorded restriction prohibiting identified uses of a property is classified as a negative covenant.

Recorded CC&Rs bind future owners of the subdivided lots, referred to as running with the land. For a covenant to run with the land and affect future owners, the restriction must directly benefit the property.

Restrictions on selling, leasing or encumbrance real estate may not unreasonably restrict the marketability of a property, except as controlled by federal mortgage law under due-on clause enforcement.

Chapter 37 Key Terms

Quiz 8 Covering Chapters 37-43 is located on page 613.



Chapter 38

Common boundary structures

Learning Objectives

After reading this chapter, you will be able to:

- identify common boundaries and common boundary improvements; and
- understand the types of common boundaries and the rights of adjacent property owners relative to them.

Key Terms

common boundary improvement

common boundary trees

nuisance

party wall

For a further discussion of this topic, see Chapter 9 of Legal Aspects of Real Estate.

Shared rights and responsibilities

Most properties have three property lines setting the **common boundary** with adjacent properties owned by others. A fourth property line usually sets the frontage on a public right of way, such as a street.

The location of the common property lines might be represented by an improvement which acts as a demarcation of the property line, called a **common boundary improvement**.

common boundary improvement
An improvement which acts as a demarcation of the property line.

A *common boundary improvement* may be a:

- party wall;
- boundary fence;
- tree line;
- driveway; or
- ditch.

Prospective buyers interested in a property are concerned about the ownership of any common boundary improvements and who is responsible for their maintenance.

The rights of the adjacent property owners when setting up, maintaining or removing common boundary improvements depend on the type of improvement which exists.

Party walls are owned by both

Common boundary improvements, other than trees, located on a property line between adjacent properties are called **party walls**.

party wall
A common boundary improvement located on a property line between adjacent properties, such as a wall, fence or building co-owned by the adjacent property owners.

A *party wall* may be in the form of a wall, fence or building wall co-owned by the adjacent property owners.

The use and ownership of a party wall is best set forth in a *written agreement* between adjacent property owners. The agreement defines each owner's responsibility for sharing the cost of maintaining the party wall. However, these written agreements rarely exist.

An adjoining property owner cannot remove or destroy a party wall without the consent of the other owner since each has an interest in the party wall.

An owner can alter a party wall, such as installing cosmetic ornamentation on their side, as long as they do not injure the wall or interfere with the adjoining property owner's use of the party wall.[1]

Boundary fences and cost contributions

For security and privacy purposes, many properties are fenced in by a **boundary fence**. A *boundary fence* may be a party wall co-owned by the adjacent property owners.

If an owner who leaves their land unfenced later decides to enclose it by using the existing fence as part of the enclosure, they need to compensate the neighbor who built the fence for the pro rata value of the neighbor's fence used by the owner.[2]

Maintaining the Good Neighbor Fence

Owners of adjoining properties are presumed to benefit equally from boundary fences. Under this presumption, all adjoining owners are equally responsible for constructing, maintaining and replacing boundary fences.[3]

The responsibility for constructing, maintaining or replacing boundary fences may be altered or removed only by:

- a written agreement between all affected owners [See **RPI** Form 323]; or
- an adjoining owner's judicial petition to remove or alter their responsibility.

1 **McCarthy** v. **Mutual Relief Ass'n of Petaluma** (1889) 81 C 584; Tate, supra
2 CC §841(2)
3 CC §841(b)(1)

Line trees, a trunk with common owners

Trees are:

- solely owned;
- government owned; or
- commonly owned.

A tree's ownership is determined by the location of its trunk.

Solely owned trees belong to the owner of the property on which the trunk is growing.[4]

Trees growing on government-owned parcels, such as a right of way for streets and sidewalks, belong to the local government.

However, shrubbery or trees whose trunks stand partly on the land of two adjacent property owners belong to the adjacent owners as **tenants in common**. These trees are called **line trees** or **common boundary trees**.[5]

common boundary trees
Shrubbery or trees with trunks which stand partly on the land of two adjacent properties belonging to the adjacent owners.

Adjacent owners who own line trees as *tenants in common* are jointly responsible for maintaining the trees.[6]

Sharing boundary trees

Co-owners of boundary trees, as adjoining property owners, both enjoy the use of the trees.

The use allowed a co-owner of boundary trees is the same as the use allowed the owner of solely-owned trees, as long as the use does not interfere with the other co-owner's use and enjoyment of the trees.

Remedies

To avoid disputes, adjacent property owners enter into an agreement detailing how they will handle the maintenance of boundary trees.

If a boundary tree injures the *health and safety* of a property owner or prevents them from enjoying their property, the tree may constitute a **nuisance** and can be removed.[7]

nuisance
An action which is injurious to health, offensive to the senses, or obstructs the use and enjoyment of surrounding property. [See **RPI** Form 550 §6.7 and 552 §7.3]

A co-owner of a boundary tree might refuse to consent to the removal of a boundary tree. If the tree constitutes a *nuisance*, an abatement of the nuisance is allowed.

For example, boundary trees may be a nuisance if their branches or the trees themselves continually fall, threatening the safety of people using the adjacent property or damaging improvements on the adjacent property.[8]

4 CC §833
5 CC §834
6 CC §841
7 CC §3479
8 **Parsons** v. **Luhr** (1928) 205 C 193

Chapter 38 Summary

Most properties have three property lines setting the common boundary. The location of the common property lines are frequently represented by a common boundary improvement. The rights of adjacent property owners when setting up, maintaining or removing common boundary improvements depend on the type of improvement which exists.

A party wall is a type of common boundary improvement which is co-owned by the adjacent property owners. The owners share the cost of maintaining the party wall.

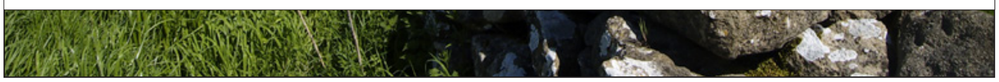
Shrubbery or trees whose trunks stand partly on the land of two adjacent property owners are called common boundary trees. Much like party walls, co-ownership of common boundary trees includes maintenance of the trees. Additionally, co-owners cannot alter or remove party walls or common boundary trees without the consent of the other co-owner.

Chapter 38 Key Terms

Quiz 8 Covering Chapters 37-43 is located on page 613.

Chapter 39

Encroachments: crossing the line



Learning Objectives

After reading this chapter, you will be able to:

- determine whether an encroachment exists extending onto real estate belonging to another person without their consent; and
- understand and apply any remedies available to an owner of property burdened by an encroachment.

Key Terms

boundary dispute
encroachment
laches
nuisance
trespass

For a further discussion of this topic, see Chapter 10 of Legal Aspects of Real Estate.

Boundaries violated and hardships balanced

Consider an owner of an unimproved parcel of real estate. Shortly after their purchase, the owner discovers the garage on their neighbor's property extends two feet over the boundary line onto the owner's property, called an **encroachment**.

The owner demands the neighbor remove the *encroachment*. The neighbor claims the improvement does not need to be removed since:

- the encroachment was unknown and unintentional;
- the square footage of the owner's property affected by the encroachment is minor; and
- the cost to remove the garage would far exceed the monetary loss to the owner if the encroachment were allowed to continue.

encroachment
An improvement on one parcel of real estate which extends onto real estate owned by another.

Can the owner obtain a court order forcing the removal of the encroaching garage?

No! The encroachment is unintentional and minor in its effect on the *burdened owner*. Thus, the burden to the owner does not justify ordering the neighbor to undertake an expensive reconstruction activity.

Instead, the owner is awarded money losses based on the rental value for the lost use of their property. Further, the neighbor is granted an **easement** over the owner's property for the life of the garage.[1] [See Chapter 40]

For the neighbor to be allowed to maintain the encroachment, the neighbor is required to have acted in **good faith** when building the improvements. This means the neighbor needs to have constructed the improvements without knowledge they encroached on the owner's property. If the neighbor had not constructed the improvements in *good faith*, the owner is entitled to a court order called an *injunction* forcing the removal of the encroaching structure –no matter how minor the encroachment.

Statute of limitations

Also, for the owner to recover money losses for the encroachment, they have to act within a three-year period of the **statute of limitations**. If the owner delays too long in making their claim, the encroaching neighbor earns the right to maintain the encroachment without paying rent or lost value.

Even if a new owner of a property burdened by an encroachment seeks an injunction or money losses from the neighbor immediately after acquiring the property, their action can be barred by the three-year *statute of limitations*.

The limitations period does not run from the discovery of the encroachment or the acquisition of the property. Instead, it begins to run from the creation date of the encroachment.

Although the owner may not recover money losses from the neighbor, they may recover losses from the seller due to the seller's failure to disclose the existence of the known encroachment. The loss is based on the diminished value of the property and the excess purchase price paid.

Encroachment, trespass and nuisance

An **encroachment** is an improvement on real estate which extends onto real estate belonging to another person without their consent. Thus, encroachments frequently take the form of a:

- building;
- fence;
- driveway; or
- tree.

1 **Christensen** v. **Tucker** (1952) 114 CA2d 554

The concept of encroachment is closely related to *trespass, nuisance* and *boundary disputes*. All involve an interference with another person's property rights.

An encroachment qualifies as a **nuisance.** *Nuisance* is broadly defined as any obstruction of another's use and enjoyment of their real estate. [See Chapter 45]

nuisance
An action which is injurious to health, offensive to the senses, or obstructs the use and enjoyment of surrounding property. [See **RPI** Form 550 §6.7 and 552 §7.3]

An encroachment also constitutes a **trespass** when it actually rests on the ground of the neighbor's property. [See Chapter 43]

However, the names used to describe interferences are unimportant. One way or another, an owner is entitled to recover for an **unauthorized interference** with their property rights.

trespass
Any wrongful and unauthorized entry onto real estate in the possession of another.

Once an encroachment has been determined, the remedies available to the owner include:

- an **injunction** ordering the removal of the encroaching structure; or
- **money losses** for the diminished value of the property.

Drawing the line

All that is needed to establish the existence of an encroachment is a survey locating the property line. If an improvement on one parcel extends over the line onto an adjacent parcel, it is an encroachment.

Occasionally, neighboring owners disputing the existence of an encroachment rely on contradictory surveys to establish the property line. If the owners cannot agree on the location of the property line, the **boundary dispute** is to be resolved before any remedy for the encroachment can be granted.

boundary dispute
When owners of neighboring property cannot agree on the location of the dividing property line.

Boundary disputes are most frequently resolved by a court. The court determines which of the surveys is more accurate.[2]

Balancing the hardships

An owner is entitled to terminate or prevent an unauthorized intrusion onto their real estate. However, when a building or other substantial improvement encroaches on an owner's property, the neighbor's cost of removing the encroachment may far exceed the damage inflicted on the owner burdened by the encroachment.

Thus, the encroachment is allowed to continue and the owner is awarded money losses for the lost use of their property, called **balancing hardships or balancing equities.**

The conditions for *balancing hardships* — i.e., merely granting money losses and allowing an encroachment to continue — are:

- the owner of the property affected by the encroachment may not suffer an *irreparable injury* due to the continued existence of the encroachment;

2 **Iacovitti** v. **Fardin** (1954) 127 CA2d 348

- the neighbor who owns the encroaching structure needs to have acted innocently and in **good faith**; and
- the **cost** to the neighbor of removing the encroachment needs to greatly exceed the damage done to the owner.[3]

The *good faith* of a neighbor who constructs improvements which encroach on the land of another needs to exist before any balancing of the hardship can take place. Thus, the good faith requirement prevents an **intentional exploitation** of the balancing hardships rule.

The encroachment easement

When the continuance of an encroachment on an owner's property is allowed, the encroaching neighbor is granted an **equitable easement** to maintain the improvement on the owner's property. [See Chapter 41]

Further, the neighbor needs to compensate the owner for the rental value of the *lost use* of their property. The easement lasts for the lifetime of the encroachment.

Limitations and delay

An owner seeking to terminate an encroachment or recover money losses is subject to a *three-year statute of limitations* running from the commencement of the encroachment.[4]

The limitations period for an encroachment is the same as for a **permanent nuisance** since the damage to the owner is complete and certain as soon as the encroachment is created. [See Chapter 45]

The limitations period runs from the creation of the encroachment, not its discovery. Whether or not an owner has knowledge an encroachment exists does not affect the statute of limitations.[5]

However, where damage resulting from an encroachment is *progressive* over time, the three-year statute of limitations does not apply from the date of creation.

For instance, an owner's building is damaged when a neighbor's building leans on it, due to a poorly compacted fill. The degree of the tilt, and the resulting damage, increases over time.

More than three years after the damage commences, the owner seeks to recover money losses from the neighbor. The neighbor claims the owner is barred from recovering money losses due to the running of the three-year limitations period.

However, the intrusion on the owner's building is continuous and progressive — a further intrusion. As with a *continuing nuisance*, a new claim accrues each time the loss increases. Thus, while the three-year statute

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3 Christensen, *supra*

4 **Bertram** v. **Orlando** (1951) 102 CA2d 506

5 **Castelletto** v. **Bendon** (1961) 193 CA2d 64

of limitations does apply, it does not begin to run on the commencement of the encroachment, but runs from the date of the last increase in damage from the progressively increasing encroachment.[6]

In addition to barring relief due to the statute of limitations, an action seeking money losses or an injunction against an encroachment can be barred by the equitable doctrine of **laches**, also called **prejudicial delay** or **detrimental reliance**.

laches
An unreasonable delay which bars pursuit of a claim.

A property owner loses their right to enforce the removal of an encroachment or recover money against the encroaching neighbor if the owner delays in making the claim, causing the neighbor to rely on the owner's acquiescence to their detriment.

6 **Kafka** v. **Bozio** (1923) 191 C 746

Chapter 39 Summary

An encroachment is an improvement on real estate, such as a building, fence, driveway or tree, which extends onto real estate belonging to another person without their consent.

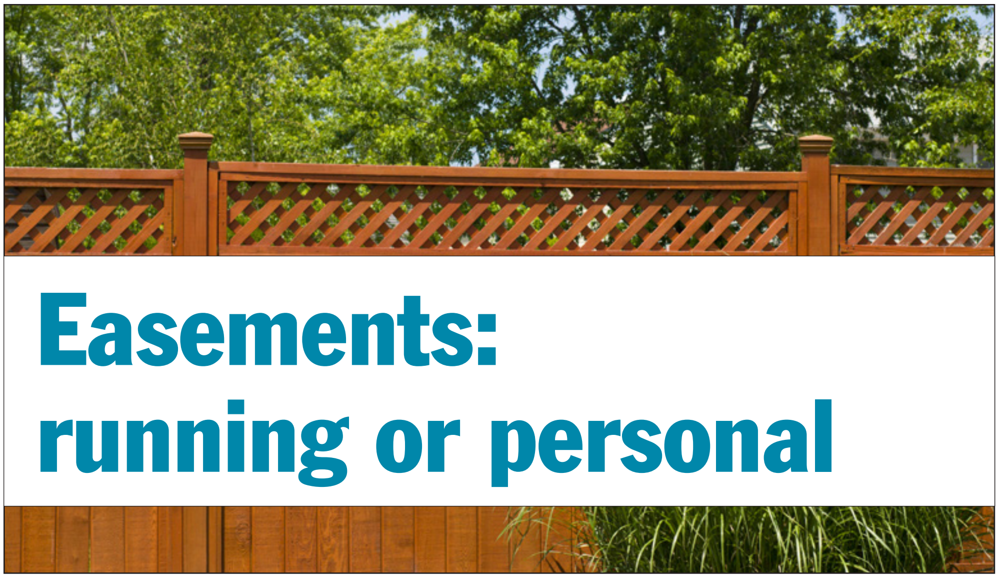
Once an encroachment has been determined, the burdened owner may seek an injunction ordering the removal of the encroachment, or money losses for the diminished value of the property.

For the owner to recover money losses for the encroachment, they have to act within a three-year period of the statute of limitations, unless the losses due to an encroachment are progressive over time. If the owner delays too long before making their claim, the encroaching neighbor earns the right to maintain the encroachment without paying money. The limitations period does not run from the discovery of the encroachment, but from the creation date of the encroachment.

Chapter 39 Key Terms

Quiz 8 Covering Chapters 37-43 is located on page 613.

Chapter 40



Easements: running or personal

Learning Objectives

After reading this chapter, you will be able to:

- understand the tenement relationship between two parcels of real estate created by an easement;
- distinguish an appurtenant easement, which belongs to land, from an easement in gross, which belongs to an individual; and
- comprehend different easements for air, light, view, sun or conservation.

Key Terms

appurtenant easement	**easement in gross**
conservation easement	**ingress and egress**
dominant tenement	**servient tenement**
easement	**solar easement**

For a further discussion of this topic, see Chapter 13 of Legal Aspects of Real Estate.

Rights in another's property

An **easement** is the right of one property owner *to use* the property of another.

The most common *easement* is used for **ingress and egress**. An easement for *ingress and egress* creates a right of way allowing one property owner to traverse a portion of another's land to access their property.

easement
The right to use another's property for a specific purpose.

ingress and egress
Access to a property by its owner directly from publicly dedicated streets or by using their right to traverse a portion of another's land using an easement.

dominant tenement
The property benefitting from an easement on a servient tenement.

An easement creates a *tenement relationship* between two parcels of real estate since it:

- *benefits* one property, referred to as the **dominant tenement**, whose owner is entitled to use the easement; and
- *burdens* another property, referred to as the **servient tenement**, the owner's use of which is subject to the easement.

When an owner whose property is burdened by an easement interferes with the use of the easement by a neighbor whose property benefits from the easement, the neighbor is entitled to have the use of the easement reinstated. The easement is reinstated by either removal, relocation or modification of the interference.

Further, the neighbor who holds the easement is entitled to compensation for their money losses caused by the servient tenement owner's obstruction of the neighbor's use of the easement.[1]

Appurtenant or in gross: does the easement run?

An easement burdening an owner's property as an encumbrance on their title is classified as either:

- an **appurtenant easement**, meaning the allowed use belongs to and benefits an adjacent property and is said to *run with the land* as an interest the adjacent property holds in the burdened real estate; or
- an **easement in gross**, meaning it belongs to an individual, not land, as their *personal right* to a specified use of the burdened real estate.

An *appurtenant easement* is incidental to the title of the property which benefits from its use. An easement is not reflected as a recorded interest on the title to the parcel of land it benefits. Nor is it a personal right held by a particular individual who may now or have previously owned the parcel benefiting from the easement.

servient tenement
A property burdened by a license or easement.

Accordingly, an appurtenant easement is recorded as an **encumbrance** on title to the burdened property. The easement remains on the property's title after a conveyance to new owners of either the benefitting or burdened property. To be enforceable, the easement does not need to be referenced in the grant deed conveying either property to new owners since it runs with the land.[2]

appurtenant easement
A type of easement which is incidental to the ownership and belongs to the property which benefits from its use.

Conversely, an *easement in gross* benefits a particular person – not the real estate owned by that person. An easement in gross is personally held only by the individual who may use the easement. No parcel of real estate may benefit from an easement in gross since only the individual holding the easement can benefit.

easement in gross
An easement which belongs to an individual and is not appurtenant to a property.

An easement in gross is a personal right that is not transferred with the sale of real estate owned by the holder of the easement. However, the right can

1 **Moylan** v. **Dykes** (1986) 181 CA3d 561
2 Moylan, supra

be *transferred* by the easement holder to another person by a writing — unless the transfer of the easement in gross is prohibited by a provision in the document creating the easement.[3]

Easements for light, air or view

A property owner has no automatic right, and cannot acquire a *prescriptive right*, to air, light or an unaltered view over neighboring properties.

However, a property owner can hold an easement created by a grant which restricts a neighbor's ability to erect or maintain any improvement which interferes with the owner's right to air, light or view. The easement might be the result of conditions, covenants and restrictions (CC&Rs) which blanket several properties with use restrictions, such as restrictions on height.

Easements for light, air and view can only be established by *written agreement* between neighboring owners, not by implication or prescription.[4]

Solar easements and shady neighbors

A relatively recent type of easement is the **solar easement**. *Solar easements* were established with the intent of encouraging the productive use of solar energy systems as a matter of public policy.

A solar easement granted in a written instrument needs to state:

- the measured angles by which sunlight is to pass;
- the hours of the day during which the easement is effective;
- the limitations on any object which would impair the passage of sunlight through the easement; and
- the terms for terminating or revising the easement.[5]

Solar easements are similar to easements of light, air or view since they restrict an owner's ability to maintain any improvements interfering with a neighbor's solar energy system.

solar easement
An easement restricting an owner's ability to maintain improvements interfering with a neighbor's solar energy system.

Conservation easements

A **conservation easement** is a voluntary conveyance of the right to keep the land in its natural, scenic, historical, agricultural, forested or open-space condition. It is conveyed by an owner of real estate to a conservation organization or government agency. A *conservation easement* can be created in the form of an easement or CC&R, by use of a deed, will or other instrument to convey the easement.[6]

Conservation easements are *perpetual* in duration and thus are binding on all successive owners of the property burdened by the conservation easement.[7]

conservation easement
A voluntary conveyance of the right to keep land in its natural or historical condition to a conservation organization or government agency.

3 **LeDeit** v. **Ehler**t (1962) 205 CA2d 154
4 Petersen, supra
5 Calif. Civil Code §801.5
6 CC §815.1
7 CC §§815.1, 815.2(b)

Chapter 40 Summary

An easement is the right of one property owner to use the property of another. An easement creates a relationship between two parcels of real estate as it benefits one property whose owner is entitled to use the easement, and burdens another property subject to the easement.

An easement is classified as either an appurtenant easement or an easement in gross. An appurtenant easement belongs to and benefits adjacent property and runs with the land. An easement in gross belongs to an individual, not land, and is a personal right.

Property owners can hold an easement restricting a neighbor's ability to interfere with the owner's right to air, light or view. Specifically, solar easements restrict an owner's ability to maintain any improvements interfering with a neighbor's solar energy system.

A conservation easement is a voluntary conveyance of the right to keep land in its natural, historical, or open-space condition to a conservation organization or government agency.

Chapter 40 Key Terms

Quiz 8 Covering Chapters 37-43 is located on page 613.

Chapter 41

Creating an easement

Learning Objectives

After reading this chapter, you will be able to:

- understand how an easement is created in favor of one parcel of real estate and as a burden on another parcel;
- apply the requirements for creating an implied easement and an easement of necessity; and
- distinguish a prescriptive easement from a claim of adverse possession.

Key Terms

easement by necessity
implied easement
prescriptive easement

For a further discussion of this topic, see Chapter 14 of Real Estate Legal Aspects.

By grant, reservation or implication

The basic method for creating an **easement** is by a writing. Any document which may be used to convey a legal interest in real estate may be used to create an easement.

An easement can be created between the *benefitting* and *burdened* properties in an:

- easement agreement;
- will;
- grant deed;
- easement deed;
- quitclaim deed;
- lease;

- order of the court; or
- *covenants, conditions and restrictions (CC&Rs).*

While the document creating an easement does not have to be recorded, an *unrecorded easement* is no longer enforceable when the owner of the burdened property sells it to a buyer who is not charged with knowledge of the easement, called a **bona fide purchaser (BFP).**

An easement is created in a conveyance either by:

- **grant**; or
- **reservation**.

For example, the owner of adjacent parcels of real estate may sell one parcel to a buyer and further *grant* the buyer an easement over the parcel retained by the owner.

Alternatively, an owner of adjacent parcels may sell a parcel, and in the grant deed conveying the parcel to the buyer, *reserve* to themselves an easement on the parcel conveyed for the benefit of the parcel the owner retained.

Conduct creates an implied easement

implied easement
An easement created by the conduct of parties without prior agreement.

An easement can be created by conduct without any prior agreement between the owner and the user, called an **implied easement.**

Implied easements exist when the circumstances surrounding an owner's division of their property and sale of a portion of the property imply the owner (grantor) and the buyer (grantee) intended either:

- the grant of an easement on the portion retained by the owner; or
- the reservation of an easement by the owner on the portion sold.[1]

For an implied easement to exist, the easement needs to be *reasonably necessary* for the beneficial use of the parcel whose owner is seeking to establish the easement.

Easement or fee title conveyed by deed

The terms "*reservation*" and "*exception*" in conveyances of real estate are used to distinguish whether the legally described reservation (easement) or exception (ownership) is:

- created as a burden on the property conveyed for the beneficial use of another property, such as an **easement by reservation**; or
- retained from the parcel conveyed as property of the seller, an *exception for land* which is not transferred on the conveyance of a portion of a larger parcel.

Implied is appurtenant

Regardless of how an implied easement is created, it is always a burden on one parcel of land for the benefit of another parcel.

1 Calif. Civil Code §1104; **Palvutzian** v. **Terkanian** (1920) 47 CA 47

Thus, an implied easement is always an **appurtenance** allowing the owner of the property benefitting from the easement to use the property of another which is burdened by the easement.

Most disputes over implied easements occur after the property burdened by the easement has been deeded out to one or more new owners.

To be entitled to an implied easement, the owner claiming the implied easement is to establish their right of use in another property existed when one of the parcels was conveyed to a buyer by the common owner of both parcels.

Easements by necessity

An **easement by necessity** is a variation of an implied easement. The demand for an *easement by necessity* arises when property is **landlocked.** Access to and from a public roadway across all adjacent properties is denied in landlocked property for the lack of the ability to create an easement by agreement or prior conduct.

easement by necessity
An easement providing access to a landlocked property.

Since public policy favors the productive use of land, an easement by necessity will be created when property is landlocked.[2]

However, to establish an easement by necessity, the user needs to:

- show **strict necessity;** and
- defend against any claim that the property was intended to be landlocked.

Strict necessity requires the easement to be the only possible means of access.[3]

Prescription: easement by adverse use

Consider a property owner who has used a roadway on an adjoining property to access their vacation home for over five years. The owner has never received permission from the neighbor to use the roadway.

The neighbor sells their property to a buyer who informs the owner they can no longer use the roadway.

The owner claims their open and continuous use of the road to access their property for more than five years entitles them to a *right-of-way easement* over the adjoining property.

Is the owner entitled to a roadway easement over the adjoining property owned by the buyer?

Yes! A **prescriptive easement** is established by the **adverse use** of another's property for a period in excess of five years.[4]

prescriptive easement
The right to use another's property established by the adverse use of the property for a period in excess of five years without a claim of ownership.

An easement created by *prescription* is similar to acquiring land by **adverse possession**. [See Chapter 43]

2 **Reese** v. **Borghi** (1963) 216 CA2d 324
3 **Zunino** v. **Gabriel** (1960) 182 CA2d 613
4 **Thomson** v. **Dypvik** (1985) 174 CA3d 329

The difference is prescription establishes the right to the mere use of another's property, whereas adverse possession is an actual taking of *exclusive possession* under a claim of ownership and the payment of property taxes.

To meet the legal requirements for acquiring an easement by prescription, the adverse use needs to be:

- *obvious* enough to give the owner of the property notice of the use;
- a *continuous* and uninterrupted pattern of use;
- a use *unauthorized* by the owner of the property;
- used under a *claim of right*; and
- used for a period of *five-or-more* years without the owner acting to terminate the adverse use.

The five-year requirement of uninterrupted use continues on the transfer of the benefitting property to a new owner as long as the new owner continues the same unauthorized use of the burdened adjoining property established by the previous owner, called **tacking.**

Chapter 41 Summary

The basic method for creating an easement is by a writing. Easements are created in a conveyance either by grant or reservation.

The terms reservation and exception in conveyances of real estate are used to distinguish if an owner is reserving an easement for themselves over the property conveyed, or excepting a portion of a parcel from conveyance on the sale.

Implied easements exist when the circumstances surrounding an owner's division of their property and sale of a portion of the property imply the owner and buyer intend either the grant of an easement for the buyer or the reservation of an easement for the owner.

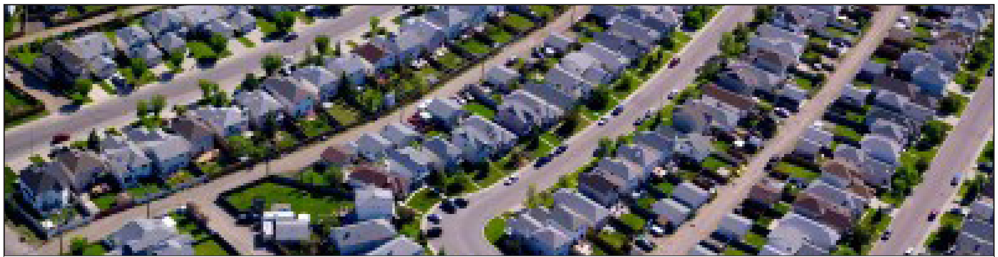
An easement by necessity is a variation of an implied easement and arises when property is landlocked. In order to establish an easement by necessity, the owner must show strict necessity and defend against any claim that the property was intended to be landlocked.

A prescriptive easement is established by the adverse use of another's property for a period in excess of five years. A prescriptive easement is distinct from adverse possession in that a prescriptive easement provides the right to use another's property without a claim of ownership or payment of property taxes.

Chapter 41 Key Terms

Quiz 8 Covering Chapters 37-43 is located on page 613.

Chapter 42



Termination of easements

Learning Objectives

After reading this chapter, you will be able to:

- identify how an easement burdening a property is extinguished by release, merger, destruction, forfeiture, prescription or abandonment; and
- distinguish the attributes of each method of extinguishment.

Key Terms

abandonment **merger**
forfeiture

For a further discussion of this topic, see Chapter 15 of Real Estate Legal Aspects.

Extinguishing an easement

An existing easement can be **extinguished.** Once *extinguished*, the easement no longer affects the burdened property as an encumbrance on its title.

Methods used to extinguish an easement include:

- *release* of the easement by a deed from the owner of the property holding the appurtenant right to the easement;
- *merger* by the acquisition of fee title to both the benefitting and burdened properties by the same owner;
- *destruction* of the burdened property which permanently prevents any further use of the easement;
- *forfeiture* due to the easement holder's abuse of their easement rights;

- *prescription* due to the burdened property owner's continuing interference with the easement; and
- *abandonment* by the conduct of the easement holder showing they do not intend to use their easement rights.

Release by deed to burdened property

An owner of property benefitting from the use of an easement may voluntarily terminate it by **releasing the easement** to the owner of the burdened property.

The *release* can be accomplished by the use of a *quitclaim* or *grant deed* in favor of the owner of the burdened property, signed by the owner of the property holding the appurtenant right to use the easement.

Merger as an extinguisher

merger
The termination of an easement when one owner acquires fee title to both the property benefitting from and the property burdened by an easement.

A **merger of legal interests** comprising the *servient* and *dominant* tenement rights and obligations in two properties due to common ownership of both properties extinguishes an easement.

A **merger** occurs when the same owner acquires fee title to both the benefitting and burdened properties.

An owner cannot have an easement over their own property for the benefit of their own property. Thus, the easement is automatically extinguished on the **common ownership** of both the properties.[1]

However, no merger occurs when the owner of burdened property acquires a fractional interest in title to the benefitting property as a co-owner since the owner is not the sole owner of both properties.[2]

Additionally, acquiring a lien such as a trust deed encumbering either the benefitting or burdened property by the owner of the other property is not a merger of interests.

Extinguished by destruction of property

An easement is terminated by the **destruction** of the burdened property. Nonexistence of the burdened property renders the use of the easement impossible.

Consider an easement to use a stairway in an adjoining building. When the building burns down, the easement is extinguished since the owner is not required to rebuild the stairway.[3]

Forfeiture for exceeding authority

An easement is terminated by **forfeiture** when the easement holder exceeds their authorized use of the easement by placing an *excessive burden* on the property encumbered by the easement.

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1 Calif. Civil Code §805

2 **Cheda** v. **Bodkin** (1916) 173 C 7

3 Cohen v. Adolph Kutner Co. (1918) 177 C 592

For example, consider a subdivider who owns land entitling them to use a right-of-way easement over a neighbor's property for access.

forfeiture
The termination of an easement when the easement holder exceeds their authorized use of the easement by placing an excessive burden on the property encumbered by the easement.

Later, the subdivider divides the property into several residential lots. For access, the subdivider constructs a road on the neighbor's property within the legally described easement to a public road. Here, the increased use of the easement constitutes an excessive burden on the property it encumbers, and thus the easement is *extinguished by forfeiture*.[4]

Prescription creates and destroys

An easement can be established by the adverse use of another's property. Likewise, an easement can be *extinguished* by the burdened property owner's use of the area within the easement which *permanently interferes* with their neighbor's ability to use the easement.

An adverse use which terminates an easement is any act by the burdened property owner which permanently obstructs the beneficial use enjoyed by the holder of the easement.

Consider a subdivider who sells an unimproved parcel of land, granting the buyer a right-of-way easement for ingress and egress over an adjoining parcel. Later, the subdivider constructs a concrete block wall on the common boundary line which blocks any use of the easement by the buyer.

abandonment
The termination of an easement when the easement holder's actions demonstrate a clear intent to permanently abandon all future use of the easement. [See **RPI** Form 581]

More than five years after the block wall was constructed, the buyer of the parcel benefitting from the easement seeks to quiet title to the right of way.

Here, the obstruction of the easement is an adverse use by the subdivider of the property burdened by the easement. Thus, the easement is extinguished since the subdivider totally interfered with the use of the easement for a period of five years.[5]

Abandonment – never to use again

An easement can also be terminated through **abandonment** by the easement holder. The termination of an easement by *abandonment* is not easily established.

The easement holder's actions need to demonstrate a clear intent to *permanently abandon* all future use of the easement, never to use it again.

4 **Crimmins** v. **Gould** (1957) 149 CA2d 383
5 **Glatts** v. **Henson** (1948) 31 C2d 368

Chapter 42 Summary

An existing easement can be extinguished, no longer affecting the burdened property as an encumbrance on its title.

Methods used to extinguish an easement include:

- release of the easement by a deed from the owner of the property;
- merger by the acquisition of both the benefitting and burdened properties by the same owner;
- destruction of the burdened property;
- forfeiture due to the easement holder's abuse of their easement rights;
- prescription due to the burdened property owner's continuing interference with the easement; and
- abandonment by the conduct of the easement holder showing they never intend to use their easement rights again.

Chapter 42 Key Terms

Quiz 8 Covering Chapters 37-43 is located on page 613.

Chapter 43

Trespass: a violation of possession

Learning Objectives

After reading this chapter, you will be able to:

- identify the different types of trespass; and
- understand the remedies a rightful occupant has against trespassers.

Key Terms

actual money losses
adverse possession
ejectment
nominal money losses
misdemeanor
trespass

For a further discussion of this topic, see Chapter 11 of Legal Aspects of Real Estate.

Ejectment, liabilities and title risks

A **trespass** is any wrongful and unauthorized entry onto real estate in the possession of another.

Thus, a *trespass* is fundamentally an interference with another's *possession* of real estate. It is distinct from any interference with **title** or an **ownership interest**.[1]

Anyone in possession of the property, such as the fee owner, a life estate owner, a tenant or even a person in wrongful possession, has the right to stop a trespass.[2]

A fee owner can even trespass on the property they own in fee simple when the property is in the legal possession of another person, such as a tenant.

trespass
Any wrongful and unauthorized entry onto real estate in the possession of another.

1 **Brenner** v. **Haley** (1960) 185 CA2d 183
2 **Allen** v. **McMillion** (1978) 82 CA3d 211

Trespasser liability for harm done

When an entry is not *privileged*, it is considered a trespass. A trespasser incurs **civil liability** for the monetary amount of any losses or injury they cause to the occupant's person, real estate or personal property.

Conversely, damage to the fee owner's property caused by the person who is in rightful possession, such as a tenant, is not a trespass. If the damage is caused by someone in rightful possession, it constitutes **waste** since they have impaired the property's value.[3]

nominal money losses
Monetary recovery when no injury has occurred.

An owner may bring an action for trespass against a trespasser even when the trespasser caused no actual injury by his presence in the owner's property. If no injury has occurred, the owner may only recover **nominal money losses** from the trespasser. *Nominal money losses* are awarded when a wrong has taken place but has not resulted in a money loss.[4]

actual money losses
Monetary losses recovered for injury to the real estate, lost use of the property, personal injury or injury to the occupant's personal property, also called damages.

To recover **actual money losses** for a trespass, a rightful occupant needs to sustain a real, actual loss. *Actual money losses* recoverable for a trespass are based on:

- injury to the real estate;
- lost use of the property;
- personal injury; and
- injury to the occupant's personal property.

Indirect trespass

A trespass does not require the trespasser's direct physical presence on the property. A trespass can result from an *indirect entry* into another's property, sometimes called **trespass on the case**.

For example, one can be liable on a trespass for losses caused by activities such as:

- depositing dirt or debris on another's property;[5]
- leaving toxic waste on another's property;[6]
- leaving personal property on real estate belonging to another;[7]
- diverting a river or surface waters across another's property;[8]
- starting a fire and negligently allowing the fire to move onto a neighbor's property;[9] or
- allowing one's animals to wander across another's property.[10]

Injunction to abate a trespass

Besides recovering money losses, an owner can obtain a court ordered **injunction** to stop a person who is a continuing trespasser.

3 **Smith** v. **Cap Concrete** (1982) 133 CA3d 769
4 **Staples** v. **Hoefke** (1987) 189 CA3d 1397
5 **Armitage** v. **Decker** (1990) 218 CA3d 887
6 **Mangini** v. **Aerojet-General Corporation** (1991) 230 CA3d 1125
7 **Herond** v. **Bonsall** (1943) 60 CA2d 152
8 **Salstrom** v. **Orleans Bar Gold Mining Co.** (1908) 153 C 551
9 **Elton** v. **Anheuser-Busch Beverage Group, Inc.** (1996) 50 CA4th 1301
10 **Montezuma Improvement Co.** v. **Simmerly** (1919) 181 C 722

A single isolated trespass is not a basis for an *injunction*. However, if seeking money losses would not prevent a trespass from being repeated in the future, the rightful occupant can obtain an injunction against the trespasser.[11]

Criminal trespass on refusal to leave

In addition to liability for property damages, a trespasser may also incur **criminal liability**. Trespassing becomes a **misdemeanor** when the trespasser:

- *refuses to leave the property* on foot or in a vehicle when requested by the owner, the owner's agent, a person in lawful possession of the property, or a law enforcement officer acting on request from the person entitled to possession;[12]
- enters and *occupies the property* without the rightful owner's consent;[13]
- *refuses to leave a transient occupancy* establishment (hotel/motel/vacation property) on the request of the owner or manager;[14]
- *enters a private dwelling*;[15] or
- *enters industrial property* (such as an oil field, a gas or electric plant or a railroad yard) where posted signs forbid trespassing.[16]

misdemeanor
A lesser crime punishable by a fine and/or county jail sentence.

A crime is not committed by merely entering another's property, except when the property is a *private residence* or posted *industrial property*.

Removing trespassers by ejectment

An owner's first course of action when confronted with a trespasser is to simply request the trespasser to leave. If the trespasser does not leave when requested, they commit a *misdemeanor*.[17]

An owner may not forcibly eject a trespasser. To discourage disturbances of the peace caused by self-help, California law allows both tenants and trespassers to recover losses from the landlord or property owner for *forcible entry and detainer* — a forcible interference with an individual's peaceful possession of a property, even if that individual's possession is wrongful.[18]

An owner may only recover possession of their property from a trespasser through a court action, except when the trespasser is a transient occupant who failed to depart as agreed. The type of action brought to recover property depends on the type of possession held in the property.

For example, the action to recover possession of a property from a tenant in default on their lease obligations is referred to as an **unlawful detainer (UD)**. In the case of a trespasser occupying property, the legal remedy is an **ejectment** action.

ejectment
A civil action to recover possession or title to land from someone wrongfully in possession.

11 **Standard Lumber Co.** v. **Madarys Planing Mill** (1921) 54 CA 107
12 Calif. Penal Code §602(k), (n)
13 Pen C §602(m)
14 Pen C §602(s)
15 Pen C §602.5
16 Pen C §554
17 Pen C §602(l)
18 CCP §§1159, 1161, 1172

Ejectment is similar to a UD action but has less stringent proof of trespass requirements. The trespasser in an ejectment action, unlike the tenant in a UD action, never had legal possession of the property for an owner to have the trespasser legally removed.

adverse possession
A method of acquiring title to real estate owned by another by openly maintaining exclusive possession of the property for a period of five years and paying all property taxes.

In an action to eject a trespasser, an owner (or other occupant) needs to prove they have a superior right to possession of the property. The owner may then obtain a court order for the removal of the trespasser from their property, called a **writ of possession.** The court order is carried out by the sheriff, not the owner.[19]

Adverse possession and owner inattention

A trespasser who occupies property without the consent of the owner can be ejected by a court order at any time and charged with a misdemeanor.[20]

However, a trespasser can acquire title to the entire property by **adverse possession** if they can maintain *exclusive possession* of the property as a trespasser for a period of five years. To establish title by adverse possession, the trespasser's possession needs to be open and known to the owner, and the trespasser is to pay all property taxes.[21]

19 CCP §715.010
20 Pen C 602
21 **Gilardi** v. **Hallam** (1981) 30 C3d 317

Chapter 43 Summary

A trespass is any unauthorized entry onto real estate in the possession of another. A trespasser incurs civil liability for the monetary amount of any losses or injury caused to the occupant's person, real estate or personal property. If no injury has occurred, the occupant may recover nominal money losses from the trespasser.

A trespasser may incur criminal liability if they do not leave when requested since the trespass becomes a misdemeanor. When a trespasser does not leave when requested, the owner may recover possession of their property through a court action, except for a transient occupant who failed to depart as agreed. The type of action brought to recover property depends on the type of possession held in the property.

A trespasser may also acquire title to the property by adverse possession.

Chapter 43 Key Terms

actual money losses .... **pg. 288**
adverse possession .... **pg. 290**
ejectment .... **pg. 289**
nominal money losses .... **pg. 288**
misdemeanor .... **pg. 289**
trespass .... **pg. 287**

Quiz 8 Covering Chapters 37-43 is located on page 613.

Chapter 44

Nuisance: offensive, unhealthful or obstructive

Learning Objectives

After reading this chapter, you will be able to:

- identify what constitutes a nuisance per se;
- apply the balancing of the rights of neighboring property owners to determine whether a nuisance exists;
- distinguish between a nuisance and trespass;
- understand the different remedies available in the instance of a permanent or continuing nuisance.

Key Terms

continuing nuisance

nuisance

nuisance per se

permanent nuisance

public nuisance

For a further discussion of this topic, see Chapter 12 of Legal Aspects of Real Estate.

Interference with use and enjoyment

A **nuisance** is anything which:

- is *offensive* to the senses;
- is *injurious* to health; or
- *obstructs* the use of property.[1]

Simply, a *nuisance* is any activity which interferes with an owner's **use and enjoyment** of their property, including conditions which are unhealthy or offensive to the senses. A nuisance is broadly interpreted to encompass a wide variety of activities.

nuisance
An action which is injurious to health, offensive to the senses, or obstructs the use and enjoyment of surrounding property. [See **RPI** Form 550 §6.7 and 552 §7.3]

1 Calif. Civil Code §3479

Nuisance per se by statute

nuisance per se
Any activity specifically declared by statute to be a nuisance, such as construction of fences of excessive height or the illegal sale of controlled substances.

An activity becomes a nuisance based on either:

- a statutory provision identifying conduct that is a **nuisance per se**; or
- a **balancing of the conflicting rights** and interests of the neighboring property owners.

A *nuisance per se* is any activity specifically declared by statute to be a nuisance. If an activity is a statutory nuisance, it can be ordered stopped by a court without proof of its harmful or offensive effect.

The list of nuisances per se is wide and diverse, including:

- fences of excessive height unnecessarily exceeding ten feet, called **spite fences**;[2]
- the illegal sale of controlled substances;[3]
- fire hazards;[4] and
- swimming pools which do not comply with statutory health and safety standards.[5]

Conversely, some activities are declared by statute not to be nuisances.

Activities done or maintained under the express authority of a statute, called **statutory authority**, cannot be nuisances. For example, the activities of a commercial agricultural processing plant are maintained under *statutory authority* and cannot constitute a nuisance.[6]

Balancing rights: inconvenient or improper

To determine whether a **nuisance** exists when an activity is not classified as a nuisance per se, a *balancing of the rights* of the neighboring property owners is applied.

Every owner is entitled to use their property for any lawful purpose. However, an owner is limited in their conduct since their permitted use may not unreasonably interfere with the right of others to use and enjoy their property.[7]

An owner's use of their property often creates some degree of inconvenience for the occupants of neighboring properties. However, to constitute a nuisance, the inconvenience created by an owner's use needs to be serious enough to be an *improper interference* with another's use and enjoyment of their property.

Public vs. private nuisance

A nuisance may be a **public nuisance**, a **private nuisance** or both.

A *public nuisance* is a nuisance which affects an entire segment of the public, such as a neighborhood.[8]

2 CC §841.4
3 CC §3479
4 Calif. Public Resources Code §4171
5 Calif. Health and Safety Code §116060
6 CC §§3482, 3482.6
7 CC §3514
8 CC §3480; Calif. Penal Code §370

Nuisance vs. trespass

Nuisance and trespass are closely related. The two categories overlap since both involve injury to or interference with the property rights of another. The distinction is based on whether a physical entry onto another's property occurs.

Trespass requires a physical entry on another's property which can be direct or indirect — i.e., the trespasser can either personally enter the property or deposit materials indirectly, such as dirt and debris from construction activity.

In contrast, a nuisance is an outside interference with an owner's or tenant's use and enjoyment of their property resulting from a condition or activity which physically remains outside the property.

Thus, trespass is based on an interference with the possession. A nuisance is an interference with the enjoyment of property since it affects the senses of the occupants.

For instance, noise is a nuisance to occupants of another property if the noise is loud, annoying and continuous. Noise is not a trespass since no physical invasion of property occurs, except for sound waves which affect the senses, not the property. The noise creates no interference with the possessory rights in another's property and thus is not a trespass.

However, the distinction between nuisance and trespass does not mean the categories are mutually exclusive. Nuisance is broadly defined by statute as anything which is injurious to health or obstructs the use of property, regardless of whether the condition exists on or off the affected property. Thus, an invasion of property which qualifies as a trespass is also a nuisance if the trespass rises to an unhealthful or offensive condition.

public nuisance
A nuisance affecting an entire segment of the public.

Stopping a public nuisance is the responsibility of state or local government authorities.

Officials may seek to:

- *abate* or *enjoin* the nuisance;
- recover *money damages*; or
- bring *criminal misdemeanor charges* against the offender responsible for the nuisance.[9]

A private property owner may not stop a public nuisance unless the public nuisance especially obstructs the owner's use of their property, making the interference a *private nuisance* as well.[10]

For a private owner to abate a public nuisance by an injunction, they need to sustain injuries to themselves or their property which are *different in kind* from the interference or injuries sustained by the public at large.

Remedies of suppression of money

The remedies for a public or private nuisance are:

- **abatement**, by suppression or termination of the interference;[11] and

9 Pen C §372
10 CC §3493
11 CC §3495

- an **injunction** and **money losses** in a civil action.[12]

An owner has the right to take self-help actions to end a private nuisance affecting their property if they can do so without creating a disturbance of the peace or causing injury.[13]

For instance, *self-help abatement* of a private nuisance typically occurs when an owner cuts off the limbs of a neighbor's tree which encroach onto the airspace of their property. [See Chapter 39]

A civil action to end a nuisance involves seeking an injunction to stop the activity or condition creating the nuisance, *money losses* from those responsible for the nuisance, or both.

The money losses an owner seeks to recover for a neighbor's nuisance are based on either:

- actual money losses for injury or loss of value to the owner's real estate, or for injury to the owner; or
- intangibles, such as emotional distress and personal discomfort.

Permanent or continuing nuisance

The type of money losses an owner can recover for property damage caused by a nuisance depends on whether the nuisance is *permanent* or *continuing*. A **permanent nuisance** exists when the nuisance cannot be abated at a reasonable cost and by reasonable means.[14]

permanent nuisance
A nuisance which cannot be abated at a reasonable cost and by reasonable means.

Conversely, a **continuing nuisance** exists if the nuisance can be reduced or terminated at any time and at a reasonable expense.

The money losses inflicted by a permanent nuisance are determined at the time the permanent nuisance is created. Losses inflicted by a continuing nuisance are limited to the actual injuries suffered prior to termination of the nuisance.[15]

Permanent nuisance remedies

A permanent nuisance cannot be abated at a reasonable expense or by reasonable means. Thus, an owner's only remedy is a recovery of money losses. The money losses are calculated based on the diminished value of the owner's property caused by the nuisance.

For instance, a building on a neighbor's property **encroaches** on the adjacent owner's property. The *encroachment* is a permanent nuisance since it perpetually obstructs the use and enjoyment of the owner's property and cannot be removed at a reasonable cost to the neighbor.

In balancing the rights of the adjacent owner and the encroaching neighbor, the cost to the neighbor to abate the nuisance by removing the encroaching improvements far exceeds the loss of the owner's use. Thus, the owner is

12 CC §§3501, 3493
13 CC §3502
14 **Mangini** v. **Aerojet-General Corporation** (1996) 12 C4th 1087
15 **Spar** v. **Pacific Bell** (1991) 235 CA3d 1480

entitled to monetary compensation for the lost use of the portion of their property hindered by the encroachment, but cannot abate the encroachment itself.[16]

Continuing nuisance remedies

In the case of a permanent nuisance, an owner can recover *money losses* equal to the permanent decline in the property's value caused by the nuisance.

However, recovery for a **continuing nuisance** cannot include lost property value since the nuisance can be entirely eliminated. The condition causing the diminished value will no longer exist once the nuisance is removed. Thus, no permanent loss in value occurs to be recovered.[17]

continuing nuisance
An ongoing nuisance that can be entirely eliminated by those adversely affected by the activity or condition.

The primary remedy for a *continuing nuisance* is an *abatement* to remove the nuisance or an *injunction* ordering the nuisance to be stopped.

In addition to an injunction, other money losses which can be recovered by the owner are limited to:

- the lost use of the property until the nuisance is abated, such as rental value;
- the costs incurred to remedy the damage done by the nuisance to the owner's real estate;
- the cost of cleanup or repairs necessary to eliminate the nuisance; and
- any expenses incurred due to personal injury or emotional distress caused by the nuisance.

Statute of limitations on recovery

Under the statute of limitations, an action on a permanent nuisance is required to be brought within **three years** after the nuisance becomes permanent.

In the case of a continuing nuisance, a new cause of action accrues and the three-year statute of limitations begins to run anew each day the nuisance continues, or when further damage is inflicted on the property.

16 **Christensen** v. **Tucker** (1952) 114 CA2d 554
17 Alexander, supra

Chapter 44 Summary

A nuisance is anything which is offensive to the senses, injurious to health or obstructs the use of property.

A nuisance per se is any activity specifically declared by statute to be a nuisance. Conversely, when an activity is not a nuisance per se, a balancing of the rights of neighboring property owners is applied to determine whether a nuisance exists.

A nuisance may be classified as public or private. A public nuisance affects an entire segment of the public and is the state or local government's responsibility to stop. An owner may take actions to reduce or end a private nuisance affecting their property if they can do so without creating a disturbance of the peace, called self-help abatement.

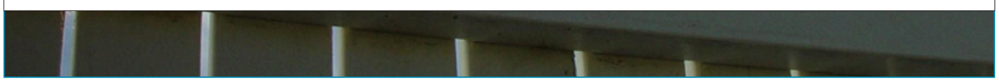
The type of money losses an owner can recover for property damage caused by a nuisance depends on whether the nuisance is permanent or continuing. For permanent nuisances, the owner may be entitled to money losses based on the diminished value of the owner's property caused by the nuisance. Recovery for a continuing nuisance cannot include lost property value since the nuisance can be entirely eliminated. The primary remedy for a continuing nuisance is an abatement to remove the nuisance or an injunction ordering the nuisance to be stopped.

Chapter 44 Key Terms

Quiz 9 Covering Chapters 44-48 is located on page 614.

Chapter 45

Boundary disputes



Learning Objectives

After reading this chapter, you will be able to:

- understand the agreed-boundary doctrine; and
- the elements needed to establish a boundary line under the agreed-boundary doctrine.

Key Terms

agreed-boundary doctrine **statute of limitations**
lot line adjustment

For a further discussion of this topic, see Chapter 9 of Legal Aspects of Real Estate.

Doctrine of agreed-to boundaries

Consider a parcel of real estate divided into two equally sized parcels by a recorded survey. Later, a fence is erected between the parcels but not located on the common boundary line, causing one parcel to appear physically larger than the other.

Multiple years later, the owner of the smaller parcel sells their land. The new owner hires a surveyor to determine the location of the boundary between the properties.

The survey sets the boundary at the location described in recorded documents. The survey shows the fence is not located on the legally described boundary between the adjacent properties.

The new owner of the smaller parcel seeks to recover possession of the land between the fence and the boundary.

The neighboring owner of the larger parcel claims the fence is the agreed boundary since it is reasonable to infer the previous owners agreed the location of the fence to be their common boundary.

agreed-boundary doctrine
When owners of adjacent properties uncertain over the true boundary agree to establish the location of their common lot line and acquiesce to the boundary line for at least five years.

The owner of the smaller parcel claims the **agreed-boundary doctrine** does not apply since a recorded legal description of the boundary is available and the true boundary is thus known and can be located.

Is the owner of the smaller parcel correct in relying on the legal description of the property to establish the actual boundary location?

Yes! The doctrine of title by agreed boundaries, commonly referred to as the *agreed-boundary doctrine*, does not apply since:

- the exact boundary location can be readily located; and
- the owner of the larger parcel defending the fence as the boundary cannot show the prior owners were **uncertain** as to the true boundary description and then, to resolve their uncertainties of location, **agreed** the fence would mark the boundary.[1]

Elements of ancient doctrine

To establish a boundary line under the *agreed-boundary doctrine*, the following facts need to exist:

- *uncertainty* as to the boundary's exact location;
- an *agreement* between the owners to set the boundary line; and
- *acquiescence* to the boundary line for a period of at least five years; or
- a *substantial loss* would be suffered due to a change in the location of the boundary line to the legally described location.[2]

The agreed-boundary doctrine was developed during a time when less advanced surveying techniques made it too difficult or expensive to locate the boundary line described in the deeds.

Thus, the more practical way to set a boundary line in rural and relatively unpopulated areas was often for owners of adjacent parcels to agree between themselves on the location of a common marker, such as a fence, to set the agreed boundary.

However, surveying techniques have significantly improved. Now, if a deed is clear and a competent surveyor is available, the true boundary line can easily be established to eliminate the uncertainty of the boundary's location. Thus, the ancient agreed-boundary doctrine has been reduced to the status of a legal last resort.

In the absence of an oral or written agreement between an owner and their neighbor to set the boundary line at some place other than a documented deed line, the boundary line described in their deeds remains as the boundary.[3]

1 **Bryant** v. **Blevins** (1994) 9 C4th 47
2 **Ernie** v. **Trinity Lutheran Church** (1959) 51 C2d 702
3 **Armitage** v. **Decker** (1990) 218 CA3d 887

Agreeing to the boundary

Once owners of adjacent properties uncertain over the true boundary agree to establish the location of their common lot line, the location they set replaces the legal line provided either:

- a five-year statute of limitations has run; or
- a substantial loss would result from the boundary line being moved to the legally described location.

Uncertain boundaries

Uncertainty over the exact location of a boundary line may arise in a number of circumstances.

For example, where natural markers, such as trees, boulders or a creek, were used to mark a boundary line, the location of the markers may have changed or disappeared over time.

Section posts and other surveyor's monuments which indicate boundary lines are also subject to earth movement, climatic changes and human activity. Also, the legal descriptions for parcels of real estate may be conflicting or simply fail to correctly set a boundary line, or may not coincide with another line or boundary.

An actual *dispute* over a boundary's location need not exist between the owners of adjacent parcels. Instead, owners are to merely be in *doubt* over the location of the true boundary and agree to the location of the boundary when they set it.

Usually, it is not the original owners who have a dispute over title or possession based on the agreed-to boundary line, it is the later owners.

However, when the boundary line in a recorded deed is readily ascertainable by a surveyor, the description in the record controls, unless the landowner defending the location of the line as the common boundary provides proof the boundary line as located settles an actual, not implied, boundary dispute.[4]

Agreement to make certain

An agreement to mark a boundary line may be oral, written or result from the conduct of neighboring property owners.

Oral or written agreements on the boundary's location are called **express agreements** since they are not implied.

Written agreements are the most efficient since they formally document the mutual intentions of both owners. However, they usually exist only in the case of a lot line adjustment map. However, unlike the conveyance of real estate, owners do not have to put their boundary agreement in writing for it to be enforceable.

With the setting of an agreed boundary, neither owner is conveying real estate to the other. Instead, the owners are agreeing to what land constitutes their own property.[5]

4 Bryant, *supra*

5 **Young** v. **Blakeman** (1908) 153 C1st 477

The element duration

Owners need to acquiesce to the agreed boundary for a period of at least five years. This five-year period is the **statute of limitations** for the recovery of real estate.[6]

statute of limitations
A period of time establishing the deadline for filing a lawsuit to resolve a dispute.

The *statute of limitations* requires the adjacent owners to resolve a dispute within the five-year period. If disputes are not settled within this period, the claims are put to rest. Thus, an owner who fails to object to a boundary dispute during the statute of limitations period is presumed to have agreed to the boundary set by the adjacent property owner.

However, an exception to the five-year rule arises if *substantial loss* will be caused by the movement of the agreed boundary to the true lot line.

Limitations of the doctrine

The agreed-boundary doctrine has limitations. The doctrine cannot be used to convey property. Further, the agreed-boundary doctrine can only set a boundary, the exact location of which is unknown to the adjacent owners without a survey or litigation.

lot line adjustment
When adjacent property owners move an existing property line.

Any attempt to convey a portion of a lot to the owner of an adjacent property by use of the agreed-boundary doctrine violates the *statute of frauds* which requires a writing documenting the intent to convey land. Thus, the agreed-boundary doctrine cannot be used to make **lot line adjustments** in which adjacent owners move an existing line, the location of which is known to them.

6 Calif. Code of Civil Procedure §318

Chapter 45 Summary

Under the agreed-boundary doctrine, owners of adjacent properties uncertain over the true boundary can agree to establish the location of their common lot line. The location they set replaces the legal line provided either a five-year statute of limitations has run or a substantial loss would result from the boundary line being moved to the legally described location.

An agreement to mark a boundary line may be oral or written or result from the conduct of neighboring property owners. The agreed-boundary doctrine cannot be used to convey property, nor can it be used to make lot line adjustments to move an already existing line.

Chapter 45 Key Terms

agreed-boundary doctrine .... **pg. 298**
lot line adjustment .... **pg. 300**
statute of limitations .... **pg. 300**

Quiz 9 Covering Chapters 44-48 is located on page 614.

Chapter 46

A deed as transfer

Learning Objectives

After reading this chapter, you will be able to:

- describe the components a deed needs to contain to convey an interest in real estate;
- understand the exceptions to the requirement for a signed writing to transfer an interest in real estate; and
- determine who is capable of conveying and receiving an interest in real estate.

Key Terms

adverse possession	**grantee**
common description	**grantor**
fee simple	**legal description**
grant	**quitclaim deed**
grant deed	

For a further discussion of this topic, see Chapter 18 of Legal Aspects of Real Estate.

A deed by any name is a grant

Real estate is *conveyed* when title is transferred from one individual to another.[1]

The transfer of an interest in title to real estate contained in a writing is called a **grant** or **conveyance**, no matter the form of writing.[2]

grant
The transfer of an interest in title to real estate.

A deed is itself the *grant* which transfers title to property.[3]

Title by deed passes either:

- *voluntarily* by agreement with the owner, as in a sale in the open market or foreclosure on a trust deed or assessment bond; or

1 Calif. Civil Code §1039

2 CC §1053

3 **Hamilton** v. **Hubbard** (1901) 134 C 603

- *involuntarily* without agreement, such as the enforcement of a creditor's judgment or tax lien.

No matter the form of writing, the individual conveying real estate is called the **grantor**. The individual acquiring title is called the **grantee**.

grantor
An individual capable of conveying an interest in real estate.

Ownership of *possessory interests* in real estate include:

- a fee simple;
- a life estate;
- a leasehold estate; and
- an estate at will.

fee simple
The absolute ownership of possessory rights in real estate for an indefinite duration.

Fee simple ownership is presumed to pass by a grant of real estate, unless a lesser possessory interest is stated, such as an easement, life estate or leasehold interest.[4]

A *fee simple* interest in real estate is the absolute ownership of the possessory rights in the real estate for an indefinite duration.

Creating a valid deed for conveyancing

To be valid, a deed needs to:

- be in writing;
- identify the grantor and the grantee;
- contain a granting clause stating the grantor's intention to convey;
- adequately describe the real estate involved;
- be signed by the grantor; and
- be handed to and accepted by the grantee. [See Form 404 accompanying this chapter]

Form deeds used in real estate transactions conform to these validity requirements by containing words of conveyance, and contain provisions for the identification of the parties and a description of the real estate. They are also of suitable size and format to permit the document to be notarized and recorded. [See **RPI** Form 404 and 405]

A deed in writing, with exceptions

To be valid, the *transfer* of an ownership interest in real estate needs to be in writing, except for:

- an estate at will or a lease for a term not exceeding one year;[5]
- an *executed* (partially or fully performed) oral agreement under which the buyer takes possession of the property and makes payments toward the purchase price or makes valuable improvements on the property; or
- adverse possession.

4 CC §1105
5 CC §1091

An *executed oral agreement* for the transfer of real estate ownership will be enforced either under the doctrines of **specific performance** or **estoppel.** The application of both doctrines is unaffected by whether the property is being sold under an oral agreement to a buyer for consideration, or given to a *donee* by gift.

Title by claims of adverse possession

To establish title by **adverse possession**, an occupant needs to show:

- their possession is based on a *claim of right* or *color of title*;
- they have occupied the property in an open and notorious way which constitutes *reasonable notice* to the record owner;
- their occupancy is *hostile and inconsistent* with the owner's title;
- they have been in possession for a *continuous and uninterrupted period* of at least five years; and
- they have *paid all taxes* assessed against the property during their occupancy.[6] [See Chapter 45]

adverse possession
A method of acquiring title to real estate owned by another by openly maintaining exclusive possession of the property for a period of five years and paying all property taxes.

An occupant's ownership by *adverse possession* based on a claim of right avoids the statute of frauds writing requirement. To obtain title by adverse possession based on a claim of right, the occupant has, by the nature of adverse possession, no written documentation or evidence of title. Essentially, the adverse possessor is a *trespasser* in possession of the owner's property without any good faith belief they hold title to the property.[7]

Thus, in the case of adverse possession by a claim of right, the owner of the property has not orally conveyed title to the real estate to the occupant. The occupant is a trespasser until their conduct on the property, time in possession and payment of all property taxes meet the requirements for them to obtain a court ordered transfer of title by adverse possession.

Alternatively, title by adverse possession based on a color of title usually occurs when the occupant's title is based on a *defective deed*.

Grantor qualifications as capable

A **grantor** of property needs to be **capable** of conveying an interest in real estate at the time the deed is signed for the deed to be an enforceable conveyance.[8]

To be *capable*, the grantor at the time the deed is signed needs to:

- be of *sound mind;*
- possess their *civil rights;* and
- be *an adult* at least 18 years of age.[9]

6 Calif. Code of Civil Procedure §§318 et seq.
7 **Brown** v. **Berman** (1962) 203 CA2d 327
8 CC §38; Calif. Family Code §6701
9 CC §1556

However, an exception exists to the "18 or over" age qualification. An **emancipated minor** is considered an adult capable of transferring an interest in real estate.[10]

Grantor identification in deed

The *grant provision* in a deed needs to identify each person who is conveying an interest in the property. If a conveyance such as a deed is signed by a person who is not named as the grantor, the deed does not convey that person's interest in the property.

The identity of the grantor in the provision containing words of conveyance needs to be certain, determined by an examination of the entire deed, not just the signatures.[11]

For example, a deed identifies several individuals as grantors in the grant provision and the document contains their signatures. However, the list of grantors named in the deed's grant provision is incomplete to convey full title. Several unnamed individuals also have an ownership interest in the property.

Further, the signatures on the grant deed include all the individuals who are co-owners of the property — even though some are not named as grantors in the grant provision.

In this instance, the deed transfers only the ownership and title held by those owners named as grantors in the grant provision in the deed. The deed by its wording does not show the necessary intent to convey title by the unnamed owners who were not listed as grantors and also signed the deed.[12]

On recording, the county recorder will only index as grantors those persons listed in the grant provisions since only they conveyed their interests in the real estate.

The grantee as any person

grantee
An individual acquiring an interest in title to real estate.

While the grantor needs to have the capacity to convey title, any existing person (individual or entity) may take and hold title to real estate as the grantee.[13]

A child or an incompetent person has the *capacity to receive* and hold title as a *grantee* even though that person does not have the legal capacity to convey the same property.[14]

A deed needs to *identify* the grantee. For example, a seller accepts a buyer's purchase agreement offer. The seller concurrently signs a deed and hands it to the broker as the seller is leaving the country. However, the space for the name of the grantee is left blank. The broker is not instructed to enter the buyer's name as the grantee. The broker, as instructed, delivers the deed to the buyer without entering the buyer's name.

10 Fam C §7050(e)(3)
11 **Childs** v. **Newfield** (1934) 136 CA 217
12 **Roberts** v. **Abbott** (1920) 48 CA 779
13 CC §671
14 **Turner** v. **Turner** (1916) 173 C 782

Form 404

Grant Deed

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

Title Order # ____________

Escrow # ____________

APN # ____________

The undersigned grantor(s) declare(s):

DOCUMENTARY TRANSFER TAX $ ____________

☐ Computed on the consideration or value of property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

☐ Unincorporated area ☐ City of ____________

GRANT DEED

NOTE: This form is used by agents, escrow officers and owners when any or all of a fee simple interest in real estate other than a leasehold is transferred, to identify the parties to the transfer, describe the property transferred and record the transfer with the county.

I/We, ____,

grant to ____

the real property in the City of ______________________________,

County of ______________________________, State of California,

referred to as ____

____

☐ See attached Signature Page Addendum. [RPI Form 251]

Date: ____________, 20______. ____________ ____________

(Print name) *(Signature)*

____________ ____________

(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 ____________

On ____________ before me, ____________

(Name and title of officer)

personally appeared ____________,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature: ____________

(This area for official notarial seal) *(Signature of notary public)*

MAIL TAX STATEMENTS AS DIRECTED ABOVE

FORM 404 03-15 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Is the deed which does not name the grantee a valid transfer of title?

No! A deed which does not identify a grantee is void. The identity of the grantee needs to be sufficient to identify with certainty the individual to whom the seller intends title to be passed.[15]

Additionally, a deed is considered valid if the individual identified as the grantee takes title under a **fictitious name** by which they are also known or have assumed for the purpose of receiving title.

15 **Tumansky** v. **Woodruff** (1936) 14 CA2d 279

However, if the *fictitious name* is established for the purpose of committing a fraud against the grantor, the grantor may set aside the deed as **voidable**.

Sometimes an unintentional error **misnames the grantee** in a recorded deed, such as by misspelling the grantee's name. A deed with a misnamed grantee is still a valid conveyance of the real estate.

Another deed from the same grantor to the grantee named with the correct spelling of the grantee's name will not correct the error, nor will re-recording the original deed with an amendment containing the grantee's correct name. The recording of a corrective deed falls outside the chain of title in the grantor-grantee index since the grantor no longer has any interest to convey. The grantor has already conveyed their title, albeit to a grantee with an erroneously spelled name.[16]

A grantor who has conveyed title cannot do so again even as an attempt to convey title to the same grantee.

grant deed
A document used to pass a fee simple interest in real estate from the grantor to another individual, unless a lesser interest is stated. [See **RPI** Form 404]

Editor's note — Title companies are only concerned the grantor on a deed is the same person who took title under the incorrect name. Title companies will generally accept a deed conveying title which identifies the grantor by both their correct name and the incorrect (misspelled) name under which they originally took title as a grantee.

Words of conveyance for a fee or less

The actual words of conveyance in a deed depend on whether the deed used is a **grant deed** or a **quitclaim deed**. [See Form 404 and 405 accompanying Chapter 48]

quitclaim deed
A document used to convey whatever interest, if any, the grantor may hold in the real estate. [See **RPI** Form 405]

A *grant deed* is used to pass a *fee simple interest* in real estate from the grantor to another individual, unless a lesser interest is stated in the deed. While no precise words of conveyance are necessary, use of the word "grant" in the granting clause, without noting a lesser interest in the description of the property, indicates the conveyance of a fee simple interest in the described property. [See Form 404]

Alternatively, a *quitclaim deed* is intended to convey whatever interest, if any, the grantor may hold in the real estate. The words of conveyance historically used in a quitclaim deed are "remise, release and otherwise quitclaim."

However, only the word "quitclaim" is required as the word of conveyance. The word "grant" is not used in a quitclaim deed since no implied warranties are included with a conveyance under a quitclaim deed. However, the parties to a quitclaim deed are referred to as the "grantor" and the "grantee." [See Form 405 accompanying Chapter 48]

16 **Walters** v. **Mitchell** (1907) 6 CA 410

Describing the property conveyed

A deed conveying property needs to sufficiently *describe* the property being conveyed. The description in the deed is necessary so the property can be reasonably located. If the property cannot be located from the description, the conveyance is void.[17]

The description of a parcel in a deed needs to be sufficient to allow the real estate conveyed to be identified and located with reasonable certainty by a surveyor.[18]

Facts not stated in the deed, known as *extrinsic evidence*, may only be used when an ambiguity arises as to the description of the property conveyed.

However, extrinsic evidence may not be used to supply the deed with a missing description or correct a defective description.

For example, real estate is conveyed by a deed describing the property as the "Occidental Mill Site, containing 4.95 acres, being a fraction of lot 2..." The use of the real estate's common name in the deed is sufficient to locate the boundaries and identify the real estate being conveyed.[19]

common description
Description of real estate by its street address. Also known as a common address.

Additionally, a deed which describes real estate by its street address, such as "879 Riverside Avenue, Riverside, CA 92507," will be considered sufficient to identify the real estate located at the street address, sometimes called a **common description** or **common address**.[20]

legal description
The description used to locate and set boundaries for a parcel of real estate.

However, the deed best includes the property's **legal description** or a map designation, such as a parcel or lot number, which contains the *metes and bounds* description needed to locate with certainty the parcel being conveyed.

Thus, the real estate can be described by reference to other documents, such as a subdivision map as it contains the metes and bounds description of the parcel. The document referenced in a deed is incorporated into the deed as the source of the metes and bounds description of the property conveyed.[21]

The grantor's signature

To transfer real estate by a deed, the deed needs to be signed by the grantor named in the deed.[22]

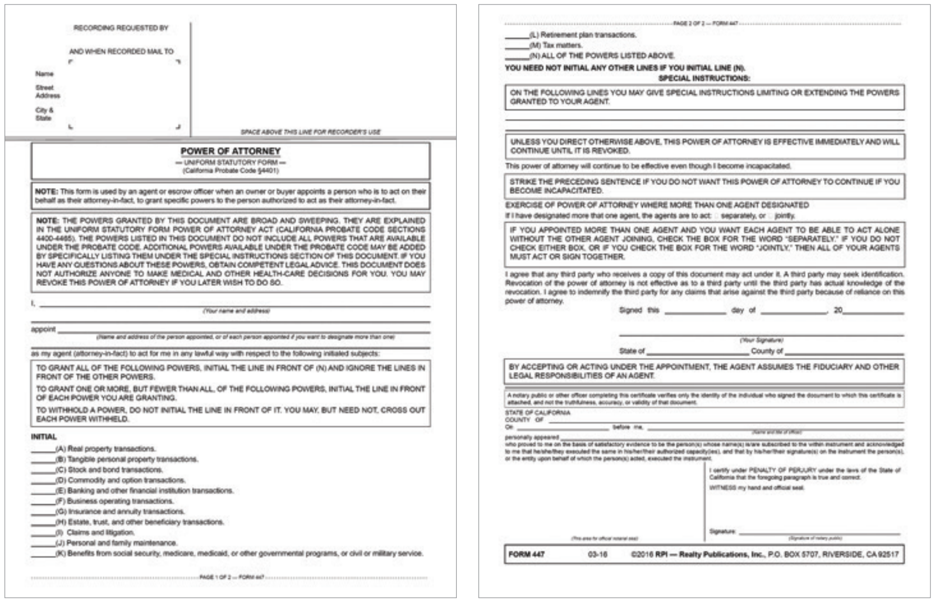
A deed can also be signed on behalf of the grantor by the grantor's agent if the agent is authorized in writing to convey the property on the grantor's behalf. The agent is called an **attorney in fact** and is operating under a *power of attorney*.[23] [See Figure 1, Form 447]

17 **Scott** v. **Woodworth** (1917) 34 CA 400
18 **Best** v. **Wohlford** (1904) 144 C 733
19 CC §1092
20 **Brudvig** v. **Renner** (1959) 172 CA2d 522
21 **Edwards** v. **Lewis** (1938) 25 CA2d 168; see Figure 1
22 CC §1091
23 CC §1091

Figure 1

Form 447

Power of Attorney



RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

POWER OF ATTORNEY

— UNIFORM STATUTORY FORM —

(California Probate Code §4401)

NOTE: This form is used by an agent or escrow officer when an owner or buyer appoints a person who is to act on their behalf as their attorney-in-fact, to grant specific powers to the person authorized to act as their attorney-in-fact.

NOTE: THE POWERS GRANTED BY THIS DOCUMENT ARE BROAD AND SWEEPING. THEY ARE EXPLAINED IN THE UNIFORM STATUTORY FORM POWER OF ATTORNEY ACT (CALIFORNIA PROBATE CODE SECTIONS 4400-4465). THE POWERS LISTED IN THIS DOCUMENT DO NOT INCLUDE ALL POWERS THAT ARE AVAILABLE UNDER THE PROBATE CODE. ADDITIONAL POWERS AVAILABLE UNDER THE PROBATE CODE MAY BE ADDED BY SPECIFICALLY LISTING THEM UNDER THE SPECIAL INSTRUCTIONS SECTION OF THIS DOCUMENT. IF YOU HAVE ANY QUESTIONS ABOUT THESE POWERS, OBTAIN COMPETENT LEGAL ADVICE. THIS DOCUMENT DOES NOT AUTHORIZE ANYONE TO MAKE MEDICAL AND OTHER HEALTH-CARE DECISIONS FOR YOU. YOU MAY REVOKE THIS POWER OF ATTORNEY IF YOU LATER WISH TO DO SO.

I, ____________________

(Your name and address)

appoint ____________________

(Name and address of the person appointed, or of each person appointed if you want to designate more than one)

as my agent (attorney-in-fact) to act for me in any lawful way with respect to the following initialed subjects:

TO GRANT ALL OF THE FOLLOWING POWERS, INITIAL THE LINE IN FRONT OF (N) AND IGNORE THE LINES IN FRONT OF THE OTHER POWERS.

TO GRANT ONE OR MORE, BUT FEWER THAN ALL, OF THE FOLLOWING POWERS, INITIAL THE LINE IN FRONT OF EACH POWER YOU ARE GRANTING.

TO WITHHOLD A POWER, DO NOT INITIAL THE LINE IN FRONT OF IT. YOU MAY, BUT NEED NOT, CROSS OUT EACH POWER WITHHELD.

INITIAL

______(A) Real property transactions.
______(B) Tangible personal property transactions.
______(C) Stock and bond transactions.
______(D) Commodity and option transactions.
______(E) Banking and other financial institution transactions.
______(F) Business operating transactions.
______(G) Insurance and annuity transactions.
______(H) Estate, trust, and other beneficiary transactions.
______(I) Claims and litigation.
______(J) Personal and family maintenance.
______(K) Benefits from social security, medicare, medicaid, or other governmental programs, or civil or military service.

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______(L) Retirement plan transactions.
______(M) Tax matters.
______(N) ALL OF THE POWERS LISTED ABOVE.

YOU NEED NOT INITIAL ANY OTHER LINES IF YOU INITIAL LINE (N).

SPECIAL INSTRUCTIONS:

ON THE FOLLOWING LINES YOU MAY GIVE SPECIAL INSTRUCTIONS LIMITING OR EXTENDING THE POWERS GRANTED TO YOUR AGENT.

UNLESS YOU DIRECT OTHERWISE ABOVE, THIS POWER OF ATTORNEY IS EFFECTIVE IMMEDIATELY AND WILL CONTINUE UNTIL IT IS REVOKED.

This power of attorney will continue to be effective even though I become incapacitated.

STRIKE THE PRECEDING SENTENCE IF YOU DO NOT WANT THIS POWER OF ATTORNEY TO CONTINUE IF YOU BECOME INCAPACITATED.

EXERCISE OF POWER OF ATTORNEY WHERE MORE THAN ONE AGENT DESIGNATED

If I have designated more that one agent, the agents are to act: ☐ separately, or ☐ jointly.

IF YOU APPOINTED MORE THAN ONE AGENT AND YOU WANT EACH AGENT TO BE ABLE TO ACT ALONE WITHOUT THE OTHER AGENT JOINING, CHECK THE BOX FOR THE WORD "SEPARATELY." IF YOU DO NOT CHECK EITHER BOX, OR IF YOU CHECK THE BOX FOR THE WORD "JOINTLY," THEN ALL OF YOUR AGENTS MUST ACT OR SIGN TOGETHER.

I agree that any third party who receives a copy of this document may act under it. A third party may seek identification. Revocation of the power of attorney is not effective as to a third party until the third party has actual knowledge of the revocation. I agree to indemnify the third party for any claims that arise against the third party because of reliance on this power of attorney.

Signed this ________ day of ________, 20________

(Your Signature)

State of ________ County of ________

BY ACCEPTING OR ACTING UNDER THE APPOINTMENT, THE AGENT ASSUMES THE FIDUCIARY AND OTHER LEGAL RESPONSIBILITIES OF AN AGENT.

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 ________

On ________ before me, ________

(Name and title of officer)

personally appeared ________

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

(This area for official notarial seal)

Signature: ________

(Signature of notary public)

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Additionally, a deed can be signed in the name of the grantor by an **amanuensis** as orally instructed by the grantor. An *amanuensis* is an individual who has the oral authority of the grantor to sign a grant deed by their own hand on behalf of the grantor.

Unlike an attorney in fact who is an agent with discretionary authority to determine whether they are to enter into a deed without prior approval from the grantor, an amanuensis has a purely ministerial duty. The amanuensis signs a document as instructed without exercising personal discretion or judgment.

Chapter 46 Summary

The individual conveying real estate is called the grantor. The individual acquiring title is called the grantee.

The transfer of title to real estate contained in writing is called a grant or conveyance. To be valid, a deed needs to:

- be in writing;
- identify the grantor and grantee;
- contain a granting clause stating the intention to convey;
- adequately describe the real estate so it can be reasonably located;
- be signed by the grantor or signed on behalf of the grantor by the grantor's agent; and
- be handed to and accepted by the grantee.

A transfer of an ownership needs to be in writing to be valid, except for:

- an estate at will;
- a lease not exceeding one year;
- an executed oral agreement in which the buyer takes possession of the property; or
- adverse possession of the property.

A grant deed is used to pass a fee simple interest in real estate from the grantor to another individual, unless a lesser interest is stated in the deed. A quitclaim deed conveys whatever interest, if any, the grantor may hold in the real estate.

A grantor of property needs to be capable of conveying an interest in real estate at the time the deed is signed for the deed to be enforceable.

Chapter 46 Key Terms

adverse possession .... **pg. 303**
common description .... **pg. 307**
fee simple .... **pg. 302**
grant .... **pg. 301**
grant deed .... **pg. 306**
grantee .... **pg. 304**
grantor .... **pg. 302**
legal description .... **pg. 307**
quitclaim deed .... **pg. 306**

Quiz 9 Covering Chapters 44-48 is located on page 614.

Notes:

Chapter 47

Grant deed vs. quitclaim deed

Learning Objectives

After reading this chapter, you will be able to:

- understand the use of a grant deed to pass a fee simple interest in real estate;
- recognize the implied covenants of grant deeds;
- determine when implied covenants in a grant deed run with the land and affect all later grantees/owners; and
- distinguish when a quitclaim deed is to be used to terminate any interest in real estate described in the deed which may be held by the grantor.

Key Terms

encumbrance	**quitclaim deed**
grant deed	**reformation**
implied covenant	**remote grantee**

For a further discussion of this topic, see Chapter 19 of Real Estate Legal Aspects.

The granting clause

Two types of deeds are commonly used to convey a real estate interest. These are:

- **grant deeds**; and
- **quitclaim deeds**.

To pass a *fee simple interest* in real estate, only the word "grant" needs to be used in the conveyance. No other precise words of conveyance are necessary in a deed to convey a fee simple ownership.[1]

grant deed
A document used to pass a fee simple interest in real estate from the grantor to another individual, unless a lesser interest is stated.

1 Calif. Civil Code §1092

The word "grant" contained in the conveyance provision in a grant deed indicates the conveyance of a fee simple interest to another individual, unless the deed states a lesser interest is conveyed. [See **RPI** Form 404; see Chapter 46]

A *quitclaim deed* customarily uses the words "remise," "release" or "quitclaim," but does not contain the word "grant." However, only the word "quitclaim" needs to be used to convey all interest held in the property by the grantor. [See Form 405 accompanying this chapter]

A quitclaim deed conveys only the grantor's interest in a property, if any exists. A quitclaim deed can also be used in lieu of a grant deed to pass fee simple in the described real estate.

The words used to convey property are evidence of the *future role* an individual conveying title undertakes after the deed has been signed and delivered.

Thus, to convey real estate with **covenants** relating to the interest conveyed, a grant deed is used.

To simply convey any interest in real estate without an assurance the individual holds that interest conveyed, a quitclaim deed is used.

Grant deed covenants are implied

The *covenants*, sometimes called **warranties**, implied in a grant deed include:

- the interest conveyed in the real estate has not been *previously conveyed* to another, except as disclosed in the grant deed; and
- the real estate has not been *further encumbered* by the grantor, except as disclosed in the grant deed.[2]

implied covenant
An implied warrant the grantor has not previously conveyed or encumbered their interest in the real estate.

Grant deed covenants are *implied*. Thus, they are not separately bargained for as provisions to be included in the grant deed conveyance.

If a grant deed covenant is breached by a grantor (seller), the grantee (buyer) may recover their money losses from the grantor for the breach of the **implied covenant**, as though the covenant had been written into the grant deed.[3]

The covenant against encumbrances

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).

Real estate **encumbrances** include:

- taxes;
- assessments;
- conditions, covenants and restrictions (CC&Rs); and
- all liens, voluntary or involuntary, attached to the real estate.[4]

Encumbrances are the subject of the implied warranty against encumbrances in the grant deed, since they burden title and depreciate its value.

2 CC §1113
3 CC §1113
4 CC §§1113, 1114

Form 405

Quitclaim Deed

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

Title Order # ____________

Escrow # ____________

APN # ____________

The undersigned grantor(s) declare(s):

DOCUMENTARY TRANSFER TAX $ ____________

☐ Computed on the consideration or value of property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

☐ Unincorporated area ☐ City of ____________

QUITCLAIM DEED

NOTE: This form is used by an agent, escrow officer, owner or title company when a person relinquishes any interest they may hold in title to real estate, to identify the parties to the transfer, describe the property involved and record the transfer with the county.

I/We, ____________,

quitclaim to ____________

the real property in the City of ____________,

County of ____________, State of California,

referred to as ____________

____

☐ See attached Signature Page Addendum. **[RPI Form 251]**

Date: ____________, 20______. ____________ (Print name) ____________ (Signature)

____________ (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 ____________

On ____________ before me, ____________ (Name and title of officer)

personally appeared ____________,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

(This area for official notarial seal)

Signature: ____________ (Signature of notary public)

MAIL TAX STATEMENTS AS DIRECTED ABOVE

FORM 405 12-14 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Encumbrances include:

- CC&Rs, such as use restrictions running with the land;
- building restrictions;
- a reservation of a right of way;
- an easement;
- an encroachment;
- a lease; and
- a pending condemnation action.[5]

5 Evans, *supra*

Covenants restricted or limited

To avoid liability arising out of the *implied covenants* in a grant deed, the deed needs to state the title conditions (encumbrances) created by the seller during their ownership. These conditions are or are not agreed to by the buyer in the purchase agreement.

The implied covenants in a grant deed are *waived* by the buyer and do not apply when the seller and buyer agree to the contrary in the purchase agreement. In this instance, the buyer and seller list all the title changes made by the seller in the grant deed.

Covenants personal to grantor/ grantee

Implied covenants are only for the *personal benefit* of a buyer, not future owners, referred to as **remote grantees**. The implied covenants in a seller's grant deed to a buyer do not impose a condition on title and do not **run with the land.**

remote grantee
A future owner of real estate who later takes title to a property, also known as a successor.

Thus, being personal to the seller and buyer, the implied covenants in a grant deed may only be enforced by the grantee named in the deed. Implied covenants cannot be enforced by future *remote grantees* who acquire the buyer's interest at a later date.

Conversely, covenants *running with the land,* such as CC&Rs and easements, bind all future owners (remote grantees) of the property. Covenants running with the land are binding on future owners whether they take title by deed or court order as covenants running with the land affect title.

For a covenant to run with the land and affect all remote grantees, the seller creating the covenant needs to state in their conveyance that **successors** (remote grantees) are bound by the covenants and restrictions imposed on the property as contained in the deed.[6]

Purchase agreement merges into deed

Title conditions bargained for and agreed to in the buyer's purchase agreement are **merged** into the grant deed accepted by the buyer on closing. [See **RPI** Form 150]

Thus, when a title condition, such as a reservation of an easement by a seller, is agreed to in the purchase agreement, it is to be restated in the grant deed if the condition is to become enforceable by the seller.

The title condition agreed to in the purchase agreement is extinguished on closing by the *merger* of the bargained for title condition into the grant deed. Thus, the grant deed becomes the sole remaining basis for enforcement of either the buyer's or seller's rights to title.

After closing, a purchase agreement provision affecting title is only enforceable if it is implied or stated in the grant deed.

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6 CC §1468

However, if a title condition, covenant or CC&R is agreed to in the purchase agreement, but is *erroneously omitted* when escrow prepares the grant deed, the grant deed can be ordered corrected by a court, a legal process called **reformation**.

reformation
A legal process to correct an omission or error in a grant deed by court action.

Once the grant deed is corrected to include the omitted title condition, the condition is then enforceable since it is present in the grant deed.[7]

Conveying lesser estates than the fee

If a buyer of real estate receives an ownership interest less than fee simple, the grant deed needs to explicitly state the lesser interest being conveyed to the buyer.

For example, to convey a **life estate**, the grant deed states the grantee is to hold the property until the grantee's (or some other individual's) death, at which point the title will revert back to the grantor or the grantor's successors. [See Chapter 46]

Quitclaim deeds: you have what I had

A **quitclaim deed** terminates any interest in the real estate described in the deed which may be held by the grantor.

Unlike a grant deed, a *quitclaim deed* does not carry with it the implied covenants contained in a grant deed. A quitclaim deed operates to *release to the grantee all interest* the grantor may hold in the property.[8]

quitclaim deed
A document used to convey whatever interest, if any, the grantor may hold in the real estate.

Thus, a quitclaim deed passes whatever title, legal or equitable, the grantor possessed when signing and delivering the quitclaim deed, activity known as **execution**.

While a quitclaim deed is not intended to assure the conveyance transfers full fee simple ownership, the grantor who **holds fee title** and signs and delivers a quitclaim deed convey fee simple ownership of the property, including all the benefits of holding fee simple title.[9]

7 CC §3399
8 **Platner** v. **Vincent** (1924) 194 C 436
9 **Spaulding** v. **Bradley** (1889) 79 C 449

Chapter 47 Summary

Grant deeds and quitclaim deeds are commonly used to convey a real estate interest.

Grant deeds contain implied covenants. The implied covenants in a grant deed warrant:

- the interest conveyed in the real estate has not previously been conveyed to another; and
- the real estate has not been further encumbered by the grantor.

To avoid liability arising out of the implied covenants in a grant deed, the deed needs to state the encumbrances on title created by the grantor (seller) during their ownership. These encumbrances are or are not agreed to by the grantee (buyer) in the purchase agreement.

Implied covenants are only for the personal benefit of a buyer and are not binding on future owners, known as remote grantees. Thus, implied covenants do not impose a condition on title and do not run with the land. For a covenant to run with the land and affect all future owners, the grantor must state in their conveyance that successors are bound by the restrictions imposed on the property.

Title conditions agreed to in the purchase agreement are merged into the grant deed accepted by the buyer on closing. If a title condition or restriction is agreed to in the purchase agreement but erroneously omitted from the grant deed, the deed can be corrected by a court and then enforced.

A quitclaim deed passes whatever title, legal or equitable, the grantor possessed when signing and delivering the quitclaim deed. Thus, unlike a grant deed, a quitclaim deed does not carry with it the implied covenants contained in a grant deed.

Chapter 47 Key Terms

Quiz 9 Covering Chapters 44-48 is located on page 614.

Chapter 48

Delivery, acceptance and validity of deeds

Learning Objectives

After reading this chapter, you will be able to:

- describe the acts and conditions which constitute the delivery and acceptance of a deed;
- avoid the improper practice of using a grant deed as a security device to assure repayment of a debt;
- understand the purpose for recording a grant deed; and
- distinguish between a void deed and voidable deed.

Key Terms

constructive delivery	**void deed**
documentary transfer tax	**voidable deed**
security	

For a further discussion of this topic, see Chapter 20 of Legal Aspects of Real Estate.

A recording is prudent, not a necessity

A grant deed conveying real estate *transfers ownership* from the owner as the **grantor** to the **grantee** when the deed is delivered. The signing of a deed by the *grantor* naming another person as the *grantee* is not enough to divest the owner of their title to the real estate. **Delivery** of the signed deed is required to transfer ownership.

Delivery refers to two separate acts:

- the grantor's present **intent to convey title**, not just the act of physically handing the deed to the grantee; and
- the grantee's **acceptance** of the grant deed as an immediately effective conveyance.

While the grantor may *intend to convey title* when they hand over the deed, if the grantee does not accept the deed, the deed will not be considered delivered and a conveyance does not occur.

However, the grant deed does not need to be **recorded** to deliver title to a new owner (or to alter a vesting between two or more persons). However, recording *perfects* the ownership received against third-parties, such as existing but unknown off-record interests.

Constructive delivery inferred

constructive delivery
Delivery of a deed occurring when the deed is understood by the grantor and grantee to be delivered by agreement, or when the deed is accepted by a third-party for the benefit of the grantee.

The delivery of a deed is *inferred* when the grantee receives or has possession of the deed. The deed may also be considered delivered without the grantee having or holding actual possession of the deed. When a grantee is not physically handed the deed, a **constructive delivery** of the deed may still have taken place.

Constructive delivery of a deed to the grantee occurs when:

- the deed is understood by the grantor and the grantee to be delivered by an agreement when the grantor signs the deed; or
- the deed is delivered to a third-party for the benefit of the grantee, and the grantee or an agent of the grantee demonstrates the grantee's acceptance of the deed.[1]

Grantor's intent to convey

Consider an owner as grantor who hands a grantee a deed as a gift. The owner orally advises the grantee the deed is not to be effective until the owner dies. If the grantee dies first, the deed is to be returned to the owner.

The owner dies and the grantee records the deed. Heirs of the owner assert they own the real estate, claiming the deed was not delivered and therefore invalid since the owner did not intend for the deed to convey ownership at the time the deed was handed to the grantee.

The grantee claims the deed is a valid conveyance of the real estate since delivery took place when the owner personally handed the grantee the deed – which the grantee accepted subject to the delayed transfer condition.

Was the deed a valid conveyance of the real estate?

No! To be a *valid delivery*, both the owner and the grantee need to **intend** for title to the real estate to be **conveyed concurrent** with the handing of the deed to the grantee. The owner of the real estate needs to intend for the document used to convey the real estate to operate as a deed to immediately divest the owner of title.

Since the owner intended the deed to become operative only upon their death, the use of a deed is an improper *probate* avoidance device. Thus, the deed is void and conveys nothing.

A deed handed to the grantee cannot act as a *will* or revocable *inter vivos (living)* trust agreement to transfer property on the death of the owner. A will and an inter vivos trust agreement are **testamentary documents** which take effect after they are signed and upon the owner's death. Thus, the owner does not give up control or ownership of the property until their death.

1 Calif. Civil Code §1059

Conversely, a deed is a document used to *immediately pass* fee simple title (or other estate). If the grantor does not intend to pass fee simple (or other estate) on handing the deed to the grantee, no actual delivery takes place and the deed is void.[2]

Grant deed as a mortgage-in-fact

A grant deed is typically used with the intent to pass full legal title to the described property when it is handed to the grantee or recorded by the grantor. [See **RPI** Form 404]

However, when a grant deed is intended to convey title to a lender as *security* for the repayment of a debt, in spite of its wording of conveyance, the grant deed does not transfer the right of ownership.

A grant deed given to provide a creditor with the property as **security**, also known as **collateral**, is a *mortgage-in-fact*. Thus, a *lien* is imposed on the property in favor of the lender by receiving a grant deed, similar in purpose to a trust deed lien.

security
Collateral for a debt in the form of a lien imposed on property.

Brokers and their agents who arrange mortgages are to use a *trust deed* as the security device which attaches the debt as a lien on real estate. Using a grant deed as a *security device* is improper practice. A grant deed is generally equated to the grantor's intent to convey all rights and title in the property to the named grantee.

A trust deed does not convey any ownership rights in the property to the lender. Rather, a trust deed imposes a lien on the property in favor of the lender to secure the owner's performance of a money obligation. On executing a trust deed, the owner retains all ownership rights to the secured property, which is not the case when using a grant deed for its intended purpose.

Acceptance by the grantee

A grantee is *presumed* to have accepted a deed if the grant is beneficial to the grantee.

Additionally, a deed is presumed to be accepted and the conveyance complete if the deed is:

- physically handed to the grantee;[3]
- recorded by the grantee;[4] or
- in the grantee's possession.[5]

A deed does not need to be recorded to convey real estate. A deed that is delivered conveys an interest in real estate even when the deed is incapable of being recorded.

A deed *capable of being recorded* with the county recorder includes:

- identification of the person requesting the recording;

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2 **In re Estate of Pieper** (1964) 224 CA2d 670

3 **California Trust Co.** v. **Hughes** (1952) 111 CA2d 717

4 **Drummond** v. **Drummond** (1940) 39 CA2d 418

5 California Trust Co., *supra*

- identification of the person to whom the document will be returned by the county recorder;[6] and
- the address where tax statements are to be sent by the county tax collector.[7] [See **RPI** Form 404]

Failure to identify the person requesting the recording of the deed, where the deed is to be sent after recording, or where the local real estate tax statements are to be sent does not affect the validity of the deed. Nor does this affect the *constructive notice* to others implied by recording the deed.[8]

documentary transfer tax
A tax imposed on a recorded document when real estate is transferred.

The deed submitted for recording needs to also include the amount of the **documentary transfer tax** to be paid. The deed will not be recorded by the recorder unless the *documentary transfer tax* is paid at the time of the recording. An additional transfer tax may be charged by the city, county or both.[9]

Recording the grant deed

Once recorded, a deed constitutes a change of ownership which may subject the property to reassessment. Thus, the recording of a deed is accompanied by a **change of ownership statement** which the recorder hands to the county assessor.[10]

If the deed submitted to the county recorder does not include a *change of ownership statement*, the recorder will record the document and either:

- include a change of ownership form with the return of the recorded deed; or
- provide the assessor with the identification of the recorded document which was not accompanied by the change of ownership statement.[11]

Void vs. voidable

Void and **voidable** are similar concepts. However, they are distinguishable by the *date* they affect the validity of a deed, and thus, the rights of those who relied on the deed.

void deed
A deed that is unenforceable and conveys no interest in real estate.

Void deeds are unenforceable at all times and never convey an interest in real estate. This is referred to as *void ab initio* — without legal effect from the beginning.

If title is claimed under a void deed, any claim of ownership under the deed fails – even if a further grantee purchases the property in good faith without any notice of a defect in title or in the deed held by the grantor.

Examples of void deeds include:

- a deed handed directly to the grantee, not a third party, with the intent it is not to be effective until the owner's death;[12]

6 Gov C §27361.6
7 Gov C §27321.5
8 Gov C §§27321.5, 27361.6
9 Calif. Revenue and Taxation Code §§11901 et seq.
10 Gov C §27280; Rev & T C §480
11 Gov C §27321
12 Estate of Pieper, *supra*

- a deed signed and delivered by a seller under the age of 18;[13]
- a deed materially altered without the grantor's consent;[14] or
- a forged deed.[15]

Voidable deeds

A *voidable deed*, unlike a void deed, is a deed which is valid and enforceable after delivery until it is challenged due to a defect and declared invalid by court order.

voidable deed
A deed that is valid and enforceable until it is challenged due to a defect and declared invalid by a court order.

Examples of voidable deeds include:

- a deed obtained through **false representations**;[16]
- a deed obtained through **undue influence** or threat;[17] or
- a deed from a grantor of **unsound mind**, but not entirely without understanding, made before the grantor's incompetency to convey has been adjudicated.[18]

Unlike void deeds, a voidable deed is enforceable by a *bona fide purchaser (BFP)* or encumbrancer who acquires an interest in the property in reliance on the title held by the grantee under a deed which is voidable but has not yet been challenged as invalid.

13 Calif. Family Code §6701
14 **Tannahill** v. **Greening** (1927) 85 CA 714
15 **Meley** v. **Collins** (1871) 41 C 663
16 **Seeger** v. **Odell** (1941) 18 C2d 409
17 **Campbell** v. **Genshlea** (1919) 180 C 213
18 CC §39

Chapter 48 Summary

A deed conveys real estate from the grantor to the grantee when the deed is delivered. Delivery is based on:

- the grantor's intent to convey title; and
- the grantee's acceptance of the grant deed as an immediately effective conveyance.

The grant deed does not need to be recorded to deliver title. Recording simply puts future buyers or encumbrancers on notice of the transfer. Once recorded, a deed constitutes a change of ownership which may subject the property to reassessment.

The delivery of a deed is inferred when the grantee has possession of the deed. Constructive delivery occurs when:

- the deed is understood by the grantor and the grantee to be delivered by an agreement when the grantor signs the deed; or
- the deed is delivered to a third-party for the benefit of the grantee, and the grantee or an agent of the grantee demonstrates the grantee's acceptance of the deed.

When a grant deed is intended to convey title to a lender as security for the repayment of debt, the grant deed becomes a mortgage-in-fact and transfers no right of ownership to the lender.

A grantee is presumed to have accepted a deed if:

- the grant is beneficial to the grantee;
- the deed is physically handed to the grantee;
- the deed is recorded by the grantee; or
- the deed is in the grantee's possession.

Void deeds are unenforceable at all times and never convey an interest in real estate. A voidable deed is valid and enforceable until it is challenged due to a defect and a court order declares the deed invalid.

Chapter 48 Key Terms

Quiz 9 Covering Chapters 44-48 is located on page 614.

Chapter 49

The right of survivorship among co-owners

Learning Objectives

After reading this chapter, you will be able to:

- apply the community property presumption when title to property is vested jointly in the names of a married couple;
- create a joint tenancy vesting based on the four unities in title;
- explain the right of survivorship and how it is severed;
- advise on how to clear title of a deceased joint tenant's ownership by an affidavit; and
- recognize the tax aspects of a joint tenancy vesting.

Key Terms

community property	**right of survivorship**
fully stepped-up cost basis	**set aside**
joint tenancy	**vesting**
ratify	

For a further discussion of this topic, see Chapter 27 of Legal Aspects of Real Estate.

What is vesting?

A **vesting** is a method of holding title to real estate. Differences in the types of title vestings present different consequences for persons who have interests in property.

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.

Title to real estate in California is held in one of four basic vestings:

1. **joint tenancy** — Ownership of fractional interests in real estate by two or more individuals each holding an equal share with the right of survivorship. When a joint tenant dies, their interest is eliminated and the surviving joint tenants share the remaining ownership equally. Joint tenants take title together on the same deed, at the same time, hold equal shares in the ownership of the property, and each has the right to possess the entire property, known as the **four unities**.

2. **tenancy in common** — Tenants in common may have varying percentages of ownership in a property, may take title at different times, and have centralized rights of possession. If a joint tenant conveys their interest in the property to another person, that person takes title as a tenant in common. A tenant in common may will their interest in the property to others on their death since a tenancy in common interest carries no right of survivorship with it.
3. **community property** — All property acquired by a married couple in California during a marriage is presumed to be community property, unless acquired as the separate property of either spouse. Under the community property vesting, the ownership interests are equal.
4. **community property with right of survivorship** — Identical to the community property vesting but with the inclusion of words creating the right of survivorship. On the death of a spouse, the surviving spouse automatically becomes the sole owner of the property.

Continue below for illustrations of the different types of vestings in application.

Vesting reflects estate planning

right of survivorship
The right of surviving joint tenants or a spouse to succeed to the entire interest of the deceased co-owner.

Consider a married couple who, with the assistance of their agent, locate real estate they intend to purchase. They will use monies accumulated during their marriage and a new purchase-assist mortgage to pay the purchase price.

The agent, as part of their *due diligence* on any property acquisition, asks the couple how they want to take title on the close of escrow. The couple wants the property to be vested in both of their names, as a married couple, with the **right of survivorship**.

On the death of a spouse, the couple wants the *surviving spouse* to automatically become the sole owner of the property, avoiding probate procedures.

Recognizing the **community property** aspect of their funds accumulated during marriage, the agent advises the couple they need to take title as:

- *"a married couple as community property with right of survivorship"; or*
- *"a married couple as joint tenants."*

The agent explains the two vestings are identical for future conveyancing since:

- both vestings may be **severed** before death by either spouse to provide for an alternative distribution of each spouse's ownership interest to others by will, a trust agreement or another vesting of their interest; and
- on death the title is cleared of the deceased spouse's interest by the surviving spouse recording an **affidavit** declaring the death of the deceased spouse and attaching a certificate of death.[1] [See **RPI** Form 460; see **RPI** Form 461]

1 Civil Code §682.1(a); Calif. Probate Code §210

However, mindful of the *tax consequences* for the surviving spouse, the agent recommends the couple vest title to the property as community property with right of survivorship. Like the tax consequences of a joint tenancy vesting by spouses, the surviving spouse is assured a fully **stepped-up cost basis** for the community property.

In this example, the agent's advice to vest the property as "community property with right of survivorship" satisfies the couple's estate planning needs for holding title to the property. Likewise, since the property was acquired during the marriage, it is considered *community property* even if the couple vested the property in their names as joint tenants.

Additionally, the couple intends to avoid probate procedures on the death of a spouse. Both right of survivorship vesting avoids enforcement of any contrary provisions in the will of the deceased since no interest remains under either vesting to be transferred by will or otherwise after death.

Community property with right of survivorship

For the surviving spouse, a **community property** vesting with right of survivorship is superior to a simple community property vesting. This is the case even though a simple community property vesting without the right of survivorship also transfers the property to the surviving spouse if the deceased dies **intestate** (with no will) or **testate** (with a will) stating the surviving spouse takes the property.

community property
All property acquired by husband or wife during a marriage when not acquired as the separate property of either spouse.

On a simple community property vesting, if no one contests the surviving spouse's right to become the sole owner of the deceased spouse's interest in the property, the surviving spouse needs to wait 40 days following the death before the property can be sold, leased or encumbered.

After 40 days, an **affidavit** by the surviving spouse is recorded to clear title by declaring the death and attaching a death certificate.[2] [See **RPI** Form 461]

A joint tenancy recommendation by the agent produces the same transferability and tax results as does the community property vesting with right of survivorship. They function identically before and after death.

However, joint tenancy provides spouses with more flexibility by allowing for avoidance of some *community debts* during the marriage and on death. This avoidance of debts incurred solely by one spouse is not available under either community property vesting.[3]

The four unities

Although most **joint tenancies** are created between a married couple, a joint tenancy can exist between non-married persons. Conversely, community property vestings are only available to married couples or registered domestic partners.[4]

joint tenancy
An ownership interest in property concurrently received by two or more individuals who share equally and have the right of survivorship.

2 Prob C §13540
3 CC §682.1
4 Calif. Family Code §297.5

Married couple: wording the grant deed vesting

Joint tenancy: John Doe and Jane Doe, married couple as joint tenants.

Community property: John Doe and Jane Doe, married couple as community property with right of survivorship.

Community property: John Doe and Jane Doe, married couple as community property.

Tenants in common: John Doe, a married man as to an undivided one-half interest, and Jane.

Doe, a married woman as to an undivided one-half interest, as tenants in common.

Separate property of one spouse: John Doe, a married man as his separate property.

Additionally, the number of joint tenants is not limited to two, as is a married couple's ownership of community property interests. Using one deed, any number of co-owners can take title to real estate as joint tenants. The only ownership condition is that the joint tenants take **equal ownership interests** in the property.

Traditionally, the creation of a **joint tenancy** requires the conveyance of *four unities***:**

- **unity of title**, meaning the joint tenants take title to the real estate through the same instrument, such as a single grant deed or court order;
- **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.[5]

Today, a joint tenancy vesting is loosely based on these four unities. For example, a joint tenancy is currently defined as ownership by two or more persons **in equal shares**. Thus, the joint tenancy co-ownership incorporates the *unity of interest* into its statutory definition.[6]

Similarly, a joint tenancy needs to be created by a **single transfer** to all the co-owners 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, this is accomplished by the recording of a conveyance transferring title to all the joint tenants.

Creating a joint tenancy

A joint tenancy ownership in real estate may be created by any of the following transfers 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;

5 **Swartzbaugh** v. **Sampson** (1936) 11 CA2d 451
6 CC §683

- a transfer from co-owners vested as tenants-in-common to themselves; or
- a transfer from a married couple holding title as community property, tenants-in-common or separately, to themselves.[7]

For the small percentage of joint tenants who are not a married couple, typically family members or life-long friends, a valid joint tenancy is created when all co-owners take title under the same deed as joint tenants, without stating their **fractional ownership interest** in the property.

Their actual fraction of ownership, if severed or transferred to others, is a function of the number of individuals who took title as joint tenants. For example, five co-owners as joint tenants each holds a one-fifth or 20% fractional ownership interest.

A joint tenant's right of survivorship

A joint tenancy vesting adds nothing to the legal aspects of the ownership interest held in real estate by each co-owner. 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.

However, the **necessary incident** of a joint tenancy vesting is the *right of survivorship*, legally referred to as *jus accrescendi*. The right of survivorship is a case law doctrine which is triggered by the death of one joint tenant.

Thus, the joint tenancy vesting, by the incident of its right of survivorship, becomes operative only on the death of a joint tenant, at which point the right of survivorship **extinguishes the deceased's interest** and leaves the remaining joint tenant(s) with the entire ownership interest they held as joint tenants. The right of survivorship is a mere **expectancy** held by each co-owner and is not a property right.

Ultimately, on the death of all other joint tenants, the last survivor becomes the sole owner of the interest in the property originally owned by all the joint tenants.

Vesting alone does not transmute community property

On a *dissolution* of the marriage, all property acquired jointly by a married couple during the marriage, no matter how vested, is **presumed** to be community property for purposes of division.[8]

Further, the community property presumption for married couples does not only come into play when a couple divorces. All property acquired by a couple or by either spouse during marriage is considered community property, unless the couple clearly states their contrary intention to own their individual interests in the real estate as separate property.[9]

7 CC §683
8 Fam C §2581
9 Fam C §760

Conveying community property

set aside
To annul by court order a document transferring an interest in real estate.

As community real estate, both spouses need to consent to the sale, lease for more than one year or encumbrance regardless of how it is vested.[10]

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers community real estate, the nonconsenting spouse 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 aside* the transaction.

Encumbering and leasing joint tenancy property

ratify
The later adoption or approval of an act performed on behalf of a person when the act was not previously authorized.

When real estate held in a joint tenancy vesting is **separate property** — as when the joint tenants are not a married couple, or when a married couple in writing agree their interests are separate property — each joint tenant can sell or encumber their interest in the real estate without the consent of the other joint tenant(s).

Additionally, when the joint tenancy in real estate represents **separate property**, a 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.[11]

However, consider a married couple who owns **community property real estate** as joint tenants. One spouse enters into an agreement to lease the property for a term over one year, which the other spouse does not sign.

Under the joint tenancy rule, either joint tenant alone may lease the property. However, under the community property rule (which applies to property acquired during marriage), **both spouses** need to execute a long-term lease agreement with a term greater than one year.

Severing right-of-survivorship vestings

Every co-owner vested as a joint tenant or as community property with the 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.

The separate or community property nature of the co-owner's interest in the property remains the same after severing the right of survivorship from the co-owner's interest.

A co-owner *unilaterally severing* their right of survivorship is not required to first give notice or seek consent from the other co-owner(s).[12]

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

10 Fam C §1102
11 Swartzbaugh, *supra*
12 **Riddle** v. **Harmon** (1980) 102 CA3d 524

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 is to include a statement noting the transfer is intended to sever the prior vesting.[13]

Recording requirement for severance

Recording is necessary to terminate another joint tenant's right of survivorship.

The **unilateral severance** of a joint tenant's interest needs to either be:

- recorded in the county where the property is located before the death of the severing joint tenant; or
- recorded within seven days after the joint tenant's death if executed and notarized within three days before the joint tenant's death.[14]

Additionally, the joint tenancy may be severed by agreement of the joint tenants. If a written agreement to sever the joint tenancy is signed by all the joint tenants, recording or notarization is not required.[15]

All the preceding rules for recording a severance apply fully to the severance deed of a spouse seeking to terminate the right of survivorship held under the community property vesting.[16]

The unilateral severance of a joint tenancy terminates the right of survivorship. Without the existence of the right of survivorship, each co-owner disposes of their interest in the property on death as they wish, such as by *will* or *inter vivos trust*, or by the severance itself.

Although the sale of a joint tenant's separate property interest in real estate severs the joint tenancy, a lease or encumbrance of the property by a joint tenant does not.

All the procedures for severing a joint tenancy are fully available for a married couple to sever the community property vesting which includes the right of survivorship.[17]

Clear title on death by affidavit

When co-ownership of property is vested as a joint tenancy, the death of a joint tenant *automatically extinguishes* the deceased joint tenant's interest in the real estate. This leaves the surviving joint tenant(s) as the sole owner(s).

However, the deceased joint tenant's interest in the property needs to be cleared from the title before the surviving joint tenant(s) will be able to sell, lease or encumber the property as the sole owner.

The new ownership interest of the surviving joint tenant(s) is documented by simply recording an **affidavit**, signed by anyone, declaring the death of a joint tenant who was a co-owner of the described real estate.[18]

13 CC §683.2(a)
14 CC §683.2(c)
15 CC §683.2(d)
16 CC §682.1
17 CC §682.1
18 Prob C §210(a)

The interest in the property held by the deceased spouse as community property with right of survivorship is extinguished by the same *affidavit* procedure used to eliminate the interest of a joint tenant, except the surviving spouse or their representative is the only one authorized to make the declaration. [See **RPI** Form 461]

Once the affidavit is **notarized, recorded and indexed**, anyone conducting a title search on the property will have notice of the joint tenant's death since the deceased joint tenant is indexed as a grantor. Thus, the surviving joint tenant becomes the **sole owner** of the property due to the right of survivorship.

Controlling the vesting of one-half

A spouse can unilaterally sever the joint tenancy and community property with right of survivorship vestings by:

- executing and delivering a deed that conveys legal title to a third party;
- executing a deed to themselves;
- executing a written severance of joint tenancy; or
- executing a written instrument that evidences an intent to sever.[19]

Additionally, the community property interest of a spouse who executes a deed to themselves to sever the title and eliminate the right of survivorship remains community property. Community property cannot be transmuted to separate property without the consent of both spouses or a court order.

A **severance deed** to oneself terminating the right of survivorship is not sufficient by itself to avoid passing the property to the surviving spouse on death for community property vested as either community property with right of survivorship or in joint tenancy.

A will needs to also be prepared or a living trust established naming the person intended to receive the spouse's community property interest on death.

Otherwise, since it is community property, the property will pass by intestate succession to the surviving spouse as though the severance of the vesting had never occurred.[20]

Joint tenancy tax aspects

Taxwise, the main question raised for a married couple when the surviving spouse becomes the sole owner of what was community property is: What is the surviving spouse's **cost basis** in the property as the sole owner after the death of the other spouse?

The surviving spouse who becomes the sole owner of community real estate 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 property vesting.

19 CC §683.2(a)

20 Prob C §13500

Thus, the surviving spouse is entitled to a **fully stepped-up cost basis** in the real estate previously owned by the community without concern for whether the property was vested as community property (with or without the right of survivorship), as joint tenants or in a revocable inter vivos (living) trust.

fully stepped-up cost basis
The tax basis of community property a surviving spouse receives on the death of a spouse is stepped up to the property's fair market value (FMV) on the date of death.

State law controls how marital property is characterized for federal tax purposes. Federal law is unconcerned with the form in which title is taken to community property.[21]

Thus, the real estate owned by a married couple (unless vested as tenants in common) is considered community property for federal income tax purposes. Accordingly, a surviving spouse entitled to the property receives a fully stepped-up cost basis to the property's FMV on the date of the other spouse's death.

21 IRS Revenue Ruling 87-98

Chapter 49 Summary

Although most joint tenancies are created by married couples, a joint tenancy can exist between non-married persons and is not limited to two individuals. Traditionally, the creation of a joint tenancy requires the conveyance of four unities:

- unity of title;
- unity of time;
- unity of interest; and
- unity of possession.

Community property vestings are only available to a married couple or registered domestic partners. All property acquired jointly by a married couple during marriage, no matter how vested, is presumed to be community property, unless the couple clearly state their intention to own their individual interests as separate property.

Both spouses need to consent to the sale, lease for more than one year or encumbrance of community real estate regardless of how it is vested. When real estate held in a joint tenancy is separate property – or when a couple state their interests are separate property – each joint tenant can sell or encumber their interest in the real estate without the consent of the other joint tenant.

The right of survivorship is provided under both a community property with right of survivorship vesting and a joint tenancy vesting. The death of a joint tenant automatically extinguishes the deceased joint tenant's interest in the real estate. However, the deceased joint tenant's interest in the property needs to be cleared from the title before the surviving joint tenant will be able to sell, lease or encumber the property as the sole owner. The new ownership interest of the surviving joint tenant is documented by recording an affidavit declaring the death of the joint tenant.

A surviving spouse is entitled to a fully stepped-up cost basis in the real estate previously owned by the community without concern for whether the property was vested as community property, as joint tenants or in a revocable inter vivos (living) trust.

Chapter 49 Key Terms

Quiz 10 Covering Chapters 49-54 is located on page 615.

Chapter 50

The lis pendens

Learning Objectives

After reading this chapter, you will be able to:

- recognize the nexus between a recorded lis pendens describing a parcel of real estate and the litigation it references asserting a claim to an interest in title or right to possession of the real estate;
- understand the interference a recorded lis pendens has on the owner's ability to convey clear title; and
- explain an expungement of a lis pendens as the remedy for clearing title of the litigation so the property can be conveyed and title insurance issued.

Key Terms

absolutely privileged publication

expungement

lis pendens

specific performance action

For a further discussion of this topic, see Chapter 31 of Legal Aspects of Real Estate.

Clouding the title with a notice

Lis pendens is Latin for *pending litigation*. More commonly, a *lis pendens* is called a **Notice of Pending Action**. In practice, a recorded lis pendens puts all persons on constructive notice that the title or right to the possession of real estate is in litigation.

The purpose of recording a lis pendens is to preserve a person's rights to the real estate until the dispute with the owner is resolved. Thus, buyers who acquire an ownership interest in property after a lis pendens describing the property has been recorded take their interest in the property subject to someone else's (the claimant's) right.

Without a recorded lis pendens or physical possession of the real estate, the person who claims an interest in title or the right to possession runs the risk

lis pendens
A notice recorded for the purpose of warning all persons that the title or right to possession of the described real property is in litigation.

the owner will encumber or convey the property to another buyer, lender or tenant who is unaware someone else already holds an interest in the property.

Title or possession to real estate

A lawsuit needs to affect title or the right to possession of real estate to support the recording of a lis pendens.[1]

Lawsuits affecting title or possession of real estate include:

- *specific performance* of an unclosed transaction or rescission of a closed transaction;[2]
- *judicial foreclosure* of a trust deed lien by a lender;[3]
- foreclosure of a *mechanic's lien* by a construction contractor;[4]
- *cancellation of a grant deed* or other conveyance by a prior owner;
- *fraudulent conveyance* to be set aside as voidable by creditors;[5]
- *evictions* and suits concerning *unexpired leaseholds* brought by tenants or leasehold lenders;
- termination or establishment of an *easement* between neighboring property owners;[6]
- *government declaration* that a building is uninhabitable;
- *ejectment* of an unlawful occupant other than a tenant from real estate by an owner;
- partition or sale of the real estate by a *co-owner*;
- *quiet title*;
- *eminent domain* actions;[7] and
- *divorce proceedings* involving real estate.

Real estate lawsuits

A lis pendens is also permitted in the following lawsuits over real estate:

- actions by *adverse possessors* to determine claims to title;[8]
- actions to re-establish *lost land records;*[9]
- actions to determine adverse interests in any liens or clouds on real estate arising out of *public improvement assessments;*[10]
- actions by purchasers or the state to *quiet title* to tax-deeded property;[11]
- actions by *innocent improvers* of real estate against owners or lenders of record;[12]

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1 Code of Civil Procedure §405.20
2 **Wilkins** v. **Oken** (1958) 157 CA2d 603
3 **Bolton** v. **Logan** (1938) 30 CA2d 30
4 Calif. Civil Code §8461
5 **Hunting World, Incorporated** v. **Superior Court** (1994) 22 CA4th 67
6 **Kendall-Brief Company** v. **Superior Court of Orange County** (1976) 60 CA3d 462
7 CCP §1250.150
8 CC §1007
9 CCP §751.13
10 CCP §801.5
11 Calif. Revenue and Taxation Code §3956
12 CC §1013.5(b)

- actions on an *improvement bond*;[13] and
- actions *terminating or establishing an easement*, except for a public utility easement.[14]

The lis pendens process

To record a lis pendens, the lis pendens is required to:

- **identify** the parties to the lawsuit; and
- give an adequate **description** of the real estate.[15]

While the object of the lawsuit and its effect on title or possession of real estate does not need to be stated in the lis pendens, the objective of the lawsuit is to be stated in the lis pendens for it to be considered an **absolutely privileged publication**.[16]

absolutely privileged publication
Any statement made as part of a legislative, judicial or other official proceeding authorized by law, barring a slander of title action.

Editor's note — An absolute privilege covers any publication during a judicial proceeding which is authorized by law, including a lis pendens. A publication made under absolute privilege bars a slander of title action against the person wrongfully claiming an interest in the property.

A technical legal description of the property subject to litigation is not required as long as the property can be sufficiently identified.

Notice by recording and indexing

A lis pendens is properly of record when it is **filed and indexed** in the county recorder's office of the county where the property is located.[17]

Recording and indexing a lis pendens constitutes *constructive notice* to all persons about the existence of a dispute over title or possession of a property. Any buyer, lender or tenant who is later conveyed an interest in the property is bound by the final resolution of the dispute.

Title insurers and specific performance actions

Title companies usually refuse to insure title when a lis pendens is recorded which involves a **specific performance action**. Without title insurance, buyers will not buy, lenders will not lend and tenants will not occupy the property.

However, a lis pendens in a buyer's *specific performance action* does not interfere with a title company insuring a lender's trust deed which secures a debt in an amount less than the price the buyer will be paying for the property.[18]

As a result, property subject to specific performance actions by buyers is often rendered unmarketable while the lis pendens remains in effect.

specific performance action
Litigation to compel performance of an agreement.

13 Calif. Streets and Highways Code §6619
14 CCP §405.4(b)
15 CCP §405.20
16 CC §47(b)(4)
17 CCP §405.20
18 **Behniwal** v. **Mix** (2007) 147 CA4th 621

expungement
A court order removing from title to real estate the effect of a recorded lis pendens regarding litigation asserting a claim to title or possession of the property.

The tremendous value of the lis pendens to litigating buyers is its ability to preserve the buyer's right to purchase the property. The recording of a lis pendens often persuades a hedging seller to perform.

Accordingly, the *potential for abuse* of the lis pendens procedure to cloud title of an owner's property is readily apparent.

Expungement of a lis pendens

Any time after a lis pendens has been recorded, anyone with an interest in the property affected may file a motion asking the court to remove the lis pendens from the record, called **expungement**.

An order *expunging* a lis pendens removes from title any restrictions sought to be imposed by the lawsuit on the transfer of the property.[19]

19 CCP §405.61

Chapter 50 Summary

The purpose of recording a lis pendens is to preserve a person's rights in a parcel of real estate until the dispute with the owner is resolved. A lawsuit needs to affect title or the right to possession of real estate to support the recording of a lis pendens.

The lis pendens is required to identify the parties to the lawsuit and give an adequate description of the real estate. Further, the objective of the lawsuit is to be stated in the lis pendens for it to be considered an absolutely privileged publication. The privilege bars a slander of title action against the person wrongfully claiming an interest in the property.

A lis pendens is considered recorded when it is both filed and indexed in the county recorder's office of the county where the property is located. The recording constitutes constructive notice to all persons about the existence of a dispute over title or possession of a property.

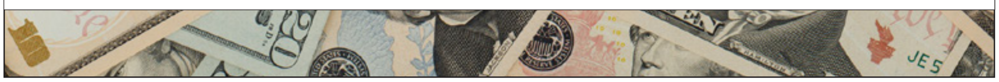
After a lis pendens has been recorded, anyone with an interest in the property affected may file a motion asking the court to expunge the lis pendens. Expungement removes from title any restrictions sought to be imposed on title or to possession by the lawsuit.

Chapter 50 Key Terms

Quiz 10 Covering Chapters 49-54 is located on page 615.

Chapter 51

Preliminary title reports



Learning Objectives

After reading this chapter, you will be able to:

- explain the function of a preliminary title report; and
- distinguish between a preliminary title report and an abstract of title.

Key Terms

abstract of title

date-down search

preliminary title report

For a further discussion of this topic, see Chapter 21 of Legal Aspects of Real Estate.

An offer to issue title insurance

A **preliminary title report** is intended to disclose the current vesting and *encumbrances* which may be reflected on the public record affecting a property's title. Encumbrances reflected on a *preliminary title report* include:

- general and special taxes;
- assessments and bonds;
- covenants, conditions and restrictions (CC&Rs);
- easements;
- rights of way;
- liens; and
- interests of others.

A preliminary title report, also known as a **prelim**, is not a representation of the condition of title or a policy of title insurance. Unlike an **abstract of title**, a prelim cannot be relied on by anyone and imposes no liability on the title company.

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

A title insurer has no duty to accurately report title defects and encumbrances on the prelim, shown as *exceptions* in the proposed policy.[1]

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.[2]

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.

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 defects and encumbrances on title inconsistent with the terms for the seller's delivery of title set in the purchase agreement and escrow instructions. They also look for title conditions which might interfere with any *intended use or change in the use* of the property contemplated by the buyer.

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 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 may **withdraw its offer** under the prelim. The title company then issues a new prelim, offering to issue a policy on different terms.

Prelim vs. abstract of title

Prelims were once compared to *abstracts of title*. An abstract of title is an accurate, factual representation of title to the property being acquired, encumbered or leased. Thus, an abstract of title may be relied on by those who order them as an absolute representation of the conditions of title.[3]

An abstract of title is a **statement of facts** collected from the public records. An abstract is not an insurance policy with a dollar limit on the insurer's

1 **Siegel** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 1181
2 Calif. Insurance Code §12340.11
3 Ins C §12340.10

liability as is set in a policy of title insurance. The content of an abstract is intended by the insurance company to be relied upon as fact. Thus, the insurer is liable for all money losses of the policy holder flowing from a failure to accurately state all conditions of title in the abstract they issue.[4]

4 **1119 Delaware** v. **Continental Land Title Company** (1993) 16 CA4th 992

Chapter 51 Summary

A preliminary title report (prelim) is a report furnished by a title insurance company in connection with an application for title insurance disclosing 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.

A prelim is not a representation of the condition of title and cannot be relied on by anyone. Thus, a prelim is no more than an offer to issue a title insurance policy based on the contents of the prelim and any modifications made by the title company before the policy is issued.

Prelims are distinct from abstracts of title. Abstracts of title are written statements which may be relied on by those who order them as an accurate, factual representation of title to the property being acquired, encumbered or leased.

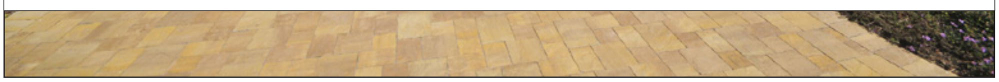
Chapter 51 Key Terms

Quiz 10 Covering Chapters 49-54 is located on page 615.

Notes:

Chapter 52

Title insurance



Learning Objectives

After reading this chapter, you will be able to:

- explain how a policy of title insurance indemnifies a person who acquires an interest in real estate against a monetary loss caused by an undisclosed encumbrance on title;
- differentiate between the various types of title insurance policies and endorsements available, such as those presented by the California Land Title Association (CLTA) and the American Land Title Association (ALTA);
- comprehend the six operative sections of a title insurance policy;
- observe the dollar limitations placed on coverage provided under the policy exclusions; and
- understand the process of settling a claim.

Key Terms

abstract of title
encumbrance
exception
exclusion
preliminary title report (prelim)
proof-of-loss statement
Schedule A
Schedule B
title insurance

For a further discussion of this topic, see Chapter 22 of Legal Aspects of real Estate.

Identifying an actual loss

A policy of **title insurance** is the contract under which a title insurance company reimburses or holds harmless a person who acquires an interest in real estate against a monetary loss caused by an **encumbrance** on title that:

title insurance
A form of indemnity insurance issued by a title insurance company which holds harmless the named insureds against monetary loss caused by an encumbrance not listed in Schedule B of the policy and not known by the insured when the policy was issued.

- is not listed in the title insurance policy as an exception to coverage; and
- the insured policy holder was unaware of when the policy was issued.[1]

Thus, a policy of *title insurance* is a form of **indemnity insurance**. Title insurance policies are issued on one of several general forms used by the entire title insurance industry in California. The policies are typically issued to:

- *buyers* of real estate;
- *tenants* acquiring long-term leases; and
- *lenders* whose mortgages are secured by real estate.

As an *indemnity* agreement, a title insurance policy is a contract. The terms of coverage in the policy set forth the extent of the title insurance company's obligation, if any, to indemnify the policy holder for money losses caused by an encumbrance on title.[2]

Encumbrances unknown, undisclosed

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).

Almost all losses due to the reduction in the value of real estate below the policy limits arise out of an encumbrance. An *encumbrance* is any condition which affects the ownership interest of the insured.

The word "encumbrance" is all encompassing. Any right or interest in real estate held by someone other than the owner which **diminishes the value** of the real estate is considered an encumbrance.

Encumbrances on title include:

- covenants, conditions and restrictions (CC&Rs) limiting use;
- reservations of a right of way;
- easements;
- encroachments;
- trust deeds or other security devices;
- pendency of condemnation; and
- leases.[3]

Property improvement and use not covered

Physical conditions on the property itself are not encumbrances affecting title. Accordingly, title insurance policies do not insure against open and notorious *physical conditions* which exist on the property.

A buyer is always presumed to have contracted to acquire property subject to known and visible physical conditions on the property which impede its use or impair its value. In the case of encumbrances, recorded or not, no such presumption exists.

1 Calif. Insurance Code §12340.1
2 Insurance Code §12340.2
3 **Evans** v. **Faught** (1965) 231 CA2d 698

Underwriting only indemnifies a loss

A title insurance policy is not an **abstract of title** which warrants or guarantees the nonexistence of title encumbrances. Instead of receiving a guarantee of title conditions, the named insured on the policy is indemnified up to the *policy's dollar limits* against a money loss caused by a title condition (encumbrance) not listed as an exception or exclusion in the policy. [See Chapter 51]

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.

Under a title insurance policy, the title company only covers the risks of a **monetary loss** caused by an encumbrance which is not listed as an exception or exclusion to coverage, and was unknown to the named insured at the time of closing. Thus, the title company has no obligation under a policy to clear title of the unlisted encumbrance.

A title insurance company issuing a policy of title insurance has two underwriting options when its title search reveals an encumbrance affecting title:

- list the encumbrance in a **preliminary title report (prelim)**, requiring the parties to either eliminate it or accept it as an *exception* to coverage in the policy of title insurance to be issued; or
- insure against the encumbrance by **writing over** the encumbrance — i.e., not listing it as an exception — and assuming any risk of loss connected to it.

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.

When title companies *write over* a known encumbrance, they usually demand an indemnity agreement from the person responsible for eliminating the encumbrance. This encumbrance typically takes the form of a money lien, such as a mechanic's lien, money judgment or blanket encumbrance. Thus, the title company can recover for a third-party guarantor if a claim by the insured is later paid due to the encumbrance.

Additionally, a title policy is not a representation – guarantee – of the nonexistence of encumbrances that are not listed in the policy. If an encumbrance is not known to the named insured, such as the buyer or lender, and is not listed as an exception in the policy, an insured's claim against the insurer for money in excess of the policy limits cannot be based on the insurer's *negligent preparation* of the encumbrances excluded from coverage. Similarly, a claim on an erroneous *prelim* cannot be based on negligent preparation. [See Chapter 51]

However, a title insurer might *intentionally write over* encumbrances at the request of a seller. If the buyer is not notified the encumbrance exists, the insurer is liable for actual losses in excess of the policy coverage. In this instance, the insurer breached the implied covenant of good faith and fair dealing imposed on title companies as a duty owed to the insured.[4]

Introduction to title policy forms

Title insurance is purchased to assure real estate buyers, tenants and lenders the interest in title they acquire is what they bargained for.

4 **Jarchow** v. **Transamerica Title Insurance Company** (1975) 48 CA3d 917

A policy of title insurance is broken down into six operative sections, including:

exclusion
Risks of loss not covered under a policy of title insurance, comprised of encumbrances arising after the transfer or known to or brought about by the insured.

Schedule A
Identification of the property interest insured, the legal description of the insured property, the date and time coverage began, the premium paid for the policy and the total dollar amount to be paid for all claims settled.

- the *risks of loss covered*, called **insuring clauses**, which are based on a completely unencumbered title at the time of transfer;
- the *risks of loss not covered,* comprised of encumbrances arising after the transfer or known to or brought about by the insured, called **exclusions**, which are a boilerplate set of title conditions;
- *identification* of the insured, the property, the vesting, the dollar amount of the coverage, the premium paid and the recording, called **Schedule A**;
- the *recorded interests*, i.e., any encumbrances affecting title and any observable on-site activities which are listed as risks agreed to and assumed by the insured and not covered by the policy, called **exceptions**, which are itemized for all types of coverage in **Schedule B**;
- the *procedures,* called **conditions**, for claims made by the named insured and for *settlement* by the insurance company on the occurrence of a loss due to any encumbrance on title which is not an exclusion or exception to the coverage granted by the insuring clauses; and
- any *endorsements* for additional coverage or removal of exclusions or pre-printed exceptions from the policy.

Insuring clauses

Coverage under the broadly worded *insuring clause* of a policy of title insurance indemnifies the named insured for risks of loss **related to the title** due to:

- anyone making a claim against title to the real estate interest;
- the title being unmarketable for sale or as security for financing;
- any encumbrance on the title; and
- lack of recorded access to and from the described property.

Exclusions from coverage

All title insurance policies contain an *exclusions* section. The exclusions section eliminates from coverage those losses incurred by the insured buyer, tenant or lender due to:

- *use ordinances* or *zoning laws*;
- *unrecorded claims known* to the insured, but not to the title company;
- encumbrances or adverse *claims created after* the date of the policy;
- claims arising out of *bankruptcy* or due to a *fraudulent conveyance* to the insured;
- *police power* and *eminent domain*; and
- *post-closing events* caused by the insured.

exception
Any encumbrances affecting title and any observable on-site activities which are listed as risks assumed by the insured and not covered by a policy of title insurance under Schedule B.

Schedule A data

All policies of title insurance on *Schedule A* set forth:

- the property interest the insured acquired;
- the legal description of the insured property;
- the date and time coverage began;
- the premium paid for the policy; and
- the maximum total dollar amount to be paid for all claims settled.

Exceptions to coverage

In addition to the policy exclusions, a policy's coverage under its "no-encumbrance" insuring clause is further limited by *Schedule B* exceptions in the policy.

Schedule B
Exceptions from coverage, both standard and itemized, by the title insurance policy.

The *exceptions* section contains an itemized list of recorded and unrecorded encumbrances which are known to the title company and affect the insured title. While the existence of these known encumbrances is insured against in the insuring clauses, they are removed by Schedule B as a basis for recovery under the policy.

An ALTA policy includes a set of pre-printed exceptions setting forth risks assumed by the insured buyer, tenant or lender.

Claims and settlements

Lastly, a policy of title insurance includes a conditions section. The conditions section outlines the procedures the insured policy holder needs to follow when making a claim for recovery under the policy. Also set forth are the settlement negotiations or legal actions available to the title company before paying a claim.

Owner's policies for buyers

Several types of title coverage are available, including:

- a **California Land Title Association (CLTA)** standard policy;
- an **American Land Title Association (ALTA)** owner's extended coverage policy;
- an **ALTA residential (ALTA-R)** policy; and
- an **ALTA homeowner's** policy.

The CLTA standard policy

The *CLTA standard policy* is purchased solely by buyers, carryback sellers and private lenders.

The CLTA standard policy insures against all encumbrances affecting title which can be discovered by a search of **public records** prior to issuance of the policy. Any encumbrance not recorded, whether or not observable by an inspection or survey, is not covered due to the CLTA policy exclusions and standard exceptions.

Figure 1

Form 150 Excerpt

Purchase Agreement (One-to-Four Residential Units)

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.

Additionally, the CLTA standard policy (as well as the ALTA policy) protects the insured against:

- the unmarketability of title or the inability to use it as security for financing;
- lack of ingress and egress rights to the property; and
- losses due to the ownership being vested in someone other than the buyer.

All title insurance policies provide coverage forever after the date and time the policy is issued. Coverage is limited to the dollar amount of the policy, which is generally adjusted for inflation. Coverage is further limited by the exclusions, exceptions and conditions on claims.

Policy exclusions

The CLTA standard policy (as well as the ALTA policy) contains Schedule A exclusions to coverage which bar recovery by the buyer or joint protection carryback seller for losses due to:

- zoning laws, ordinances or regulations restricting or regulating the *occupancy, use or enjoyment* of the land;
- the character, dimensions or location of any *improvement erected* on the property;
- a *change in ownership* or a parceling or combining of the described property by the insured buyer;
- *police power*, *eminent domain* or violations of *environmental protection laws*, unless a notice or encumbrance resulting from the violation was recorded with the county recorder before closing;
- *encumbrances known to the insured buyer* or lender which are not recorded or disclosed to the title company;
- encumbrances which do not result in a *monetary loss*;
- encumbrances which are created or become encumbrances *after issuance* of the policy;
- encumbrances resulting from the buyer's payment of *insufficient consideration* for the property or delivery of improper security to the lender also insured under the policy; and

- the unenforceability of the insured lender's trust deed lien due to the lender's *failure to comply* with laws regarding usury, consumer credit protection, truth-in-lending, bankruptcy and insolvency.

Pre-printed exceptions

The CLTA standard policy contains **pre-printed exceptions** listed in the policy as Schedule B, also called **standard exceptions** or **regional exceptions**. It is the inclusion of these pre-printed boilerplate exceptions which makes the CLTA policy a *standard* policy.

An ALTA owner's policy does not contain pre-printed exceptions, only the typewritten exceptions listing the encumbrances which are known to the title company and affect title to the property.

The pre-printed standard exceptions in Schedule B of the CLTA standard policy eliminate coverage for losses incurred by the buyer due to:

- taxes or assessments not shown in the records of the county recorder, the county tax collector or any other agency which levies taxes on real property;
- unrecorded rights held by others which would have been discovered by the buyer on an inspection of the property or inquiry of persons in possession;
- easements or encumbrances which are not *recorded and indexed* by the county recorder;
- unrecorded encroachments or boundary line disputes which a survey would have disclosed; and
- recorded or unrecorded, unpatented mining claims or water rights.

A lower premium is charged to issue a CLTA policy since the title company undertakes a lower level of risk for indemnified losses due to the CLTA pre-printed exceptions, as compared to the extended risks covered by the more expensive ALTA owner's policy.

The ALTA owner's policy and survey

Most policies issued today are of the ALTA variety since the CLTA policy format with pre-printed standard exceptions does not provide protection for unrecorded encumbrances or claims to title.

The ALTA owner's policy provides greater coverage than the CLTA policy. If the pre-printed exceptions are included in Schedule B and attached to the ALTA policy, the policy becomes an ALTA standard policy, comparable in cost and coverage to the CLTA standard policy since unrecorded encumbrances will not be covered.

As the ALTA owner's policy covers **off-record matters** not covered under the CLTA standard policy, prior to issuance of a policy, the title company may require:

- the parcel to be surveyed; and
- those in possession of the property to be interviewed or estopped.

The exclusions section of an ALTA owner's policy is identical to exclusions in the CLTA policy, except for additional exclusions relating to an insured lender or carryback seller. The ALTA owner's policy is not issued to secured creditors. More precisely, a *joint protection* ALTA policy is never issued.

The ALTA residential policy

For buyers of parcels of real estate containing one-to-four residential units, *an American Land Title Association Residential (ALTA-R)* policy is available in lieu of the ALTA owner's or homeowner's policies. Parcels insured include lots and units in common interest developments (CIDs), such as condominiums.

The ALTA-R is referred to by the title companies as the "plain language" policy. Thus, the ALTA-R is written with wording which avoids legalese. Also, the ALTA-R policy contains a user-friendly *table of contents* and an *owner's information sheet* which outlines the policy's features.

The coverage, exclusions and exceptions in the ALTA-R policy are similar to the ALTA owner's policy. In addition, the ALTA-R policy covers losses due to:

- *mechanic's liens* incurred by someone other than the buyer; and
- the inability of the buyer to occupy the property if the residence violates the CC&Rs listed in the Schedule B exceptions in the policy or existing zoning.

The premium for an ALTA-R policy is priced lower than the premium for an ALTA owner's policy. This is due to the fact that the ALTA-R policy is usually issued only on parcels in an existing subdivision or CID which has no known problems with easements, encroachments or legal access.

The ALTA homeowner's policy

A **homeowner's policy** exists to provide more coverage than the ALTA owner's or the ALTA-R policies.

Before an *ALTA homeowner's policy* will be issued by a title insurer, two requirements need to be met:

- the property needs to be *improved* with a one-to-four unit family residence; and
- the buyer needs to be a natural person, not an entity such as a corporation, limited liability company (LLC) or partnership.

In addition to the risks covered by the ALTA owner's and ALTA-R policies, the homeowner's policy covers several risks to ownership which may arise *after closing*, including:

- the *forging* of the buyer's signature on a deed in an attempt to sell or encumber the buyer's property;
- the construction on an adjoining parcel of a structure which *encroaches* onto the buyer's property, excluding a boundary wall or fence;
- the *recording of a document* which prevents the buyer from obtaining a secured mortgage or selling the property;

- claims of *adverse possession* or *easement by prescription* against the buyer's property; and
- claims by others of a right in the buyer's property arising out of a lease, contract or option *unrecorded and unknown* to the buyer at the time of closing.

Losses due to other risks

The ALTA homeowner's policy also covers losses arising out of a lack of vehicular and pedestrian access to and from the property. Other owner's policies only cover losses resulting from the lack of a legal right to access, not a practical means of access which is covered by the ALTA homeowner's policy.

Also covered by the ALTA homeowner's policy are losses incurred due to many other risks which may exist at the time of closing, including:

- the correction of any pre-existing violation of a CC&R;
- the inability to obtain a building permit or to sell, lease or use the property as security for a mortgage due to a pre-existing violation of a subdivision law or regulation;
- the removal or remedy of any existing structure on the property if it was built without obtaining a building permit, excluding a boundary wall or fence;
- damage to existing structures due to the exercise of a right to maintain or use an easement;
- damage to improvements due to mineral or water extraction;
- the enforcement of a discriminatory CC&R;
- the assessment of a supplemental real estate tax due to construction or a change of ownership or use occurring before closing;
- an incorrect property address stated in the policy; and
- the map attached to the policy showing the incorrect location of the property.

Encumbrances relating to the insured title and known to the title company will be itemized in the policy as additional *exceptions* which limit coverage. The exceptions are reviewed by the buyer and buyer's agent in a prelim before closing and issuance of a policy.

The ALTA homeowner's policy contains the same exclusions from coverage stated in the ALTA-R policy, plus an exclusion for any *building code violations*, unless notice of the violation has been recorded with the county recorder.

Many title insurance companies use the ALTA homeowner's policy as their default policy which is used if a specific title policy is not requested by escrow. The premium for the policy is approximately 10% more than the CLTA owner's policy.

The CLTA standard joint protection policy

A lender or carryback seller has options when calling for title insurance. The lender or carryback seller may either:

- be named as an additional insured on a CLTA standard **joint protection (JP)** title insurance policy with the buyer; or
- request a separate ALTA mortgage policy as a only named insured.

The *JP policy* enables one or more individuals or entities to be named as insured. Thus, in addition to the owner's standard CLTA title coverage, the JP policy provides coverage for a trust deed held by a lender or carryback seller.

The JP policy indemnifies the lender or carryback seller against losses arising from risks such as:

- the invalidity or unenforceability of the insured creditor's trust deed lien;
- the priority of a lien or other encumbrance which was not listed in the policy exceptions; and
- the invalidity or unenforceability of an assignment of the insured trust deed when the assignment is listed in the exceptions as affecting the trust deed.

If a loss covered by a JP policy occurs, the named insureds who suffer from the loss share in any recovery up to the dollar limit of the policy. The recovery is subject to disbursements based on their priority or pro rata interest between them in title.

No windfall recovery

No windfall occurs since title policies only indemnify an insured against the insured's actual monetary loss. If there is no loss of value, there is no basis for recovery.

Most policy limits are established based on the value of the property, and as part of that value, the mortgage amount. Accordingly, once a policy loss has been paid to an insured owner, lender or carryback seller, the amount of coverage under the policy is reduced.

Who is insured?

Those insured under the CLTA standard policy, ALTA owner's policy or ALTA-R policy include the name of the insured in *Schedule A*. They also include the name of those who succeed to the interest of the named insured by *operation of law*, not by purchase.

If title is to be transferred to another vesting, concurrently or within a few months, the title company is requested to include that vesting as a named insured by endorsement.

A policy covering an owner does not cover a buyer who purchases the insured property from the owner. A new policy needs to be obtained, unless the seller holds a **binder** and uses it to request the title insurer issue a policy naming the buyer as the insured.

Settling a claim

To begin the claims process on becoming aware of an encumbrance covered as a loss by the policy of title insurance, the insured promptly gives the title insurance company written **notice of claim**.

Upon being notified of the claim, the title company has 15 days to:

- acknowledge receipt of the claim or pay the claim;
- provide the insured with all forms, instructions, assistance and information necessary to prove the claim; and
- begin any investigation of the claim.[5]

Further, the insured needs to provide the title company with a **proof-of-loss statement** within 90 days after incurring the loss.

proof-of-loss statement
A statement submitted to the title insurance company by the insured referencing the encumbrance discovered after they were issued the policy, the amount of the loss and the basis for calculating the loss.

The title company may require the insured party to make available records, checks, letters, contracts, insurance policies and other papers related to the claim.

After receipt of the 90-day *proof-of-loss statement*, the title insurance company has 40 days to **accept or reject** the claim, in whole or in part.[6]

On accepting a claim, the title company may handle the claim in one of several ways, including:

- *pay policy limits*, plus any authorized costs, attorney fees and expenses incurred by the insured;
- *pay the loss* incurred by the insured, plus costs, attorney fees and expenses;
- negotiate a *settlement*;
- bring or defend a *legal action* on the claim; or
- for an insured lender, *purchase the mortgage* from the lender for the amount owed by the borrower, plus any authorized costs, attorney fees and expenses incurred by the insured lender.

Extent and limitation of liability

The **conditions section** of a title insurance policy limits the amount the title company is required to pay to settle a claim made by an insured.

For owners, the title company may *settle a claim* by paying the lesser of:

- the full dollar amount of the policy; or
- the reduction in value of the insured's ownership interest caused by the title defect or encumbrance missed by the title company and not listed in the policy exceptions.

For lenders, the title company may settle a claim by paying the lesser of:

- the full dollar amount of the policy;
- the impairment or reduction in value of the security interest due to the title defect or encumbrance not listed in the policy exceptions; or
- the amounts due on the unpaid mortgage at the time of the loss caused by a defect or encumbrance not listed in the policy exceptions.

5 10 Calif. Code of Regulations §2695.5(e)(1-3)

6 10 CCR §2695.7(b)

The title company will not pay a claim:

- if the title company is able to remove the encumbrance from title;
- until any litigation over the encumbrance has become final; or
- if the owner or lender settles the claim without written permission of the title company.

All claim payments made by the title insurance company, except payments made for costs, attorney fees and expenses, reduce the dollar amount of coverage remaining under the title policy.

Chapter 52 Summary

A policy of title insurance is the means by which a title insurance company indemnifies a person who acquires an interest in real estate against a monetary loss caused by an encumbrance on title that is not listed in the policy and the insured was unaware of when the policy was issued.

A policy of title insurance includes six operative sections including:

- the risks of loss covered;
- the risks of loss not covered, called exclusions;
- identification of the insured, called Schedule A;
- the recorded interests, called exceptions and listed in Schedule B;
- the procedures for claims made and any endorsements for additional coverage; and
- any endorsements for additional coverage or removal of exclusions or pre-printed exceptions from the policy.

Several types of title coverage are available, including:

- a California Land Title Association (CLTA) standard policy;
- an American Land Title Association (ALTA) owner's extended coverage policy;
- an ALTA residential (ALTA-R) policy; and
- an ALTA homeowner's policy.

Chapter 52 Key Terms

Quiz 10 Covering Chapters 49-54 is located on page 615.

Chapter 53

Automatic and declared homesteads

Learning Objectives

After reading this chapter, you will be able to:

- advise a homeowner whether they qualify to voluntarily sell and protect the equity in their residence from creditor seizure;
- differentiate between an automatic homestead and a recorded declaration of homestead and the protections afforded under each;
- determine the specified dollar amounts of net equity homestead protection available; and
- understand the components of a recorded homestead declaration.

Key Terms

abstract of judgment	**homestead**
declaration of homestead	**quiet title**

For a further discussion of this topic, see Chapter 33 of Legal Aspects of Real Estate.

The owner's homestead interest in title

A **homestead** is the dollar amount of equity in a homeowner's dwelling the homeowner qualifies to exempt from creditor seizure. The dollar amount of the homestead held by the homeowner in the equity in their home has priority on title over most judgment liens and some government liens.

Two types of *homestead* procedures are available to California homeowners:

- the **declaration of homestead**, which is recorded [See Figure 1, **RPI** Form 465];[1] and
- the **automatic homestead**, also called a *statutory homestead exemption*, which is not recorded.[2]

homestead
The dollar amount of equity in a homeowner's principal dwelling the homeowner qualifies to shield as exempt from creditor seizure. [See **RPI** Form 465]

1 Calif. Code of Civil Procedure §704.920
2 CCP §704.720

Recording yields full benefits

Both homestead arrangements provide the same dollar amount of home-equity protection in California. However, a homeowner needs to record a declaration of homestead to receive all the benefits available under the homestead laws. These benefits allow homeowners the right to sell, receive the net sales proceeds up to the dollar amount of the homestead and reinvest the funds in another home. [See Figure 1]

declaration of homestead
A document signed by a homeowner and filed with the county recorder's office to shield the owner-occupant's homestead equity from seizure by creditors. [See **RPI** Form 465]

Neither the declared nor the automatic homestead interfere with:

- **voluntary liens** previously or later placed on title to the property by the homeowner, such as trust deeds; and
- **involuntary liens** given priority to the homestead exemption under public policy legislation; or
- the homeowner's credit ratings or title conditions.

Some *involuntary liens* and encumbrances are given priority by statute and are enforced as senior to the amount of the homestead exemption, including:

- mechanic's (contractor's) and vendor's (seller's) liens;
- homeowners' association (HOA) assessments;
- judgments for alimony or child support;
- real estate property taxes; and
- Internal Revenue Service (IRS) liens.

Involuntary liens that are subordinate and junior to the homestead amount include:

- Franchise Tax Board personal income tax liens;
- Medi-Cal liens; and
- judgment creditor's liens.

Automatic and declared homesteads

An *automatic homestead* is always available on the principal dwelling occupied by the homeowner or their spouse when:

- a judgment creditor's abstract is recorded against the homeowner and attaches as a lien on the property; and
- the occupancy by the homeowner continues until a court determines the dwelling is a homestead.[3]

The *automatic homestead exemption* applies to the equity in:

- a real estate dwelling (and its outbuildings);
- a mobilehome;
- a condominium;
- a planned development;
- a stock cooperative;
- a community apartment project together with the land it rests on; or
- a houseboat or other waterborne vessel used as a dwelling.[4]

3 CCP §704.710(c)
4 CCP §704.710(a)

The recorded homestead declaration includes:

- *the name of the homeowner declaring the homestead;*
- *a description of the property homesteaded; and*
- *a statement that the declared homestead is the principal dwelling in which the homeowner resides on the date the homestead is recorded. [Calif. Code of Civil Procedure §704.930(a); see Form 465]*

The declaration needs to be signed, notarized, and recorded to take effect. [CCP §704.930]

The homestead declaration may be signed and recorded by any one of several individuals, including:

- *the owner of the homestead;*
- *the owner's spouse; or*
- *the guardian, conservator, or a person otherwise authorized to act for the owner or the owner's spouse, such as an attorney-in-fact. [CCP §704.930(b)]*

*An individual's personal residence that is vested in the name of a revocable inter vivos (living) trust, or other type of title holding arrangement established for the benefit of the homeowner, can also be declared a homestead by anyone who has an interest in the property and resides there. [**Fisch, Spiegler, Ginsburg & Ladner** v. **Appel** (1992) 10 CA4th 1810]*

Declaring a homestead as asset preservation

Conversely, a *recorded declaration of homestead* applies only to real estate dwellings. Thus, mobilehomes which are not established as real estate on the property tax records and houseboats are not protected by a recorded homestead.

To qualify a property for the homestead exemption, the homeowner needs to use the homesteaded property as the **principal residence** for themselves and their family.

Amount of equity protected

The dollar amount of home equity protection a homeowner qualifies to preserve is the same under either the automatic homestead or a recorded declaration of homestead.

California homeowners qualify for a net equity homestead protection of up to $300,000 or the median sale price for a single family residence (SFR) in their county in the calendar year prior to the year in which the exemption is claimed, not to exceed $600,000. This dollar threshold is adjusted annually for inflation.[5]

Combating a creditor's attempt to sell the home

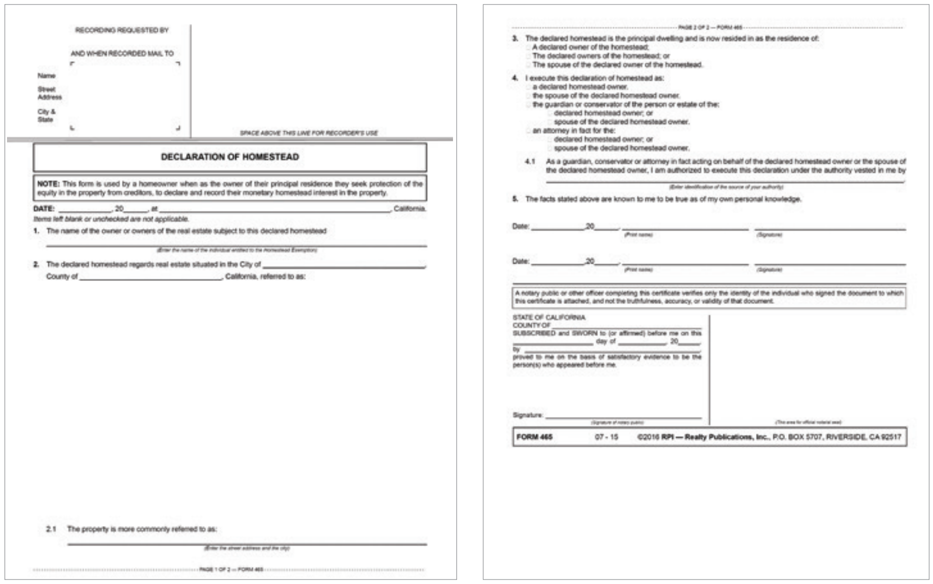
A judgment creditor with a recorded **abstract of judgment** always needs to first petition a court for authorization to sell a homesteaded property and collect on a money judgment. The court then determines whether the owner's

5 CCP §704.730

Figure 1

Form 465

Declaration of Homestead



RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DECLARATION OF HOMESTEAD

NOTE: This form is used by a homeowner when as the owner of their principal residence they seek protection of the equity in the property from creditors, to declare and record their monetary homestead interest in the property.

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

Items left blank or unchecked are not applicable.

1. The name of the owner or owners of the real estate subject to this declared homestead ______________________________

(Enter the name of the individual entitled to the Homestead Exemption)

2. The declared homestead regards real estate situated in the City of ______________________________, County of ______________________________, California, referred to as:

2.1 The property is more commonly referred to as: ______________________________

(Enter the street address and the city)

PAGE 1 OF 2 — FORM 465

PAGE 2 OF 2 — FORM 465

3. The declared homestead is the principal dwelling and is now resided in as the residence of:
   - A declared owner of the homestead;
   - The declared owners of the homestead; or
   - The spouse of the declared owner of the homestead.

4. I execute this declaration of homestead as:
   - a declared homestead owner.
   - the spouse of the declared homestead owner.
   - the guardian or conservator of the person or estate of the:
     - declared homestead owner; or
     - spouse of the declared homestead owner.
   - an attorney in fact for the:
     - declared homestead owner; or
     - spouse of the declared homestead owner.

4.1 As a guardian, conservator or attorney in fact acting on behalf of the declared homestead owner or the spouse of the declared homestead owner, I am authorized to execute this declaration under the authority vested in me by ______________________________.

(Enter identification of the source of your authority)

5. The facts stated above are known to me to be true as of my own personal knowledge.

Date: ____________, 20____, ______________________ ______________________

(Print name) *(Signature)*

Date: ____________, 20____, ______________________ ______________________

(Print name) *(Signature)*

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)

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abstract of judgment
A condensed written summary of the essential holdings of a court judgment.

net sales equity in their home is a dollar amount greater than the amount of the owner's homestead exemption. If it is, the creditor may proceed to judicial foreclosure on their judgment lien by an **execution sale**.[6]

A home with a net equity less than the homestead amount leaves nothing for the creditor to sell and receive too apply to the debt owed under the judgment. However, the sale of a homesteaded dwelling can be forced by a creditor if a net equity exists beyond the amount of the homestead the homeowner holds in the property.

If the homeowner has not recorded a declaration of homestead on the property, they need to prove their residency in the dwelling qualifies the property for the automatic homestead exemption.[7]

Automatic homestead is a shield

A creditor may be permitted by the court to force the sale of the debtor's home. However, the court will first exclude the dollar amount of the *automatic homestead* from the anticipated net sales proceeds to determine if any funds remain to apply on the judgment. If so, the dollar amount of the homestead received by the homeowner on the sale is protected from the creditor's attachment during a **six-month reinvestment period** following the sale.

Further, an automatic homestead exemption is provided on the replacement residence to protect the reinvested funds.[8]

However, if the replacement home acquired is in the same county where the judgment lien is recorded, the lien will attach to the new residence (subject to the owner's homestead exemption) the instant title is transferred into the

6 CCP §704.740(a)
7 CCP §704.780(a)(1)
8 CCP §704.720(b)

homeowner's name.

A homeowner who *voluntarily sells* their residence when title is subject to a creditor's lien cannot use the automatic homestead exemption to protect the sales proceeds from being taken by the judgment creditor.

In contrast, a *declaration of homestead* recorded prior to the recording of the judgment lien allows the homeowner who voluntarily sells their home to first withdraw their homestead amount from the net sales proceeds before the judgment creditor receives any funds.

Although an insufficient net equity may exist barring the judgment creditor from forcing a sale of the home, the homeowner claiming only an automatic homestead exemption may not use a **quiet title action** to remove the lien and sell the home, unlike what is accomplished under a declared homestead.

quiet title
A court action to remove a cloud and establish title to a property.

Duration of a recorded homestead

Once recorded, a declaration of homestead lasts until:

- the homestead owner records a declaration of **abandonment of the homestead**; or
- the homestead owner records a **new declaration** of homestead on another residence.[9]

If a homeowner decides to sell their home which is subject to a *declared homestead* when title to their home has become clouded with a creditor's lien, the homeowner may either:

- negotiate a release of the lien with the creditor; or
- clear title to the home through a quiet title action based on the priority of their declaration of homestead.

After title is cleared and the homeowner sells their property, they have *six months* to reinvest the homestead proceeds in another home. If the proceeds are reinvested in a new residence within six months, the new residence may then be declared a homestead by recording a new homestead declaration.

When the homeowner records a new homestead declaration on their replacement residence, the recording *relates back* to the time the prior homestead was recorded.[10]

Homestead equity exemption amounts are increased from time to time. If the amount changes after the creditor records their abstract of judgment, the amount of exemption, even on the new replacement residence, is the amount that was in effect when the abstract of judgment was recorded, not the later increased amount.

However, if the homeowner does not invest the proceeds of the sale in a new homestead within six months, and the proceeds are still in the State of California, the exempt proceeds from the sale can be attached by the judgment creditor.

9 CCP §§704.980, 704.990
10 CCP §704.960

Chapter 53 Summary

A homestead is the dollar amount of equity in a homeowner's dwelling the homeowner qualifies to exempt from creditor seizure. Two types of homestead procedures are available to California homeowners: the automatic homestead and the declaration of homestead.

The dollar amount of the homestead held by the homeowner has priority on title over most judgment liens and some government liens. Homeowners qualify for one of three specified dollar amounts of net equity homestead protection with either type of homestead.

When a creditor is permitted by a court to force the sale of a debtor's home, the automatic homestead protects the amount of the net sales proceeds up to the dollar amount of the homestead from the creditor's attachment during a six-month reinvestment period from the close of escrow.

However, a homeowner needs to record a declaration of homestead to receive all the benefits available under the homestead laws. In contrast to an automatic homestead exemption, a recorded declaration of homestead coupled with a quiet title action allows the homeowner to remove judgment liens attached to their title. A declaration of homestead allows homeowners to voluntarily sell their home, receive the net sales proceeds up to the dollar amount of the homestead and reinvest the funds in another home.

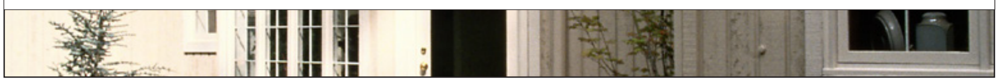
Once recorded, a declaration of homestead lasts until the homestead owner records a declaration of abandonment of the homestead or the homestead owner records a new declaration of homestead on another residence.

Chapter 53 Key Terms

Quiz 10 Covering Chapters 49-54 is located on page 615.

Chapter 54

Conventional financing on a sale, and the buyer's agent



Learning Objectives

After reading this chapter, you will be able to:

- undertake the duties of a transaction agent (TA) to police all facets of their buyer's mortgage process;
- understand the adversarial relationship between a lender and buyer; and
- advise buyers of the financial advantage gained by submitting mortgage applications to multiple lenders.

Key Terms

Loan Estimate

mortgage shopping worksheet

transaction agent (TA)

Uniform Residential Loan Application

For a further study of this discussion, see Chapter 37 of Real Estate Finance.

Role of the transaction agent (TA)

The ability of a buyer or an owner to obtain **financing** is an integral component of most real estate transactions.

The submission of a **mortgage application** to a private or institutional lender is the catalyst which sets the machinery of the mortgage industry in motion.

The *buyer's agent* owes their buyer the duty to ensure their buyer negotiates the best financial advantage available among mortgage lenders. As viewed and identified by lenders, the buyer's agent is called a **transaction agent (TA)**.

transaction agent (TA)
The term lenders use to identify the buyer's agent in a sales transaction, its closing contingent on the buyer obtaining a mortgage to fund the purchase price.

Sources of conventional financing

*When applying for a **conventional mortgage**, a buyer has several types of lenders to choose from, including:*

- *portfolio lenders, such as banks, thrifts and credit unions;*
- *institutional lenders, such as insurance companies and trade association pensions; and*
- *warehousing lenders, such as mortgage bankers who resell the mortgage in the secondary mortgage market.*

While portfolio and institutional lenders typically service their own mortgages, they often originate mortgages for immediate sale in a process called warehousing.

*Warehoused mortgages are sold on the **secondary mortgage market** to investment pools, such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Mortgage Corporation (Freddie Mac), the Government National Mortgage Association (Ginnie Mae) and Wall Street bankers.*

The business of servicing mortgages is also bought and sold. This causes the mortgage to appear to be changing hands. Typically, the originating lender continues to service the mortgage when they sell the mortgage to an investor.

The *TA* neither arranges nor makes a mortgage. Further, they are barred from receiving any compensation for referring the buyer to service providers or policing lender activity. Events related to the transaction serviced by the TA are covered solely by the broker fee negotiated on the sales transaction.

The TA's duties

The duties imposed by agency law on the TA include:

- helping the buyer locate the most advantageous mortgage terms available in the market;
- oversight of the mortgage application submission; and
- policing the lender's mortgage packaging process and funding conditions.

These TA activities ensure all documents needed to comply with the lender's requests and closing instructions are in order. If not, funding cannot take place and closing the sales escrow is jeopardized.

Diametrically opposed interests

A lender's objectives and goals are diametrically opposed to those of the buyer – a debtor versus creditor relationship.

On the advice from their agents, buyers need to understand that the lender's product – money – is always unpriced until the closing has taken place. This truth exists in spite of the **Loan Estimate** and interest rate disclosures that are given to the buyer within three business days following the lender's receipt of the mortgage application. [See **RPI** Form 204-5]

The buyer needs to understand the *Loan Estimate* is not a commitment to lend and is not a guarantee a mortgage on substantially the same terms will be funded. A lender at any time may change the mortgage terms then simply provide another, refreshed **Loan Estimate**. [See **RPI** Form 204-5]

Loan Estimate
An estimate of a buyer's settlement charges and mortgage terms handed to the buyer on a standard form within three business days following the lender's receipt of the mortgage application. [See **RPI** Form 204-5]

*Editor's note — The new Loan Estimate and Closing Disclosure forms published by the Consumer Financial Protection Bureau (CFPB), which apply to all consumer mortgages, went into effect October 3, 2015. The new forms significantly simplify and streamline the mortgage lending process for homebuyers. [See **RPI** Form 204-5 and 402]*

*The Loan Estimate replaces both the initial Truth-in-Lending statement and the good faith estimate of costs (GFE). The Loan Estimate is provided within three business days of the lender's receipt of the application, and provides the mortgage terms and details quoted by the lender. [See **RPI** Form 204-5]*

*The Closing Disclosure replaces both the old final Truth-in-Lending statement and the HUD-1 Settlement Statement. This form is provided within three business days of mortgage closing. It summarizes the "final" mortgage terms and details.[1] [See **RPI** Form 402]*

Before meeting with a lender

After their buyer's offer has been accepted, it's time for the buyer's agent to assist their buyer with submitting a **Uniform Residential Loan Application** to multiple lenders. [See Chapter 55; see **RPI** Form 202 (FNMA 1003)]

Uniform Residential Loan Application
A standardized mortgage application completed by the buyer with the assistance of the transaction agent and the mortgage lender's representative. [See **RPI** Form 202]

Editor's note – Instructions for the accurate completion of the Uniform Residential Loan Application are provided in Chapter 55.

As part of the TA's advice and guidance in the mortgage application process, the TA instructs the buyer regarding:

- the *expectations held* and the *role* of each servicer or affiliate involved in the mortgage transaction, such as the lender's mortgage representative, an appraiser, any mortgage broker involved, credit agencies, creditors of the buyer, etc.;
- *what is going to take place* during the application process, such as lender disclosures, payment of lender costs, funding requirements, etc.; and
- *what to guard against*, such as excuses and claims usually made by the lender to justify an increase in rates at the time of closing.

Documents the buyer needs to gather and submit to the lender to process the mortgage include:

- *W-2s* or other tax documents for the self-employed;
- recent bank statements; and

1 12 Code of Federal Regulations §§1026.19 et seq.

Government financing programs at a glance

A variety of state and federal loan programs exist, offering down payment assistance for low- to moderate-income buyers and first-time buyers, mortgage refinance or modification programs to distressed owners, and special programs for veterans.

***Federal programs**:*

***Federal Housing Administration (FHA)-insured mortgage**: The FHA insures lenders against loss for the full amount of a mortgage. FHA-insured mortgages permit small cash down payments and higher loan-to-value ratio (LTV) requirements than mortgages originated by conventional lenders. [See Chapter 56]*

***U.S. Department of Veterans Affairs (VA) mortgage guarantee**: The VA mortgage guarantee program assists qualified veterans or their surviving spouses to buy a home with zero down payment.*

***Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) and Government National Mortgage Association (Ginnie Mae)**: Fannie Mae, Freddie Mac and Ginnie Mae are government-sponsored enterprises (GSEs) designed to help facilitate home purchases for low- to moderate-income buyers. Fannie Mae and Freddie Mac do not provide home mortgages directly. Instead, they purchase and package pools (tranches) of qualifying single family residence (SFR) mortgages originated by mortgage bankers, known as conforming mortgages, as mortgage-backed bonds (MBBs). They then sell the MBBs to Wall Street Bankers on the secondary mortgage market.*

***State programs**:*

***California Housing Finance Agency (CalHFA)**: CalHFA administers several first-time homebuyer assistance programs, offering 30-year fixed rate mortgages with interest rates and fees typically lower than conventional financing.*

***California Department of Veterans Affairs (CalVet)**: CalVet provides a veteran with an ARM mortgage at a rate generally below market, low monthly payments and flexible credit standards, as compared to conventional financing or mortgages insured by the FHA or guaranteed by the VA.*

***California Department of Housing and Community Development (HCD)**: HCD programs fund local public agencies and private entities which produce affordable housing for rental or ownership.*

- recent *pay-stubs* to evidence the employment information represented by the buyer in section four of the mortgage application. [See Chapter 55; see **RPI** Form 202 (FNMA 1003)]

Lenders also verify other information in the application by requesting and reviewing:

- an appraisal report to establish the value of the property serving as security;
- verification of deposit or tax returns to establish the buyer's income and assets; and
- a credit report to establish the buyer's liabilities and propensity to repay the mortgage. [See Chapter 55; see **RPI** Form 202 (FNMA 1003)]

Form 312

Mortgage Shopping Worksheet

MORTGAGE SHOPPING WORKSHEET

NOTE: This form is used by a transaction agent and their buyer when a mortgage application is submitted to two or more lenders, to compare mortgage rates and origination costs offered by different lenders competing to make the same type of mortgage.

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

Items left blank or unchecked are not applicable.

Lender 1:	Lender 2:	Lender 3:
Lender:	Lender:	Lender:
Loan Officer:	Loan Officer:	Loan Officer:
Date of Contact: ____________, 20____	Date of Contact: ____________, 20____	Date of Contact: ____________, 20____

	Lender 1:	Lender 2:	Lender 3:	Current Mortgage:
Total mortgage amount				
Down payment				
Mortgage term (years)				
Total monthly payment to lender				
If taxes and insurance (TI) are not included in the monthly payment, what is the additional monthly TI amount?				
If private mortgage insurance (PMI) or mortgage insurance premiums (MIPs) are required, what is the monthly cost?				
If PMI/MIP is included, when may it be cancelled?				
□ Fixed rate mortgage (FRM): [See **RPI** Form 320]	□ Conventional, □ FHA, □ VA, □ Jumbo.	□ Conventional, □ FHA, □ VA, □ Jumbo.	□ Conventional, □ FHA, □ VA, □ Jumbo.	□ Conventional, □ FHA, □ VA, □ Jumbo.
Interest rate	%	%	%	%
□ Adjustable rate mortgage (ARM): [See **RPI** Form 320-1]	Initial rate %	Initial rate %	Initial rate %	Initial rate %
When is the first interest rate adjustment?				
How often does the rate change?				
Interest rate adjustment floor/cap				
Rate index name				
Lender's margin	%	%	%	%
Lender fees for processing the mortgage				
Origination / points charged				
Appraisal fee charged				
Other fees ____________________				
If there is a final/balloon payment, when is it due and in what amount?				
If there is a prepayment penalty, what is the amount?				

Date Prepared: ______________, 20______

Prepared by: ________________________________ Prepared for: ________________________________

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Government supports multiple applications

To best protect the buyer, applications are to be submitted to at least two lenders. The second application is insurance against lenders' last minute changes to the rates and terms at the time of closing.

Without a backup application processed by another lender, the buyer is left with no opportunity to reject the lender's changes.

Multiple government agencies promote the practice of submitting multiple applications. To assist the buyer with the task of comparing the products of two

Mortgage Shopping Worksheet
A worksheet designed for use by buyers when submitting applications for a consumer mortgage to compare mortgages offered by different lenders based on a list of all the variables commonly occurring as costs at the time of origination and over the life of the mortgage. [See **RPI** Form 312]

or more lenders, entities such as the Department of Financial Protection and Innovation (DFPI), Freddie Mac, the Federal Reserve, and the Federal Trade Commission publish **Mortgage Shopping Worksheets**.

The *Mortgage Shopping Worksheet* published by **Realty Publications, Inc. (RPI)** is designed to be completed by the buyer with the assistance of the TA. The worksheet contains a list of all the mortgage variables commonly occurring on origination and during the life of the mortgage. [See Form 312 accompanying this chapter]

After submitting mortgage applications to two lenders and receiving the corresponding Loan Estimates, the buyer will possess all the information needed to fill out a Mortgage Shopping Worksheet for each lender. Once complete, the buyer and TA can clearly compare the terms offered by the competing lenders and if that lender remains competitive, close with that lender. [See Form 312]

Chapter 54 Summary

It is the duty of the buyer's transaction agent (TA) to ensure their buyer negotiates the best financial advantage available to them. Further, the TA ensures all documents needed to comply with the lender's closing instructions are timely delivered and in order. The TA neither arranges nor makes a mortgage, but polices all facets of the mortgage process.

A buyer's first step toward obtaining a mortgage is the submission of a standardized Uniform Residential Loan Application to a lender as a prospective borrower. The Uniform Residential Loan Application is designed to be completed by the buyer with the assistance of the TA and the lender's mortgage representative.

To ensure competitive mortgage rates and terms, the TA needs to advise their buyer to submit separate mortgage applications to multiple lenders. By having mortgage applications with two or more lenders, the TA is able to direct the buyer to the lender who offers the superior set of mortgage costs, terms for payment and interest rates, and keep it that way through closing.

Chapter 54 Key Terms

Quiz 10 Covering Chapters 49-54 is located on page 615.

Chapter 55

The Uniform Residential Loan Application and post-submission activities

Learning Objectives

After reading this chapter, you will be able to:

- understand the components of the Uniform Residential Loan Application;
- guide your buyer on how to prepare the mortgage application; and
- advise on the lender disclosures required under the Real Estate Settlement Procedures Act (RESPA).

Key Terms

balance sheet
buyer mortgage capacity
creditworthiness
debt-to-income ratio (DTI)
loan-to-value ratio (LTV)
mortgage package
Real Estate Settlement Procedures Act (RESPA)
transaction agent (TA)
Uniform Residential Loan Application

For a further study of this discussion, see Chapter 38 of Real Estate Finance.

Fundamentals of the Uniform Residential Loan Application

The **Uniform Residential Loan Application** prepared by the buyer with the assistance of their **transaction agent (TA)** provides the lender with necessary information about the buyer and the property which will secure the mortgage. It also gives the lender authorization to start the *mortgage packaging process*. [See Figure 1, **RPI** Form 202 (FNMA 1003)]

Uniform Residential Loan Application
A standardized mortgage application completed by the buyer with the assistance of the transaction agent and the mortgage lender's representative. [See **RPI** Form 202]

Generally, a mortgage is sought in a home sales transaction which is contingent on the buyer obtaining a mortgage to fund the purchase of the property, known as **purchase-assist financing**. However, a mortgage may also be needed for funding by:

- an owner of vacant land to construct a dwelling;
- a property owner to improve or renovate a property they currently own;
- a property owner to refinance an existing mortgage; or
- a tenant on a long-term lease who has agreed to make **tenant improvements (TIs)** to the property they rent.

transaction agent (TA)
The term lenders use to identify the buyer's agent in a sales transaction, its closing contingent on the buyer obtaining a mortgage to fund the purchase price.

As implied by its title, the *Uniform Residential Loan Application* is intended primarily for use on mortgages secured by residential properties.

However, as a generic mortgage application, it is used by mortgage brokers as an application for a mortgage funding any purpose and secured by any type of property. The Uniform Residential Loan Application contains all the information required for arranging all types of real estate mortgages. In practice, the type of property intended to be purchased by use of the mortgage funds is provided by the description of the property in the mortgage application.

Components of the Uniform Residential Loan Application

The first section of the Uniform Residential Loan Application calls for the **type of mortgage sought**, such as conventional, VA or FHA-insured. The buyer also indicates:

- the total dollar amount of the mortgage requested;
- the anticipated interest rate, and whether it is to be fixed or adjustable;
- the periodic payment schedule (constant or graduated); and
- the amortization period (positive or negative). [See Figure 1, **RPI** Form 202 (FNMA 1003)]

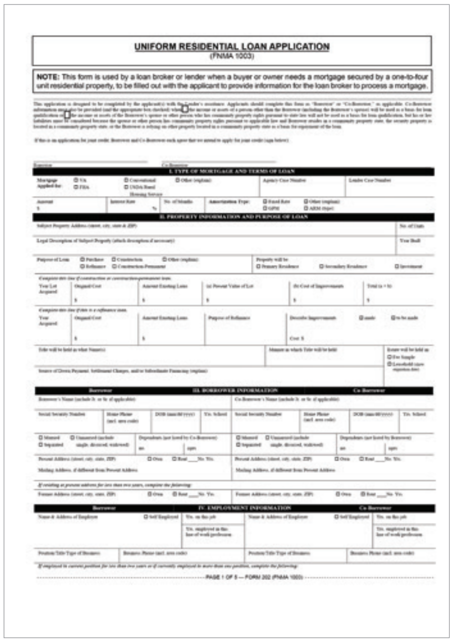
The property under contract to secure the mortgage is identified and its intended use set forth in section two. Section two also states the purpose to be funded by the mortgage, such as purchase-assist or refinance. Also disclosed is the source of down payment funds and closing costs. [See Figure 1, **RPI** Form 202 (FNMA 1003)]

Buyer information

Information identifying the buyer, such as their name and *social security number*, is entered in section three. Space is left to insert any co-borrower information if the income, assets and liabilities of a co-borrower are to be considered for mortgage qualification purposes.

A separate form is used to disclose to the lender the applicant's assets and liabilities if:

- the assets and liabilities result from separate property owned by a co-borrower;


UNIFORM RESIDENTIAL LOAN APPLICATION
(FNMA 1003)

PAGE 1 OF 5 — FORM 202 (FNMA 1003)


PAGE 2 OF 5 — FORM 202 (FNMA 1003)

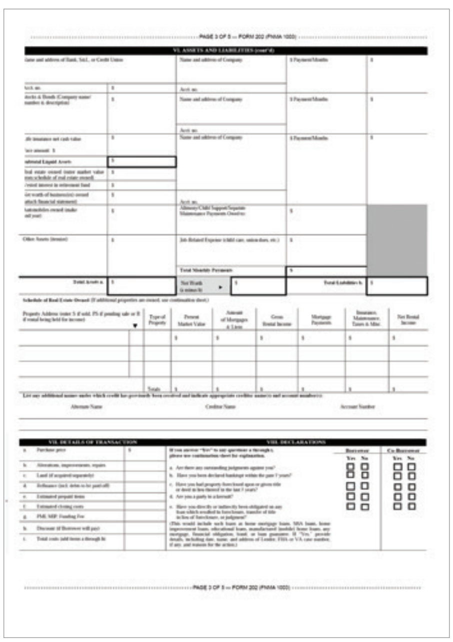

PAGE 3 OF 5 — FORM 202 (FNMA 1003)

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Figure 1

Form 202

Uniform Residential Loan Application

- the co-borrower is a necessary party to the transaction as the property encumbered is considered community property; or
- the co-borrower is a co-signer of the note as a primary borrower. [See Figure 2, **RPI** Form 209-3]

The buyer and co-borrower need to prepare a **balance sheet** if their assets and liabilities are sufficiently joined to make one combined statement viable. If not, each co-borrower is to prepare a separate asset and liabilities statement for individual consideration by the lender. [See Figure 2, **RPI** Form 209-3]

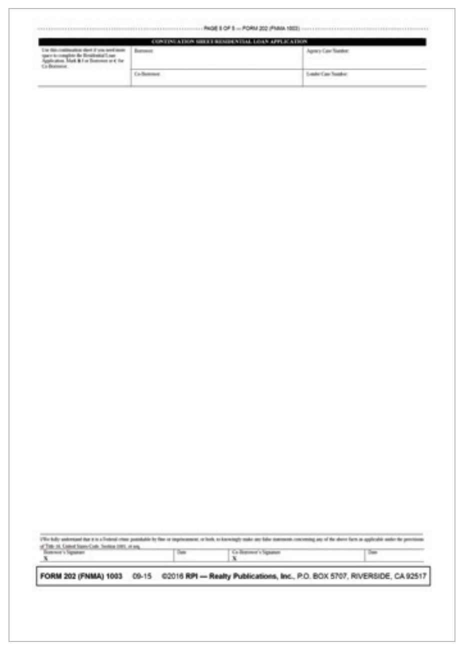
balance sheet
An itemized, dollar-value presentation for setting an individual's net worth by subtracting debt obligations (liabilities) from asset values. [See **RPI** Form 209-3]

Figure 1

Form 202 Cont'd

Uniform Residential Loan Application

For a full-size, fillable copy of this or any other form in this book that may be used in your professional practice, go to realtypublications.com/forms



Employment information

The buyer's (and co-borrower's) **employment information** necessary to identify their source of income is entered in section four of the Uniform Residential Loan Application.

Employment information includes:

- the employment currently held by the buyer;
- the buyer's job title; and

- years spent at that specific job and within that profession. [See Figure 1, **RPI** Form 202 (FNMA 1003)]

If the buyer is self-employed, they indicate this by checking the self-employed box. [See Figure 1, **RPI** Form 202 (FNMA 1003)]

Next, the buyer reports their **monthly income** and **housing expenses** in section five. [See Figure 1, **RPI** Form 202 (FNMA 1003)]

The buyer's **assets** and **liabilities** are entered into section six. This discloses the buyer's net worth. The information is pertinent since the buyer's *liabilities* affect their ability to repay the mortgage. However, the buyer may not want to disclose all their *assets*. Thus, a balance needs to be struck between maintaining financial privacy and disclosing enough assets to get creditworthiness clearance so the mortgage will be funded. [See Figure 1, **RPI** Form 202 (FNMA 1003)]

Since the mortgage funds the acquisition of property, the buyer enters pricing **details about the transaction** in section seven, including the cost of repairs, alterations and improvements made to the property. [See Figure 1, **RPI** Form 202 (FNMA 1003)]

Additional components of the application

The buyer (and any co-borrower) declares any relevant **miscellaneous creditworthiness issues** in section eight of the mortgage application. This includes debt enforcement or debt avoidance the buyer has experienced. [See Figure 1, **RPI** Form 202 (FNMA 1003)]

The buyer **signs** the application (with any co-borrower) to acknowledge and agree to the numerous conditions, some of which are:

- the property will be occupied as represented in the application;
- the buyer will amend the application and resubmit it to the lender if the facts originally stated substantially change;
- the lender may sell/assign the mortgage to others, though the buyer will not be able to sell the property and delegate the mortgage responsibility to another person who acquires the property; and
- the lender is authorized to verify all aspects of the mortgage application as represented by the buyer. [See Figure 1, **RPI** Form 202 (FNMA 1003)]

"Willing and able" to pay

A lender evaluating a mortgage package considers a buyer's *willingness* and *capacity* to pay. To comply, borrowers applying for a *consumer mortgage* are evaluated by the lender for their **ability-to-repay (ATR)**, part of *Regulation Z (Reg Z)*, which implements *TILA*.[1]

debt-to-income ratio (DTI)
Percentage of monthly gross income that goes towards paying debt.

Generally, the **debt-to-income ratio (DTI)** for conventional mortgages, also called the **debt-to-income standard**, limits the buyer's:

- monthly payments for the maximum purchase-assist mortgage, including impounds for hazard insurance premiums and property taxes, to approximately 31% of the buyer's monthly gross income; and

1 12 CFR 1026.43 et seq.

Types of mortgages

The typical conventional mortgage is a 30-year amortized mortgage with a fixed rate of interest.

The buyer's monthly payment remains the same during the life of the fixed-rate mortgage. Fixed-rate mortgages offer greater long-term stability for the buyer than adjustable rate mortgages (ARMs) with their varying interest rates and payment schedules.

Financing options include:

- *ARMs where the interest rate changes periodically based on an index for short-term consumer rates, plus a profit margin. ARMs cause the buyer's monthly payment to periodically adjust;*
- *rate buy-downs where the buyer receives an initial interest rate which is periodically increased, along with the monthly payment, to a fixed rate within a few years, called a graduated payment mortgage (GPM);*
- *the length of the mortgage, which is typically 15 or 30 years, although some lenders offer mortgages with irregular terms;*
- *assumable mortgages allowing resale to a creditworthy buyer, with or without a rate adjustment [See Chapter 57];*
- *bi-weekly mortgages with payments made every two weeks to reduce the total amount of interest paid on the mortgage; and*
- *private mortgage insurance (PMI) where a qualifying buyer obtains a mortgage with less than a 20% down payment while paying a premium for insurance to cover the lender's risk of loss created by the smaller down payment. [See Chapter 60]*

buyer mortgage capacity
A buyer's ability to make mortgage payments based on their debt-to-income ratios (DTI).

creditworthiness
An individual's ability to borrow money, determined by their present income, wealth and previous debt payment history.

- long-term debt, plus the monthly payments, to approximately 41% of the buyer's gross monthly income. [See **RPI** Form 229-1, 229-2 and 230]

Lenders use the *DTI ratio* to evaluate the buyer's ability to make timely mortgage payments. This is referred to as **buyer mortgage capacity**. [See **RPI** Form 230]

The buyer's willingness to make mortgage payments is evidenced by the **credit report**. The credit history demonstrates to the lender whether or not the buyer has a propensity to pay, called **creditworthiness**.

The DTIs can be adjusted depending on one or more compensating factors, such as if the buyer has:

- ample cash reserves;
- a low LTV; and
- spent more than five years at the same place of employment.

RESPA disclosures

The **Real Estate Settlement Procedures Act (RESPA)** mandates lenders active in the secondary mortgage market to disclose all mortgage related charges on mortgages used to purchase, refinance or improve one-to-four unit residential properties.

Mortgage related charges include:

- origination fees;
- credit report fees;
- insurance costs; and
- prepaid interest.

RESPA is now administered and enforced by the **Consumer Financial Protection Bureau (CFPB)** — not the U.S. Department of Housing and Urban Development (HUD).

Real Estate Settlement Procedures Act (RESPA)
Legislation prohibiting brokers from giving or accepting referral fees if thebroker or their agent is already acting as a transaction agent in the sale of a one-to-four unit residential property which is being funded by a purchase-assist, federally-related consumer mortgage.

A RESPA-controlled lender provides the buyer with:

- a **Loan Estimate** of all mortgage terms quoted by the lender within three business days of the lender's receipt of the buyer's mortgage application [See **RPI** Form 204-5; see Chapter 54];[1]
- a **special information booklet** published by the CFPB to help the buyer understand the nature and scope of real estate settlement costs within three business days after the lender's receipt of the buyer's application;[2]
- a **Closing Disclosure**, which summarizes the "final" mortgage terms and details, provided by the lender at least three days before the consumer closes on the mortgage [See **RPI** Form 402];[3] and
- a list of homeownership counseling organizations.

Editor's note: A list of homeownership counseling organizations approved by HUD can be found at the CFPB's website.

If the buyer is arranging financing through a mortgage broker, the broker, not the lender, provides a copy of the special information booklet to the buyer.[4]

However, the booklet does not need to be given to the buyer if the mortgage funds:

- the refinance of an existing mortgage;
- a closed-end mortgage in which the lender takes a subordinate lien;
- a reverse mortgage; and
- any federally related mortgage used to fund the purchase of other than a one-to-four unit residential property.[5]

Also, on *ARMs,* the lender informs the buyer not only of the interest rate, but also the index, margin and payment and interest rate floors and caps. [See **RPI** Form 320-1]

Property appraisal

On the lender's receipt of a mortgage application, the property is **appraised**. [See **RPI** Form 223-2 and 207; see Chapter 29]

1 12 CFR §1026.37
2 12 CFR §1026.19(g)
3 12 CFR §1026.19(f)(ii)
4 12 CFR §1024.6(a)(1)
5 12 CFR §1024.6(a)(3)

Figure 2

Form 209-3

Balance Sheet Financial Statement

BALANCE SHEET FINANCIAL STATEMENT
Assets, Liabilities, and Net Worth

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

NOTE: This form is used by a loan broker when processing a mortgage application, to be prepared by the borrower for the loan broker to determine the borrower's net worth.

This statement and attached schedule is to be completed by both co-borrowers if their assets and liabilities are sufficiently joined to make one combined statement viable. If not, each co-borrower is to prepare their separate statements.

DATE: ______, 20____. Prepared by ______.
FOR: ______

SECTION I - ASSETS:

1. Checking and saving account information: **AMOUNT**
1.1 Name of depository ______, Account No. ______ . . . . $______
Address ______
1.2 Name of depository ______, Account No. ______ . . . . $______
Address ______
1.3 Name of depository ______, Account No. ______ . . . . $______
Address ______
1.4 Name of depository ______, Account No. ______ . . . . $______
Address ______
1.5 Name of depository ______, Account No. ______ . . . . $______
Address ______

2. Tradable stocks and bonds:
2.1 Company name ______
Description/Quantity held ______ . . . . $______
2.2 Company name ______
Description/Quantity held ______ . . . . $______
2.3 Company name ______
Description/Quantity held ______ . . . . $______
2.4 Company name ______
Description/Quantity held ______ . . . . $______

3. SUBTOTAL of liquid assets (sum of lines 1.1 through 2.4) . . . . $______
4. Real estate owned (enter market value from line 17.7(a)) . . . . $______
5. Vested interest in retirement fund . . . . $______
6. Net worth of businesses owned:
6.1 Name ______ . . . . $______
Percentage owned ____%, entity type ______
(attach current and prior year profit and loss statement)
6.2 Name ______ . . . . $______
Percentage owned ____%, entity type ______
(attach current and prior year profit and loss statement)
6.3 Name ______ . . . . $______
Percentage owned ____%, entity type ______

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(attach current and prior year profit and loss statement)

7. Notes owned:
7.1 Unpaid principal of trust deed notes . . . . $______
7.2 Unpaid principal of unsecured notes . . . . $______

8. Vehicles owned (market value):
8.1 Make ______ year ______ . . . . $______
8.2 Make ______ year ______ . . . . $______
8.3 Make ______ year ______ . . . . $______
8.4 Make ______ year ______ . . . . $______

9. Other assets (collectibles, equipment, etc.):
9.1 Description ______ . . . . $______
9.2 Description ______ . . . . $______
9.3 Description ______ . . . . $______

10. TOTAL assets (sum of lines 3 through 9.3) . . . . $______

SECTION II - LIABILITIES:
Include auto loans, charge accounts, real estate loans, alimony/child support, loans collateralized by stock/bonds/notes, etc.

11. Creditor and loan information: **Monthly Payment** **Unpaid Balance**
11.1 Name of Creditor ______ Account No. ______ $______ $______
Address ______ Months left ______
Type of debt ______
11.2 Name of Creditor ______ Account No. ______ $______ $______
Address ______ Months left ______
Type of debt ______
11.3 Name of Creditor ______ Account No. ______ $______ $______
Address ______ Months left ______
Type of debt ______
11.4 Name of Creditor ______ Account No. ______ $______ $______
Address ______ Months left ______
Type of debt ______
11.5 Name of Creditor ______ Account No. ______ $______ $______
Address ______ Months left ______
Type of debt ______
11.6 Name of Creditor ______ Account No. ______ $______ $______
Address ______ Months left ______
Type of debt ______
11.7 Name of Creditor ______ Account No. ______ $______ $______
Address ______ Months left ______
Type of debt ______
11.8 Name of Creditor ______ Account No. ______ $______ $______
Address ______ Months left ______
Type of debt ______
11.9 Name of Creditor ______ Account No. ______ $______ $______
Address ______ Months left ______
Type of debt ______

12. Spousal support owed to ______ $______
Months left ______
12.1 Child support owed to $______
Months left ______

13. Job-related expenses:
13.1 Union dues . . . . $______
13.2 Child care . . . . $______
13.3 Other ______ . . . . $______

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13.4 Other ______ . . . . $______
14. TOTAL monthly payments . . . . $______
15. TOTAL liabilities . . . . $______
16. NET WORTH (line 10 minus line 15) . . . . $______

SECTION III - REAL ESTATE OWNED:

17. Property description:

	a. Market Value	b. Loan(s) Amount	c. Owner's Equity (line a minus line b)	d. Monthly Rental income	e. Monthly Operating Expenses	f. Monthly Loan Payments	g. Spendable income (line d minus lines e and f)
17.1 Type ______ Address ______	$____	$____	$____	$____	$____	$____	$____
17.2 Type ______ Address ______	$____	$____	$____	$____	$____	$____	$____
17.3 Type ______ Address ______	$____	$____	$____	$____	$____	$____	$____
17.4 Type ______ Address ______	$____	$____	$____	$____	$____	$____	$____
17.5 Type ______ Address ______	$____	$____	$____	$____	$____	$____	$____
17.6 Type ______ Address ______	$____	$____	$____	$____	$____	$____	$____
17.7 **TOTALS**	$____	$____	$____	$____	$____	$____	$____

The information provided above is true and correct.
Date: ______, 20____ Date: ______, 20____
Name: ______ Name: ______

Signature: ______ Signature: ______

For a full-size, fillable copy of this or any other form in this book that may be used in your professional practice, go to realtypublications.com/forms

loan-to-value ratio (LTV)
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value. The degree of leverage.

The *appraisal* determines whether the property is of sufficient value to support the amount of financing the buyer requests. Essentially, the lender uses the appraisal to gauge whether the **loan-to-value ratio (LTV)** meets the lender's standards. [See Chapter 29]

Generally, an acceptable LTV for conventional mortgages is 80% of the property's value, requiring the buyer to make a minimum 20% down payment. A greater LTV compels the lender to require the buyer to obtain **private mortgage insurance (PMI).**

Once a lender approves property based on an appraisal, a **mortgage package** is assembled and sent to a mortgage underwriter for review.

Mortgage approval

A **mortgage approval** issued by a lender is often conditioned on a buyer providing more information or taking corrective actions. For example:

- the *physical condition* of the property may need correction;
- *title* may need to be cleared of defects;
- *derogatory entries* on the buyer's credit report may need to be eliminated; or
- the buyer's *long- or short-term debt* is to be reduced.

Once conditions for funding are met and verified, the mortgage is classified as *approved*. Escrow calls for mortgage documents and funds, and on funding, the sales transaction is closed.

Agents need to remind themselves that the degree of risk each lender finds acceptable is different. More often than not, a lender exists who will make a mortgage of some amount and under some conditions to nearly *any buyer*. It is the business of lenders to do so.

mortgage package
A collection of documents required to process a mortgage application and sent to a mortgage underwriting officer for review after receipt of the appraisal on the property offered as security.

Chapter 55 Summary

The Uniform Residential Loan Application prepared by the buyer with the transaction agent (TA) supplies the lender with necessary information about the buyer and the property securing the mortgage. It also gives the lender authorization to start the mortgage packaging process.

The Uniform Residential Loan Application calls for the buyer, with the assistance of the mortgage representative and TA, to enter information such as:

- the type of mortgage sought;
- the identity of the property used to secure the mortgage;
- the buyer's name and employment information;
- the buyer's monthly income and housing expenses;

- the buyer's assets and liabilities; and
- relevant miscellaneous creditworthiness issues to be disclosed to the lender.

A Real Estate Settlement Procedures Act (RESPA)-controlled lender needs to provide the buyer with a Loan Estimate of all mortgage related charges, a copy of the HUD-published special information booklet, a Closing Disclosure detailing all charges actually incurred and a list of homeownership counseling organizations.

Once a lender receives a mortgage application and any processing fee, the property is appraised to determine if it qualifies as security for the mortgage. If a lender approves the property based on an appraisal, a mortgage package is assembled and sent to an underwriter for review.

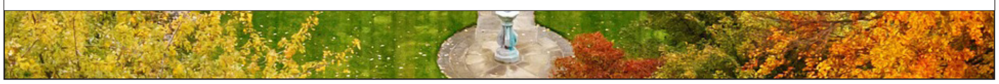
Once mortgage conditions are met and verified, the mortgage is classified as approved. Escrow calls for mortgage documents and funds. On funding, the sales transaction is closed.

Chapter 55 Key Terms

Quiz 11 Covering Chapters 55-61 is located on page 616.

Chapter 56

The FHA-insured home mortgage



Learning Objectives

After reading this chapter, you will be able to:

- understand how purchase-assist mortgages insured by the Federal Housing Administration (FHA) enable buyers to become owners;
- explain the minimum down payment and loan-to-value ratio (LTV) for FHA-insured financing;
- determine whether a buyer and property qualify for an FHA insured mortgage; and
- advise buyers on the use of an FHA Energy Efficient Mortgage to finance energy efficient improvements.

Key Terms

Energy Efficient Mortgage (EEM)

Federal Housing Administration (FHA)-insured mortgage

fixed payment ratio

loan-to-value (LTV) ratio

mortgage insurance premium (MIP)

mortgage payment ratio

Real Estate Settlement Procedures Act (RESPA)

For a further study of this discussion, see Chapter 41 of Real Estate Finance.

Enabling tenants to become homeowners

Consider a residential tenant who is solicited by a real estate agent to buy a home. The financial and tax aspects together with the social benefits of home ownership are compared to the corresponding benefits and mobility provided by renting their shelter.

The tenant indicates they are ready and willing to be owners of a home for their shelter. However, they have not accumulated enough cash reserves for the **down payment** needed to qualify for a mortgage they need to fund the purchase of a home.

Federal Housing Administration (FHA)-insured mortgage
A mortgage originated by a lender and insured by the FHA, characterized by a small down payment requirement, high loan-to-value (LTV) ratio and high mortgage insurance premiums (MIPs), typically made to first-time homebuyers.

The agent assures the tenant that first-time homebuyers with little cash available for a down payment can buy a home by qualifying for a *purchase-assist mortgage* insured by the **Federal Housing Administration (FHA)**.

By insuring mortgages made with less demanding cash down payment requirements, and with high **loan-to-value (LTV)** ratios of up to 96.5%, the FHA enables prospective buyers to become homeowners.

The FHA does not lend money to buyers. Rather, the FHA insures mortgages originated by approved *direct endorsement lenders* to qualified buyers who will occupy the property as their principal residence. For issuing insurance to the lender covering losses on a default, the buyer will pay premiums to FHA for the coverage.

To qualify for an FHA-insured fixed-rate mortgage, a first-time homebuyer is required to make a down payment of at least 3.5% of the purchase price. The interest rate on the underlying mortgage is negotiated between the buyer and the lender.[1]

Buyer liability on a default

If a buyer defaults on an FHA-insured mortgage, the FHA covers the lender against loss on the entire remaining balance of the mortgage. This is unlike **private mortgage insurance (PMI)** and insurance from the **Veterans Administration (VA)** which only insures a portion of the total mortgage amount.

After the lender acquires the property through foreclosure and conveys the property to the FHA, the FHA pays the lender the amount of the unpaid principal balance remaining on the mortgage.[2]

Before accepting a conveyance from the lender, the FHA requires the lender to confirm the property is in a marketable condition and has not suffered any **waste**. The FHA then sells the property to recoup the amount it paid to the lender.

Unlike conventional home mortgages where only a lender is involved, a buyer who takes out an FHA-insured mortgage with a lender is *personally liable* to the FHA for any loss the FHA suffers as a result of the homebuyer's default.

When the FHA suffers a loss, the FHA can obtain a money judgment against the homebuyer for the difference between:

- the amount the FHA paid the lender; and
- the price received from the sale of the property.

California anti-deficiency mortgage laws do not apply to FHA-insurance coverage for lender claims on insured mortgages.[3]

1 24 Code of Federal Regulations §203.20
2 24 CFR §203.401
3 24 CFR §203.369

One-to-four unit mortgage default insurance

The most commonly used FHA-insurance program is the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, **Section 203(b)**. Buyers obtaining a Section 203(b) mortgage need to occupy the property as their **primary residence.**

For the privilege of making a **small down payment**, the buyer needs to pay a **mortgage insurance premium (MIP)** to the FHA. This essentially increases the annual cost of borrowing as the annual rate charged for MIP is added to interest payments. Together, the MIP and interest are the annual cost incurred to borrow FHA-insured funds for the purchase of a home.

mortgage insurance premium (MIP)
The cost for default insurance incurred by a borrower on an FHA-insured mortgage set as a percent of the mortgage amount paid up front and an annual rate on the principal balance paid with monthly principal and interest for the life of the mortgage.

FHA guidelines include:

- manual underwriting for homebuyers whose debt-to-income ratio (DTI) exceeds 43% and whose credit scores are below 620;
- 5% minimum down payments on FHA mortgages greater than $625,000; and
- MIP to continue through the life of the mortgage (previously it was cancelled once the homeowner reached a 78% LTV).

Further, an *upfront premium*, paid once at the time the mortgage is originated, is calculated as 1.75% of the funded mortgage amount.

The public policy rationale behind the FHA Section 203(b) program is based on the proposition homeowners are less of a financial burden on the government in their later years than life-time tenants.

FHA-insured dollar limits by regions

The maximum FHA-insured mortgage available to assist a buyer in the purchase of one-to-four unit residential property is determined by:

- the type of residential property; and
- the county in which the property is located.

A list of counties and their specific mortgage ceilings is available from FHA or an FHA direct endorsement lender, or online from the Department of Housing and Urban Development (HUD) at *http://www.hud.gov*.

Loan-to-value (LTV) ceilings and costs

The FHA sets limitations on the amount of a mortgage it will insure. The limit is a ceiling set as a percentage of the appraised value of the property, called the **loan-to-value ratio (LTV)** .

loan-to-value ratio (LTV)
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value. The degree of leverage.

The *LTV ratio* on an FHA-insurable mortgage is capped at a ceiling of 96.5% of the property's fair market value. Thus, the minimum down payment is 3.5%.[4]

Additionally, even after including buyer-paid closing costs in the LTV calculations, the insurable mortgage amount cannot exceed the ceiling of 96.5% of the property's appraised value.

4 HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.b

The maximum mortgage amount the FHA will insure is the LTV ratio's percentage amount of the lesser of:

- the property's sales price; or
- the appraised value of the property.[1]

Closing costs may not be used to help meet the 3.5% minimum down payment requirement. Also, closing costs are not deducted from the sales price before setting the maximum mortgage amount.[2]

The lender's origination fee included as a closing cost is limited to 1% of the mortgage amount, excluding any competitive discount points and the 1.75% upfront MIP.

Either the buyer or seller may pay the buyer's closing costs, called **non-recurring closing costs**. The lender may also advance closing costs on behalf of the buyer.

Credit approval

mortgage payment ratio
A debt-to-income ratio (DTI) used to determine eligibility for an FHA-insured mortgage limiting the buyer's mortgage payment to 31% of the buyer's gross effective income.

fixed payment ratio
A debt-to-income ratio (DTI) used to determine eligibility for an FHA-insured mortgage limiting the buyer's total fixed payment on all debts to 43% of the buyer's gross income, also called the DTI back-end ratio.

For a buyer to be creditworthy for an FHA-insured mortgage, the following debt-to-income (DTI) ratios need to be met:

- the buyer's *mortgage payment* may not exceed 31% of the buyer's gross effective income, called the **mortgage payment ratio**; and
- the buyer's *total fixed payments* may not exceed 43% of the buyer's gross effective income, called the **fixed payment ratio**.[3]

A buyer's income consists of salary and wages. Social security, alimony, child support, and government assistance are factored into the buyer's income to determine *effective income*. The buyer's effective income before any reduction for the payment of taxes is referred to as **gross effective income**.

The maximum *mortgage payment ratio* of 31% of the gross effective income determines the maximum amount of principal, interest, taxes and insurance (fire and MIP) the buyer is able to pay on the mortgage. Collectively, this is called **PITI**.

Lenders use the maximum *fixed payment ratio* of 43% of the gross effective income. Applying this ratio, they determine whether a buyer can afford to incur the long-term debt of an FHA-insured mortgage in addition to all other long-term payments the buyer is obligated to pay.

When computing the fixed-payment ratio, the lender adds the buyer's total mortgage payment to all the buyer's recurring monthly obligations. This includes debts extending ten months or more, such as all installment loans, alimony and child support payments.[4]

1 HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.a
2 HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.d
3 HUD Handbook 4155.1 Rev-5 Ch-4 §F.2
4 HUD Handbook 4155.1 Rev-5 Ch-4 §C.4

Acceptable sources of cash down payment include:

- ***Savings and checking accounts**: Lenders need to verify the account balance is consistent with the buyer's typical recent balance and no large increase occurred just prior to the mortgage application. [See **RPI** Form 211]*
- ***Gift funds**: The donor of the gift needs to have a clearly defined interest in the buyer and be approved by the lender. Relatives or employer unions typically are acceptable donors. Gift funds from the seller or broker are kickbacks considered an inducement to buy and result in a reduction in the mortgage amount.*
- ***Collateralized mortgages**: Any money borrowed to make the down payment needs to be fully secured by the buyer's marketable assets (i.e., cash value of stocks, bonds, or insurance policies), which may not include the home being financed. Cash advances on a credit card, for example, are not acceptable sources for down payment funds.*
- ***Broker fees**: If the buyer is also a real estate agent involved in the sales transaction, the fee received on the sale may be part of the buyer's down payment.*
- ***Exchange of equities**: The buyer may trade property they own to the seller as the down payment. The buyer needs to produce evidence of value and ownership before the exchange will be approved.*
- ***Sale of personal property**: Proceeds from the sale of the buyer's personal property may be part of the down payment if the buyer provides reliable estimates of the value of the property sold.*
- ***Undeposited cash** is an acceptable source of down payment funds if the buyer can explain and verify the accumulation of the funds. [HUD Handbook 4155.1 Rev-5 Ch-5 §B.1]*

Acceptable source of cash down payment

However, even if the buyer's ratios exceed FHA requirements, the mortgage may be approved if the buyer:

- makes a large down payment;
- has a good credit history;
- has substantial cash reserves; and
- demonstrates potential for increased earnings due to job training or education.

Taken together, these are referred to as **compensating factors**.[5]

RESPA and TILA disclosures

The **Real Estate Settlement Procedures Act (RESPA)** requires any lender making an FHA-insured mortgage to deliver to the mortgage applicant a **Loan Estimate** published by the Consumer Financial Protection Bureau (CFPB) of costs paid to providers of services on the sale of a one-to-four unit residential property. [See **RPI** Form 204-5; see Chapter 54]

5 HUD Handbook 4155.1 Rev-5 Ch-4 §F.3

Lenders also deliver a Housing and Urban Development (HUD) information booklet. Both need to be delivered within three days after receiving the buyer's application. [See Chapter 54]

Upon closing a sale, the lender delivers a **Closing Disclosure** published by the CFPB detailing all mortgage related charges incurred by the buyer and seller.[1] [See **RPI** Form 402; see Chapter 54]

Mortgages insured by the FHA under Section 203(b) are subject to both disclosure requirements since they fund personal use mortgages and are federally related (RESPA).[2]

Personal liability of the seller

Real Estate Settlement Procedures Act (RESPA)
Legislation prohibiting brokers from giving or accepting referral fees if thebroker or their agent is already acting as a transaction agent in the sale of a one-to-four unit residential property which is being funded by a purchase-assist, federally-related consumer mortgage.

When a home is sold with the buyer taking title subject to an existing FHA-insured mortgage under some arrangement to pay for the seller's equity, the seller is released from personal liability, if:

- they request a release from personal liability;
- the prospective buyer of the property is creditworthy;
- the prospective buyer assumes the mortgage; and
- the lender releases the seller from personal liability by use of an FHA-approved form.[3]

If the conditions for release from personal liability are not satisfied, the seller remains liable for any FHA loss on their insurance coverage for five years after the sale.[4]

However, if five years pass from the time the property is resold, the seller is then released from personal liability if:

- the mortgage is not in default by the end of the five-year period;
- the buyer assumes the mortgage with the lender; and
- the seller requests the release of liability from the lender.[5]

Energy efficiency

Energy Efficient Mortgage (EEM)
An FHA-insured purchase-assist or refinance mortgage which includes the additional amount to cover the costs of constructing energy improvements on the mortgaged property.

Homebuyers and homeowners have a way to finance energy efficient improvements under the FHA's **Energy Efficient Mortgage (EEM)** program.

The underlying idea behind the EEM program is this: reduced utility charges allow applicants to make higher monthly mortgage payment to fund the cost of the energy efficient improvements.

Financeable energy efficient improvements funded under FHA's program include:

- purchasing energy efficient appliances or heating and cooling systems;
- installing solar panels;

1 24 CFR §3500 et seq.
2 12 CFR §226.19
3 HUD Form 92210; 24 CFR §203.510(a); HUD Handbook 4155.1 Rev-5 Ch-7
4 12 USC §1709(r)
5 24 CFR §203.510(b)

- installing energy efficient windows;
- installing wall or ceiling installation; and
- completing repairs of existing systems to improve energy efficiency.

Under the EEM program, the costs of fundable energy improvements are added to the base FHA maximum mortgage amount on a purchase or refinance.[6]

Like most FHA mortgage programs, the EEM is not funded by the FHA. It is funded by a lender, and insured to guarantee repayment by the FHA.

An EEM may be used in connection with either an FHA-insured purchase or refinance mortgage (including streamline refinances), under the:

- "standard" 203(b) program for one-to-four unit residential properties;
- 203(k) rehabilitation program;
- 234(c) program for condominium projects; and
- 203(h) program for mortgages made to victims of presidentially declared disasters.[7]

Eligible property types include new and existing:

- one-to-four unit residential properties for the 203(b) and 203(k) programs;
- one-unit condominiums; and
- manufactured housing.[8]

6 HUD Mortgagee Letter 2009-18
7 HUD Handbook 4155.1 Chapter 6.D.2.a
8 HUD Handbook 4155.1 Chapter 6.D.2.a

Chapter 56 Summary

The Federal Housing Administration (FHA) insures mortgages originated by approved direct endorsement lenders to qualified buyers to fund the purchase of their principle residence.

FHA-insured mortgages provide for a down payment as low as 3.5% and a higher loan-to-value (LTV) ratio than conventional mortgages. For the privilege of making a small down payment, the buyer pays a mortgage insurance premium (MIP) to the FHA, effectively increasing the annual cost of borrowing as an addition to interest.

If a buyer defaults on an FHA-insured mortgage, the FHA covers the lender against loss on the entire remaining balance of the mortgage.

The most commonly used FHA-insurance program is the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, Section 203(b).

Before the FHA will insure a mortgage, the lender needs to determine the buyer's creditworthiness. For a buyer to be creditworthy for FHA mortgage insurance, the following debt-to-income ratios (DTI) need to be met:

- the buyer's mortgage payment ratio may not exceed 31% of their gross effective income; and
- the buyer's fixed payment ratio for all installment debts may not exceed 43% gross effective income.

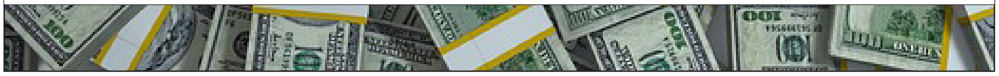
Homebuyers and homeowners may finance energy efficient improvements under the FHA's Energy Efficient Mortgage (EEM) program. With reduced utility charges, buyers and owners may make higher monthly mortgage payment to fund the cost of the energy efficient property improvements.

Chapter 56 Key Terms

Quiz 11 Covering Chapters 55-61 is located on page 616.

Chapter 57

Carryback financing in lieu of cash



Learning Objectives

After reading this chapter, you will be able to:

- comprehend the financial benefits afforded to a seller and a buyer under seller carryback finance arrangements;
- identify the seller's risks involved in carryback financing; and
- explain the tax advantages available to a seller for carrying back a portion of the sales price.

Key Terms

all-inclusive trust deed (AITD)

nonrecourse

portfolio category income

private mortgage insurance (PMI)

seller financing

For a further discussion of this topic, see Chapter 26 of Real Estate Finance.

Seller financing supports the price

When the availability of real estate mortgages tightens, a seller hoping to locate a buyer amenable to the seller's asking price needs to consider **seller financing**.

Seller financing is also known as:

- an installment sale;
- a credit sale;
- carryback financing; or
- an owner-will-carry (OWC) sale.

seller 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 carryback financing.

Seller financing occurs when a seller carries back a note executed by the buyer to evidence a debt owed for purchase of the seller's property. The amount of the debt is the remainder of the price due after deducting:

- the down payment; and
- the amount of any existing or new mortgage financing used by the buyer to pay part of the price.

On closing, the rights and obligations of real estate ownership held by the seller are shifted to the buyer. Concurrently, the seller carries back a note and trust deed taking on the rights and obligations of a secured creditor.

Editor's note —California brokers and agents who make, offer or negotiate residential mortgages for compensation are required to obtain a Mortgage Loan Originator (MLO) license endorsement on their Department of Real Estate (DRE) license. A residential mortgage is a consumer purpose loan secured by a one-to-four unit residential property.

Thus, offering or negotiating carryback financing triggers the MLO license endorsement only if the broker or agent receives additional compensation for the act of offering or negotiating the carryback, beyond the fee collected for their role as seller's agent or buyer's agent.

Marketing property: the seller will carry

The seller who offers a convenient and flexible financing package to prospective buyers makes their property **more marketable** and **defers the tax bite** on their profits.

Qualified buyers who are rational are willing to pay a higher price for real estate when attractive financing is available. This holds regardless of whether financing is provided by the seller or a mortgage lender. For most buyers, the primary factors when considering their purchase of a property is the amount of the down payment and the monthly mortgage payments.

Buyer willingness is especially apparent when the rate of interest on the carryback financing is in line with or below the rates lenders are charging on their purchase-assist mortgages. The lower the interest rate, the higher the price may be.

Flexible sales terms for the buyer

For buyers, seller carryback financing generally offers:

- a moderate down payment;
- competitive interest rates;
- less stringent terms for qualification and documentation than imposed by lenders; and
- no origination (hassle) costs.

In a carryback sale, the amount of the down payment is negotiable between the buyer and seller without the outside influences a traditional mortgage broker and borrower has to contend with.

Additionally, a *price-to-interest rate tradeoff* often takes place in the carryback environment. The buyer is usually able to negotiate a lower-than-market interest rate in exchange for agreeing to the seller's higher-than-market asking price.

Tax benefits and flexible sales terms

Taxwise, it is preferable for a seller to carry back a portion of the sales price, rather than be cashed out when taking a significant taxable profit.

The seller, with a reportable profit on a sale, is able to defer payment of a substantial portion of their profit taxes until the years in which principal is received. When the seller avoids the entire profit tax bite in the year of the sale, the seller earns interest on the amount of the note principal that represents taxes not yet due and payable.

portfolio category income
Unearned income from interest on investments in bonds, savings, income property, stocks and trust deed notes.

If the seller does not carry a note payable in future years, they will be cashed out and pay profit taxes in the year of the sale (unless exempt or excluded).

What funds they have left after taxes are reinvested in some manner. These *after-tax sales proceeds* will be smaller in amount than the principal on the carryback note. Thus, the seller earns interest on the net proceeds of the carryback sale before they pay taxes on the profit allocated to that principal.

The tax impact the seller receives on their carryback financing is classified as **portfolio category income**.

The closing documents needed for the carryback

On closing the sale, the seller financing may be documented in a variety of ways. Common arrangements include:

- land sales contracts;
- lease-option sales;
- sale-leasebacks; and
- trust deed notes, standard and all-inclusive.

Legally, the **note and trust deed** provides the most certainty. Further, they are the most universally understood of the various documents used to structure seller financing. In this arrangement, **carryback documentation** consists of:

- a *promissory note* executed by the buyer in favor of the seller as evidence of the portion of the price remaining to be paid for the real estate before the seller is *cashed-out* [See **RPI** Form 421]; and
- a *trust deed lien* on the property sold to secure the debt owed by the buyer as evidenced by the note. [See **RPI** Form 450]

The note and trust deed are legally coupled, inseparable and function in tandem. The note provides evidence of the debt owed but is not filed with the County Recorder. The trust deed creates a lien on property as the source for repayment of the debt in the event of a default.

Form 303

Foreclosure Cost Sheet

FORECLOSURE COST SHEET

Costs and Net Proceeds on Foreclosure and Resale

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

NOTE: This form is used by a seller's agent or mortgage loan broker when the transaction involves a carryback seller or lender secured by a junior trust deed, to advise them of the funding necessary to foreclose and the likely net proceeds of a foreclosure and resale of the encumbered property.

1. This estimate of costs incurred to foreclose and resell property under a trust deed is prepared for the following:

☐ Purchase Agreement ☐ Loan Agreement ☐ Exchange Agreement
☐ Trust Deed and Note ☐ Option

1.1 dated ____________, 20____, at ______________________________, California,
1.2 entered into by ______________________________,
1.3 regarding property referred to as ______________________________.

2. Estimated resale value of the real estate............$__________
3. Balances on senior trust deeds at the time of resale
3.1 Underlying first trust deed............$__________
3.2 Underlying second trust deed............$__________
4. Cash advances from the time of default through closing of a resale
4.1 Taxes............$__________
4.2 Insurance............$__________
4.3 Improvement bond assessments............$__________
4.4 Common interest development (CID) assessments (condos)............$__________
4.5 Payments on underlying trust deeds (number of months _____)............$__________
5. Foreclosure costs and fees to recover a property
5.1 Trustee's guarantee policy............$__________
5.2 Recording notices............$__________
5.3 Publishing notices............$__________
5.4 Postage............$__________
5.5 Trustee's fees............$__________
5.6 Miscellaneous charges............$__________
6. Resale costs after foreclosure and recovery of the property
6.1 Repairs and fixer-up costs............$__________
6.2 Title insurance premiums............$__________
6.3 Escrow fees and charges............$__________
6.4 Broker fees and charges............$__________
7. Estimated loans, advances, costs and charges to foreclose and resell (3, 4, 5 and 6): ....(-)$__________
8. Estimated net proceeds available to pay off carryback trust deed............$__________

I have diligently prepared this estimate
Date: ____________, 20 ______
Seller's Broker: ______________________
CalBRE #: ______________________

By: ______________________

I have read and received a copy of this estimate.
Date: ____________, 20 ______
Seller's Name: ______________________

Seller's Signature: ______________________

Seller's Signature: ______________________

FORM 303 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

In addition, when the seller carries back a note executed by the buyer as part of the sales price for property containing four-or-fewer residential units, a **financial disclosure statement** is to be prepared. This statement is prepared by the broker who represents the person who first offers or counteroffers on terms calling for a carryback note.[1] [See **RPI** Form 300]

1 Calif. Civil Code §2956

Carryback risks for the seller

A carryback seller assumes the **role of a lender** at the close of the sales escrow. This includes all the risks and obligations of a lender holding a secured position in real estate – a mortgage. The secured property described in the trust deed serves as collateral, the seller's sole source of recovery to mitigate the **risk of loss** on a default by the buyer on the note or trust deed.

Another implicit risk of loss for secured creditors arises when the property's value declines due to deflationary future market conditions or the buyer committing **waste**. The risk of waste, also called impairment of the security, is often overlooked during boom times.

However, a decline in property value during recessionary periods due to the buyer's lack of funds poses serious consequences for the seller when the buyer defaults on the payment of taxes, assessments, insurance premiums or maintenance of the property.

nonrecourse
A debt secured by real estate, the creditor's source of recovery on default limited solely to the value of their security interest in the secured property.

Also, the seller needs to understand a carryback note secured solely by a trust deed lien on the property sold is **nonrecourse paper.** Thus, the seller will be barred from obtaining a money judgment against the buyer for any part of the carryback debt not satisfied by the value of the property at the time of foreclosure – the unpaid and uncollectible deficiency.[2]

However, as with any mortgage lender, if the **risk premium** built into the price, down payment, interest rate and due date on the carryback note is sufficient, the benefits of carryback financing level out or outweigh the risks of loss. [See **RPI** Form 303]

2 Calif. Code of Civil Procedure §580b

Chapter 57 Summary

Seller financing, also known as carryback financing, occurs when the seller carries back a note for the unpaid portion of the price remaining after deducting the down payment and the amount of the mortgage the buyer is assuming.

Carryback financing offers considerable financial and tax advantages for both buyers and sellers when properly structured. A carryback seller is able to defer a meaningful amount of profit taxes, spreading the payment over a period of years. Further, a seller who offers a convenient and flexible financing package makes their property more marketable.

For buyers, seller carryback financing generally offers a moderate down payment, competitive interest rates, less stringent terms for qualification than those imposed by lenders and no origination costs.

A carryback seller takes on the role of a lender in a carryback sale, with all the risks and obligations of a lender holding the seller's secured

position on title. As with any creditor, if the risk premium built into the rate and terms of the carryback note is sufficient, the benefits of carryback financing outweigh the risks of loss.

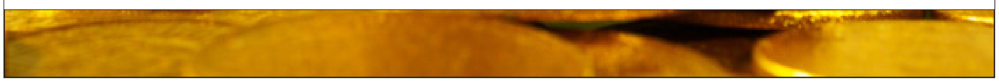
Chapter 57 Key Terms

nonrecourse .... **pg. 387**
portfolio category income .... **pg. 385**
seller financing .... **pg. 384**

Quiz 11 Covering Chapters 55-61 is located on page 616.

Chapter 58

Usury and the private lender



Learning Objectives

After reading this chapter, you will be able to:

- determine which lending arrangements are subject to or exempt from usury restrictions on interest rates;
- identify extensions of credit on property sales as excluded from usury restrictions;
- discern when the usury threshold rate applies; and
- explain the penalties imposed on a non-exempt private lender on violations of usury law.

Key Terms

exempt debt	**treble damages**
excluded debt	**usury**

For a further study of this discussion, see Chapter 43 of Real Estate Finance.

Broker arranged mortgages avoid usury

When a mortgage is made, the lender charges the borrower **interest** for use of the money during the period lent.

However, the amount of interest a private, non-exempt lender can charge is regulated by statute and the California Constitution. Collectively, these are referred to as **usury laws**.[1]

Today, the remaining goal of *usury laws* is the prevention of **loan-sharking** by private lenders. Loan-sharking involves charging interest at a higher rate than the ceiling-rate established by the usury laws. These mortgages are categorized as *usurious*.[2]

usury
A limit on the lender's interest rate yield on nonexempt real estate mortgages.

1 Calif. Constitution, Article XV; Calif. Civil Code §§1916-1 through 1916-5

2 CC §1916-3(b)

Usury exemptions spur competition

Adopted in 1918 as a consumer protection referendum, the first California usury laws set the maximum interest rate at 12% for *all lenders* — no exceptions.

During the *Great Depression*, California legislation exempted certain types of lenders from usury restrictions. The exemptions were implemented with the intent to open up the mortgage market.[1]

These exemptions to usury laws remain in place today and more have been added. For example, in 1979, mortgages made or arranged in California by real estate *brokers* were exempted from usury restrictions.

Other types of lenders exempted from usury law restrictions include:

- savings and loan associations (S&Ls);
- state and national banks;
- industrial mortgage companies;
- credit unions and pawnbrokers;
- agricultural cooperatives;
- corporate insurance companies; and
- personal property brokers.[2]

Exemptions successfully opened the market by increasing the availability of funds. In turn, interest rates were soon driven lower due to increased competition.

Interest paid with goods and services

When a borrower pays interest on a mortgage, they are paying rent to the lender for use of its money for a period of time. The money lent is fully repaid during or at the end of the period.

Normally, the amount of interest charged is a fixed or adjustable percentage of the amount of money loaned.

Though interest is commonly paid with money, interest may also be paid by the borrower by providing the lender with personal property, goods or services. The many **types of consideration** given by the borrower for the lender making a mortgage become part of the lender's yield on the mortgage—*interest*.[3]

Thus, interest includes the value of all compensation a lender receives for lending money, whatever its form, excluding reimbursement or payment for mortgage origination costs incurred and services rendered by the lender.[4]

Setting the interest rate

If the use of the proceeds of a mortgage is earmarked primarily for **personal, family, or household use** by the borrower, the maximum annual interest rate is 10% per annum.[5]

1 Cal. Const. Art. XV
2 Cal. Const. Art. XV
3 CC §1916-2
4 CC §1915
5 Calif. Const. Art. XV §1(1)

Mortgages made to fund the improvement, construction, or purchase of real estate when originated by a non-exempt private lender are subject to a different usury threshold rate, which is the greater of:

- 10% per annum; or
- the applicable discount rate of the *Federal Reserve Bank of San Francisco (FRBSF)*, plus 5%.

Usury law and real estate mortgages

Two basic classifications of private mortgage transactions exist relating to interest rates private lenders may charge on real estate mortgages:

- **brokered** real estate mortgages; and
- **restricted** or **non-brokered** real estate mortgages.

Brokered real estate mortgages are exempt from usury restrictions and fall into one of two categories:

- mortgages **made** by a licensed real estate broker **acting as a principal** for their own account as the private lender who funds the mortgage; or
- mortgages **arranged** with private lenders by a licensed real estate broker acting **as an agent** in the mortgage transaction for compensation.

restricted real estate loans
All mortgages made by private party lenders which are neither made nor arranged by a real estate broker.

Restricted real estate mortgages are all mortgages made by private party lenders which are neither made nor arranged by a broker.

Editor's note — Private lenders include corporations, limited liability companies, partnerships and individuals. These entities are not exempt from usury limitations unless operating under an exempt classification, such as a personal property broker or real estate broker.

The most common *restricted mortgage* involves private party lenders, unlicensed and unassisted by brokers, who make secured or unsecured mortgages.

exempt debt
Private party transactions exempt from usury laws involving the origination of a mortgage secured by real estate and made or arranged by a real estate broker.

Exceptions for private parties

Private party transactions involving the creation of a *debt* which avoid usury laws break down into two categories:

- **exempt debts**, being *debts* which involve a mortgage or a forbearance on a mortgage and are broker-made or arranged; and
- **excluded debts,** being *debts* which do not involve a mortgage.

excluded debt
Extensions of credit by sellers of real estate creating a debt obligation in sales transactions which avoid usury laws.

The most familiar of the excluded "non-mortgage" type debts is **seller carryback financing**. [See Chapter 57]

Carryback notes executed by the buyer in favor of the seller are not loans of money. They are *credit sales*, also called **installment sales**. A seller may carry back a note at an interest rate in excess of the usury threshold rate. The rate exceeding the usury law threshold is enforceable since the debt is not a mortgage. Thus, carryback notes are not subject to usury laws.

Penalties for usury

The most common penalty imposed on a non-exempt private lender in violation of usury law is the forfeiture of **all interest on** the mortgage. Thus, the lender is only entitled to a return of the principal advanced on the mortgage. All payments made by the borrower are applied entirely to principal reduction, with nothing applied to interest.[1]

treble damages
A usury penalty computed at three times the total interest paid by the borrower during the one year period immediately preceding their filing of an action on a non-exempt private lender mortgage.

The lender may also have to pay a usury penalty of **treble damages**.[2]

Treble damages are computed at three times the **total interest paid** by the borrower during the one year period immediately preceding their filing of a suit and during the period of litigation until the judgment is awarded.

An award of treble damages is typically reserved for a lender the court believes took *grossly unfair advantage* of an unwary borrower.[3]

A borrower who knew at all times a loan interest rate was usurious is not likely to be awarded treble damages. Also, a lender who sets a usurious rate in complete ignorance of the illegality of usury would not be additionally penalized with treble damages.

1 **Bayne** v. **Jolley** (1964) 227 CA2d 630
2 CC §1916-3
3 **White** v. **Seitzman** (1964) 230 CA2d 756

Chapter 58 Summary

The amount of interest a private, non-exempt lender can charge a borrower is regulated by the California Constitution and statutes, collectively called usury laws.

Mortgages made or arranged by a California real estate broker are exempt from usury restrictions. Further, sales transactions involving the extension of credit by a seller are not subject to usury laws.

Non-exempt mortgages made to fund the improvement, construction, or purchase of real estate are subject to an interest restriction of 10% annually or the current discount rate of the Federal Reserve Bank of San Francisco plus 5%, whichever is greater.

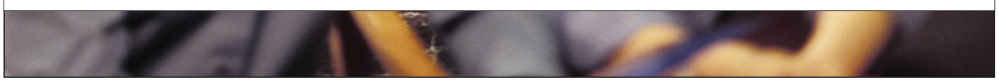
Penalties for violating usury law include the forfeiture of all interest on a usurious mortgage. Lenders who are found to have taken grossly unfair advantage can also be penalized with treble damages.

Chapter 58 Key Terms

Quiz 11 Covering Chapters 55-61 is located on page 616.

Chapter 59

A lender's oral promises as commitments



Learning Objectives

After reading this chapter, you will be able to:

- identify the unenforceability of a lender's oral or unsigned mortgage commitment; and
- better your buyer's chance of closing with the best rates and terms possible by submitting mortgage applications to at least two lenders.

Key Terms

mortgage commitment

For a further study of this discussion, see Chapter 39 of Real Estate Finance.

No responsibility for oral or conditional promises

Consider an owner planning to make improvements to their industrial property. The owner applies for a mortgage to upgrade the facilities, add equipment and construct additional improvements. The owner has a long-standing business relationship with a lender, having borrowed from it in the past.

The mortgage officer processing the mortgage **orally assures** the owner it will provide permanent long-term financing to refinance the short-term financing the owner will use to fund the improvements. Nothing is put to writing or signed. Relying on the lender's oral assurances, the owner enters into a series of short-term mortgages and credit sales arrangements to acquire equipment and improvements.

The mortgage officer visits the owner's facilities while improvements are being installed and constructed. The lender orally assures the owner they will provide long-term financing again.

On completion of the improvements, the owner makes a demand on the lender to fund the permanent financing. However, the lender refuses. The owner is informed the lender no longer considers the owner's business to have sufficient value as security to justify the financing.

The owner is unable to obtain permanent financing with another lender. Without amortized long-term financing, the business fails for lack of capital. The business and property are eventually lost through foreclosure to the holders of the short-term financing. The owner seeks to recover money losses from the lender, claiming the lender breached its commitment to provide financing.

Can the owner recover for the loss of their business and property from the lender?

mortgage commitment
A lender's commitment to make a mortgage, enforceable only when written, unconditional and signed by the lender for consideration.

No! The lender never entered into an enforceable **mortgage commitment.** Nothing was placed in writing or signed by the lender which unconditionally committed the lender to specific terms of a mortgage.

Even though the lender orally assured the owner multiple times a mortgage will be funded, and despite the owner's reliance on their pre-existing business relationship with the lender, the owner cannot rely on the lender's oral commitment.[1]

The only other course of action the buyer may take is to purchase a *written mortgage commitment*, paying for the assurance funds will be provided on request.

However, these commitments are always conditional, never absolute. The lender is allowed to deny a mortgage even after delivering a written mortgage commitment in exchange for a commitment fee without liability if they refuse to fund.

Escape from an oral commitment

Once a lender signs a written agreement, it is bound to follow it. The preceding scenario is an example of the reason lenders rarely enter into signed written promises regarding a mortgage application. When they do, they need to do nothing more than the limited federally mandated nonbinding disclosures on single family residence (SFR) mortgages under **Regulation Z (Reg Z)**, also known as the **Truth-in-Lending Act (TILA).** [See Chapter 54]

Lenders customarily process applications and prepare mortgage documents. However, these documents are at all points only signed by the buyer. The lender orally advises the buyer whether the mortgage has been approved, but signs nothing that binds it.

The first and only act committing the lender is its actual *funding of the mortgage* — at the time of closing.

Thus, the lender-borrower relationship is one of power, not one of an open market arrangement. Lending is an **asymmetrical power relationship**.

1 **Kruse** v. **Bank of America** (1988) 202 CA3d 38

Until the lender delivers funds and a closing has occurred, the lender can back out of its oral or unsigned written commitment at any time without liability.

When a lender breaches its oral commitment to lend, the buyer's reliance on anything less than an **unconditional written mortgage commitment** is not legally justified — even though the buyer had no realistic choice other than to rely on the lender's oral promises.

Agents provide protection for their buyers

In order to prepare a buyer for the mortgage application process, agents need to advise their buyer of the likely scenarios they will encounter. Thus, the informed buyer is best able to anticipate and defend themselves when confronted with unscrupulous eleventh-hour changes.

Always advise buyers seeking a purchase-assist mortgage to "double app"; that is, submit mortgage applications to a minimum of two lenders as recommended by the U.S. Department of Housing and Urban Development (HUD) and the Department of Real Estate (DRE). [See **RPI** Form 312]

Multiple competitive applications keep lenders vying for your buyer's business up to the very last minute – the ultimate moment of funding, when commitments truly are commitments. [See Chapter 54]

Chapter 59 Summary

A lender's oral or unsigned mortgage commitment is unenforceable by a buyer. A mortgage commitment is only enforceable when it is placed in writing and signed by the lender, unconditionally committing the lender to the specific terms of a mortgage for consideration.

Lenders customarily process applications and prepare mortgage documents. However, these documents are signed only by the buyer. The first and only act committing the lender is its actual funding of the mortgage which occurs at the time of closing. Thus, until the lender delivers funds and a closing has occurred, the lender can back out of its oral commitment at any time without liability.

To better your buyer's chance of closing with the best rate and terms possible, counsel them to submit applications for a mortgage to at least two institutional lenders. A second application with another institution gives the buyer additional leverage in mortgage negotiations needed at closing.

Chapter 59 Key Terms

mortgage commitment .... pg. 394

Quiz 11 Covering Chapters 55-61 is located on page 616.

Notes:

Private mortgage insurance

Chapter 60

Learning Objectives

After reading this chapter, you will be able to:

- advise your buyers who have a down payment less than 20% about the availability of private mortgage insurance (PMI) on conventional mortgages with loan-to-value ratios (LTVs) exceeding 80%; and
- review the qualification and approval process for obtaining PMI with buyers.

Key Terms

lender-paid mortgage insurance (LPMI)

loan-to-value ratio (LTV)

private mortgage insurance (PMI)

For a further study of this discussion, see Chapter 42 of Real Estate Finance.

Protecting the lender from loss

Private mortgage insurance (PMI) indemnifies a lender against losses on a mortgage when a borrower defaults.[1]

private mortgage insurance (PMI)
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios higher than 80%.

The lender's recoverable losses include:

- principal on the debt;
- any deficiency in the value of the secured property; and
- foreclosure costs.

PMI insurers are unrelated to government-created insurance agencies, such as the Federal Housing Administration (FHA) and the Veterans Administration (VA), which also insure or guarantee mortgages made to qualified borrowers. [See Chapter 56]

1 Calif. Insurance Code §12640.02

PMI is not **mortgage life insurance,** which pays off the insured mortgage in the event a borrower dies, becomes disabled, or loses their health or income.

Private mortgage insurance coverage

PMI insures the lender for losses incurred up to a percentage of the mortgage amount. In turn, the mortgage amount represents a percentage of the property's value, called the **loan-to-value ratio (LTV).**

Typically, mortgages insured by PMI are covered for losses on amounts exceeding 67% of the property's value at the time the mortgage is originated.

Who pays for PMI?

loan-to-value ratio (LTV)
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value. The degree of leverage.

lender-paid mortgage insurance (LPMI)
Default mortgage insurance provided by private insurers in which the lender pays the mortgage insurance premium and recovers the cost through a higher interest rate.

The buyer usually pays the PMI premiums, not the lender (although the lender is the insured and holder of the policy).

However, some lenders and PMI insurers offer a **lender-paid mortgage insurance (LPMI)** program. If issued by the PMI insurer, the lender pays the mortgage insurance premium and charges the borrower a higher interest rate on their principal payments.

Premium rates are set as a percentage of the mortgage balance and are calculated in the same manner as interest.

If the buyer is current on PMI payments and has not taken out other mortgages on their property, the buyer may terminate their PMI coverage when the equity in their property reaches 20% of its value at the time the mortgage was originated. Once the buyer reaches 22% equity, PMI is automatically cancelled (unless the mortgage is a piggyback 80-10-10).

Furthermore, the buyer may cancel PMI two years after the mortgage is recorded if the LTV for the mortgage balance is 75%. The lender may agree to a higher LTV for cancellation.

When PMI may be cancelled as agreed, the lender may not charge advance PMI payments unless the borrower has:

- incurred more than one late penalty in the past 12 months; or
- been more than 30 days late on one or more payments on the note.[1]

Premiums charged by PMI insurers do not include an up-front fee on origination like FHA, only an *annual fee* calculated as a percentage of the mortgage balance and payable monthly with principal and interest payments.

Buyer and property standards

Depending on the policies of the insurer, the buyer needs to meet PMI qualification standards such as:

- a minimum credit score of upwards of 680;
- a debt-to-income ratio between 41% and 45%;

1 Calif. Civil Code §2954.12(a)(3)

- two months principal, interest, taxes and insurance (PITI) payments in cash reserves;
- employment full time during the past two years, a current pay stub, written *verification by employer* (VOE form), and telephone confirmation of employment at closing, unless self-employed;
- if self-employed, financial statements for the two prior years and year-to-date, plus IRS tax returns;
- all documents and title vestings to be in the name of the buyer as an individual;
- limit to three mortgages under PMI coverage in the name of the buyer;
- completion of a homeowners' course of education on mortgage debt obligations;
- no bankruptcy within four years, unless excused by extenuating circumstances; and
- no prior foreclosure under a mortgage.

The PMI investigation and documentation takes place after submission of a mortgage application. It is generally limited to verification of all the buyer's representations on the application. The availability of PMI coverage for different types of California real estate is limited. Only properties classified as *single family residences (SFRs)* may receive PMI.

Defaulting borrower and PMI recourse

Most PMI contracts do not authorize the insurer to seek **indemnity** from the borrower for claims made on the policy by the lender. This is distinct from FHA or VA insurance programs which place homeowners at a risk of loss for a greater amount than their down payment.

Most insured mortgages are *purchase-money mortgages* made to buyer-occupants to acquire their principal residence. Purchase money mortgages are **nonrecourse obligations**, with recovery on the mortgage limited to the value of the real estate.[2]

However, if the mortgage is recourse, as is the case of a refinance, the lender's right to seek a deficiency judgment may be assigned to the PMI insurer. Pursuing a *money judgment* to collect from the borrower for a deficiency in the value of the property requires a judicial foreclosure action. [See Chapter 70]

In the case of fraud on recourse or nonrecourse mortgages, the PMI insurer is not barred by anti-deficiency statutes from recovering losses. Thus, they may enforce collection of their losses against the borrower for misrepresentations, such as the property's value, job status, etc.

The PMI credit check

To qualify for PMI, the buyer needs to be a natural person and take title as the vested owner of the property.

2 Calif. Code of Civil Procedure §580b

The lender, when qualifying the buyer for a mortgage to be covered by PMI, relies on the more restrictive PMI insurer's requirements regarding the buyer's:

- liquid assets after closing;
- debt-to-asset ratio;
- debt-to-income ratio; and
- regard for financial obligations.

A buyer required to qualify for PMI before a lender funds a mortgage undergoes an in-depth risk analysis based on the PMI insurer's eligibility requirements.

At a minimum, the buyer is required to submit documents for review by the PMI insurer, including:

- a copy of the mortgage application;
- a credit report current within 90 days and covering a minimum of two years; and
- an appraisal of the real estate to be purchased.

However, the PMI carrier may also require additional documentation to verify the mortgage transaction fulfills the insurer's underwriting requirements, such as verification the buyer will occupy the property and a copy of the signed purchase agreement.

The buyer's credit rating and disposable income need to clearly support their ability to make the monthly payments on the low down payment mortgage.

Chapter 60 Summary

Private mortgage insurance (PMI) indemnifies a lender for loss on a mortgage secured by an interest in real estate when a borrower whose down payment is less than 20% defaults.

If the buyer is current on PMI payments and has taken out no other mortgages on their property, the buyer may terminate their PMI coverage when the equity in their property reaches 20% of its value at the time the mortgage was originated. Once the buyer reaches 22% equity, PMI is automatically cancelled.

The lender making a conventional mortgage to fund the purchase of a principal residence when the mortgage will exceed 80% of the property value requires the buyer to meet the qualifications for PMI coverage, not just the lender's qualifications.

Chapter 60 Key Terms

lender-paid mortgage insurance (LPMI)................................ pg. 398
loan-to-value ratio (LTV).. pg. 398
private mortgage insurance (PMI).. pg. 397

Quiz 11 Covering Chapters 55-61 is located on page 616.

Chapter 61

The promissory note

Learning Objectives

After reading this chapter, you will be able to:

- understand a signed promissory note is evidence of the existence of an underlying debt, not the debt itself;
- recognize the linkage between a promissory note and a trust deed; and
- identify the different types of promissory notes and debt repayment arrangements they are used to evidence.

Key Terms

adjustable rate mortgage (ARM)
all-inclusive trust deed (AITD)
applicable federal rate (AFR)
balloon payment
graduated payment mortgage (GPM)
installment note
promissory note
reconveyance
straight note
usury

For a further discussion of this topic, see Chapter 5 of Real Estate Finance.

Evidence of the debt

Most real estate sales hinge on financing some portion of the purchase price. A buyer promises to pay a sum of money, in installments or a single payment at a future time, to a lender who funds the sales transaction. Alternately, the buyer may make payments to the seller under a *carryback financing arrangement*.

Given in exchange for property or a loan of money, the *promise to pay* evidences a debt owed by the buyer and payable to the seller or lender to whom the promise is made.

promissory note
A document given as evidence of a debt owed by one person to another. [See **RPI** Form 421 and 424]

The promise to pay is set out in a written document called a **promissory note**. A *promissory note* represents an underlying debt owed by one person to another.

The signed promissory note is not the debt itself, but evidence the debt exists.

The buyer, called the **debtor** or **payor**, signs the note and delivers it to the lender or carryback seller, called the **creditor**.

The note can be either *secured* or *unsecured*. If the note is secured by real estate, the security device used is a **trust deed**. When secured, the debt becomes a voluntary lien on the real estate described in the *trust deed*.

The promissory note

installment note
A note calling for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a final balloon payment. [See **RPI** Form 420, 421 and 422]

Notes are categorized by the method for repayment of the debt as either:

- **installment notes**; or
- **straight notes**.

The *installment note* is used for debt obligations with constant periodic repayments in any amount and frequency negotiated.

Variations of the installment note include:

- *interest-included*; and
- *interest-extra*.

Finally, notes are further distinguished based on interest rate calculations, such as:

- fixed interest rate notes, commonly called *fixed rate mortgages (FRMs)*; and
- variable interest rate notes, commonly called *adjustable rate mortgages (ARMs)*.

Installment note, interest included

straight note
A note calling for the entire amount of its principal to be paid together with accrued interest in a single lump sum when the principal is due. [See **RPI** Form 423]

An *interest-included installment note* with constant periodic payments produces a schedule of payments. The schedule contains diametrically varying amounts of principal and interest from payment to payment. Principal reduction on the mortgage increases and interest paid decreases with each payment made on the mortgage. [See Form 420 accompanying this chapter]

Each payment is applied first to the interest accrued on the remaining principal balance during the period between payments, typically monthly. The remainder of the payment is applied to reduce the principal balance of the debt for accrual of interest during the following period before the next payment is due.

Interest-included installment notes may either:

- be fully amortized through constant periodic payments, meaning the mortgage is fully paid at the end of the term; or

NOTE SECURED BY DEED OF TRUST
Installment — Interest Included

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

NOTE: This form is used by a loan broker or escrow officer when originating a mortgage with a lender or carryback seller, to evidence the debt owed by the borrower or buyer on terms calling for installment payments of principal and interest.

$____________, dated ____________, 20____, at ______________________________, California.

1. In installments, for value received, I, jointly and severally, promise to pay to
 1.1 ______________________________, as the Payee, or order,
 1.2 at ______________________________,
 1.3 the sum of ______________________________ DOLLARS,
 1.4 with interest from ______________, 20______, on unpaid principal,
 1.5 at the rate of _______% per annum.

2. Principal and interest payable in installments of ______________________ DOLLARS, or more,
 2.1 on the ______________ day of every ☐ month, ☐ quarter, ☐ year,
 2.2 beginning on the ______________ day of ______________, 20______,
 2.3 and continuing until ______________, 20______, when the principal is due and payable.
 2.4 Principal and interest payable in lawful money of the United States.
 2.5 Each payment is to be credited first on interest then due and the remainder on principal.

3. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder

4. ____

5. In any action to enforce this Note, the prevailing party will receive attorney fees.

6. This Note is secured by a DEED OF TRUST.

7. ☐ See attached Signature Page Addendum. [**RPI** Form 251]

Payor's Name: ______________________	Payor's Name: ______________________
Signature ______________________	Signature ______________________
Payor's Name: ______________________	Payor's Name: ______________________
Signature ______________________	Signature ______________________

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Form 420

Note Secured by Deed of Trust

Installment — Interest included

- include a **final/balloon payment** after a period of installment payments, called a **due date**.

balloon payment
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment. [See **RPI** Form 418-3 and 419]

Installment note, interest extra

Interest-extra installment notes call for a constant periodic payment of principal on the debt. In addition to the payment of principal, accrued interest is paid concurrently with the principal installment.

The principal payments remain constant until the principal amount is fully paid or a *due date* calls for a final balloon payment. Accordingly, the interest payment decreases with each payment of principal since the interest is paid on the remaining balance. [See **RPI** Form 422]

Thus, unlike an interest-included note, the amount of each scheduled payment of principal and interest on an interest-extra note is a declining amount from payment to payment.

Straight notes

A *straight note* calls for the entire amount of its principal to be paid in a single lump sum due at the end of a period of time. No periodic payments of principal are scheduled, as with an installment note. [See **RPI** Form 423]

Interest usually accrues unpaid and is due with the lump sum principal installment. Thus, this form of real estate financing is sometimes referred to as a *sleeper trust deed*. Occasionally, the interest accruing is paid periodically during the term of the straight note, such as monthly payments of interest only with the principal all due at the end of a fixed period of time.

The straight note is typically used by bankers for short-term mortgages since a banker's short-term note is not usually secured by real estate. In real estate transactions, the note evidences what is generally called a **bridge loan**, a short term obligation.

Payment variations

adjustable rate mortgage (ARM)
A variable interest rate note, often starting out with an introductory teaser rate, only to reset at a much higher rate in a few months or years based on a particular index. [See **RPI** Form 320-1]

While the installment note and the straight note are common, variations on the interest rate and repayment schedules contained in the installment and straight notes are available to meet the specific needs of the lender and borrower.

The variations include the:

- **adjustable rate mortgage (ARM)**;
- **graduated payment mortgage (GPM)**;
- **all-inclusive trust deed (AITD)**; and
- **shared appreciation mortgage (SAM).**

Adjustable rate mortgage

The *ARM*, as opposed to an FRM, calls for periodic adjustments to the interest rate. Thus, the amount of scheduled payments fluctuates from time to time. The interest rate varies based on movement in an agreed-to index, such as *Cost-of-Funds* index for the 11th District Federal Home Loan Bank.

The ARM provides the lender with periodic increases in its yield on the principal balance during periods of rising and high short-term interest rates.

When an upward interest adjustment occurs, the note's repayment schedule calls for an increase in the monthly payment to maintain the original amortization period. If the amount of the original monthly payment is retained without an increase to reflect an increase in the interest rate, the mortgage term is extended or **negative amortization** occurs.

Graduated payment mortgage

GPM provisions, in which the payment increases gradually from an initial low base level, are in demand when interest rates or home prices rise too quickly and ARM mortgages are disfavored. A graduated payment schedule allows buyers time to adjust their income and expenses in the future. A GPM often has a variable interest rate.

For example, the GPM provision allows low monthly payments on origination. The payments are gradually increased over the first three- to five-year period of the mortgage, until the payment amortizes the mortgage over the desired number of remaining years.

However, any accrued monthly interest remaining unpaid each month is added to the principal balance resulting in *negative amortization*. The negative amortization causes the unpaid interest to bear interest as though it were principal, called **compounding**.

graduated payment mortgage (GPM)
A mortgage providing for installment payments to be periodically increased by predetermined amounts to accelerate the payoff of principal.

All-inclusive trust deed note

The *AITD* variation of a note is used more often in carryback transactions than money lending. AITDs become popular in times of recession, increasing long-term rates and tight credit. The property is subject to one or more trust deed mortgages with lower than current mortgage rates, though the opposite can be the case.

The AITD "wraparound" note typically calls for the buyer to pay the carryback seller constant monthly installments of principal and interest. The carryback seller then pays the installments due on the underlying (senior) trust deed note from the payments received on the AITD note.

Shared appreciation mortgage

The *SAM* repayment schedule variation is designed to help sellers attract buyers during times of tightening mortgage money. Usually, the real estate sales volume is in a general decline, followed in a year by a drop in prices. The SAM is an example of a *split-rate note*. [See Figure 1, **RPI** Form 430]

Under a SAM note, the buyer pays an initial fixed interest rate, called a *"floor"* or *"minimum"* rate. The floor rate charged is typically two-thirds to three-fourths of the prevailing market rate, but not less than the **applicable federal rate (AFR)** for reporting imputed interest.

In return, the carryback seller receives part of the property's appreciated value as additional interest, called **contingent interest**, when the property is sold or the carryback SAM is due.

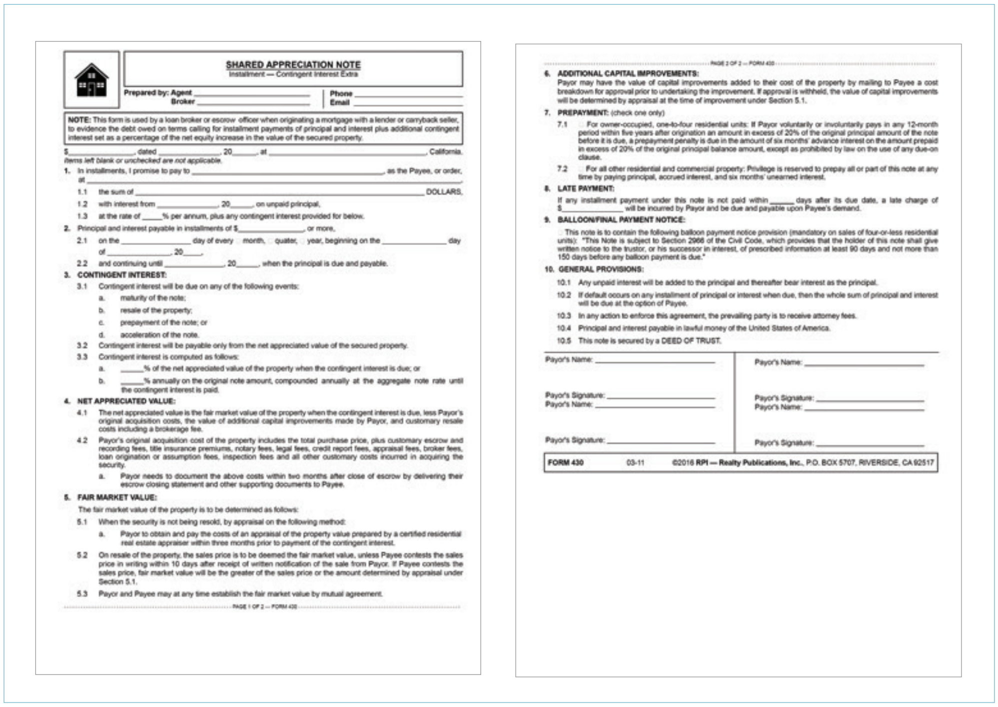
applicable federal rate (AFR)
Rates set by the Internal Revenue Service for carryback sellers to impute and report income at the minimum interest when the note rate on the carryback debt is a lesser rate.

Figure 1

Form 430

Shared Appreciation Note

Installment — Contingent Interest Extra



SHARED APPRECIATION NOTE
Installment — Contingent Interest Extra

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

NOTE: This form is used by a loan broker or escrow officer when originating a mortgage with a lender or carryback seller, to evidence the debt owed on terms calling for installment payments of principal and interest plus additional contingent interest set as a percentage of the net equity increase in the value of the secured property.

$______________, dated ______________, 20____, at ______________, California.
Items left blank or unchecked are not applicable.

1. In installments, I promise to pay to ______________, as the Payee, or order, at ______________.
   1.1 the sum of ______________ DOLLARS,
   1.2 with interest from ______________, 20____, on unpaid principal,
   1.3 at the rate of _____% per annum, plus any contingent interest provided for below.
2. Principal and interest payable in installments of $______________, or more,
   2.1 on the ______________ day of every ☐ month, ☐ quater, ☐ year, beginning on the ______________ day of ______________, 20____,
   2.2 and continuing until ______________, 20____, when the principal is due and payable.
3. **CONTINGENT INTEREST:**
   3.1 Contingent interest will be due on any of the following events:
   a. maturity of the note;
   b. resale of the property;
   c. prepayment of the note; or
   d. acceleration of the note.
   3.2 Contingent interest will be payable only from the net appreciated value of the secured property.
   3.3 Contingent interest is computed as follows:
   a. _____% of the net appreciated value of the property when the contingent interest is due; or
   b. _____% annually on the original note amount, compounded annually at the aggregate note rate until the contingent interest is paid.
4. **NET APPRECIATED VALUE:**
   4.1 The net appreciated value is the fair market value of the property when the contingent interest is due, less Payor's original acquisition costs, the value of additional capital improvements made by Payor, and customary resale costs including a brokerage fee.
   4.2 Payor's original acquisition cost of the property includes the total purchase price, plus customary escrow and recording fees, title insurance premiums, notary fees, legal fees, credit report fees, appraisal fees, broker fees, loan origination or assumption fees, inspection fees and all other customary costs incurred in acquiring the security.
   a. Payor needs to document the above costs within two months after close of escrow by delivering their escrow closing statement and other supporting documents to Payee.
5. **FAIR MARKET VALUE:**
   The fair market value of the property is to be determined as follows:
   5.1 When the security is not being resold, by appraisal on the following method:
   a. Payor to obtain and pay the costs of an appraisal of the property value prepared by a certified residential real estate appraiser within three months prior to payment of the contingent interest.
   5.2 On resale of the property, the sales price is to be deemed the fair market value, unless Payee contests the sales price in writing within 10 days after receipt of written notification of the sale from Payor. If Payee contests the sales price, fair market value will be the greater of the sales price or the amount determined by appraisal under Section 5.1.
   5.3 Payor and Payee may at any time establish the fair market value by mutual agreement.

PAGE 1 OF 2 — FORM 430

PAGE 2 OF 2 — FORM 430

6. **ADDITIONAL CAPITAL IMPROVEMENTS:**
   Payor may have the value of capital improvements added to their cost of the property by mailing to Payee a cost breakdown for approval prior to undertaking the improvement. If approval is withheld, the value of capital improvements will be determined by appraisal at the time of improvement under Section 5.1.
7. **PREPAYMENT:** (check one only)
   7.1 ☐ For owner-occupied, one-to-four residential units: If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.
   7.2 ☐ For all other residential and commercial property: Privilege is reserved to prepay all or part of this note at any time by paying principal, accrued interest, and six months' unearned interest.
8. **LATE PAYMENT:**
   If any installment payment under this note is not paid within _____ days after its due date, a late charge of $______________ will be incurred by Payor and be due and payable upon Payee's demand.
9. **BALLOON/FINAL PAYMENT NOTICE:**
   ☐ This note is to contain the following balloon payment notice provision (mandatory on sales of four-or-less residential units): "This Note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 days and not more than 150 days before any balloon payment is due."
10. **GENERAL PROVISIONS:**
    10.1 Any unpaid interest will be added to the principal and thereafter bear interest as the principal.
    10.2 If default occurs on any installment of principal or interest when due, then the whole sum of principal and interest will be due at the option of Payee.
    10.3 In any action to enforce this agreement, the prevailing party is to receive attorney fees.
    10.4 Principal and interest payable in lawful money of the United States of America.
    10.5 This note is secured by a DEED OF TRUST.

Payor's Name: ______________	Payor's Name: ______________
Payor's Signature: ______________	Payor's Signature: ______________
Payor's Name: ______________	Payor's Name: ______________
Payor's Signature: ______________	Payor's Signature: ______________

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Financial aspects

all-inclusive trust deed (AITD)
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

A note documents the terms for repayment of a mortgage or the unpaid portion of the sales price carried back after a down payment, including:

- the amount of the debt;
- the interest rate;
- the periodic payment schedule; and
- any due date.

The dollar amount of the note carried back by a seller on an installment sale as evidence of the portion of the price remaining to be paid is directly influenced by whether the carryback is:

- an *AITD* note; or
- a regular note.

The face amount of an AITD note carried back by a seller will always be greater than had a regular note been negotiated in any given sales transaction. The AITD note is for the difference remaining after deducting the down payment from the purchase price. Thus, the AITD note includes the principal amount of the wrapped mortgages. However, a regular note is only for the amount of the seller's equity remaining after deducting from the purchase price the down payment and the principal balance due on the existing trust deed notes taken over by the buyer.

Interest rate limitations on mortgages

California's **usury law** limits the interest rate on non-exempt real estate mortgages to the greater of:

- 10%; or
- the discount rate charged by the Federal Reserve Bank of San Francisco, plus 5%.[1] [See Chapter 58]

The trust deed

In most carryback transactions, the buyer gives the seller a trust deed lien on the real estate sold as security for payment of the portion of the price left to be paid.

The trust deed is recorded to give notice and establish priority of the seller's security interest in the property.[2]

usury
A limit on the lender's interest rate yield on nonexempt real estate loans.

A trust deed alone, without a monetary obligation for it to attach to the described property, is a worthless trust deed for there is nothing to be secured. Although the note and trust deed executed by a buyer in favor of the seller are separate documents, a trust deed is only effective as a lien when it provides security for an existing promise to pay or perform any lawful act that has a monetary value.[3]

Even though they are separate documents, the note and trust deed are for the same transaction and are considered one contract to be read together.[4]

Satisfaction of the debt

The promissory note, once signed by the borrower and delivered to the lender, represents the *existence of a debt*.[5]

When a secured debt has been fully paid, the trust deed securing the debt is removed from title to the secured property, a process called **reconveyance**.[6]

reconveyance
A document executed by a trustee named in a trust deed to release the trust deed lien from title to real estate, used when the secured debt is fully paid. [See **RPI** Form 472]

1 Calif. Constitution, Article XV
2 **Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454
3 **Domarad** v. **Fisher & Burke, Inc.** (1969) 270 CA2d 543
4 Calif. Civil Code §1642
5 Calif. Code of Civil Procedure §1933
6 CC §2941

Chapter 61 Summary

A promissory note is a document given as evidence of a debt owed by one person to another. To be enforceable, the promissory note needs to be signed by the payor and delivered to the lender or carryback seller on closing the sale.

A note may be secured or unsecured. If the note is secured by real estate, the security device used is a trust deed, commonly called a mortgage. When secured, the debt evidenced by the note becomes a voluntary lien on the real estate described in the trust deed that references the note. Even though they are separate documents, the note and trust deed are for the same transaction and are considered one contract to be read together.

Notes are categorized by the method for repayment of the debt as either installment notes or straight notes. The installment note is used for debts paid periodically in negotiated amounts and at negotiated frequencies. A straight note calls for the entire amount of its principal to be paid together with accrued interest in a single lump sum when the principal is due.

An interest-included installment note produces a schedule of constant periodic payments which amortize the mortgage principal. Interest-extra installment notes call for a constant periodic payment of principal on the debt. In addition to the payment of principal, accrued interest is paid separately, typically concurrent with payment of the principal installment.

Variations exist on the interest rate and repayment schedules contained in installment and straight notes.

When a debt secured by a trust deed lien on real estate has been fully paid, the lien is removed from title, a process called reconveyance.

Chapter 61 Key Terms

adjustable rate mortgage (ARM) .... **pg. 404**
all-inclusive trust deed (AITD) .... **pg. 406**
applicable federal rate (AFR) .... **pg. 405**
balloon payment .... **pg. 403**
graduated payment mortgage (GPM) .... **pg. 405**
installment note .... **pg. 402**
promissory note .... **pg. 402**
reconveyance .... **pg. 407**
straight note .... **pg. 402**
usury .... **pg. 407**

Quiz 11 Covering Chapters 55-61 is located on page 616.

Chapter 62

Late charges and grace periods

Learning Objectives

After reading this chapter, you will be able to:

- determine the provisions and conduct needed for a lender or carryback seller to establish their right to collect a late charge;
- differentiate late charge arrangements based on the type of property securing repayment, and whether the loan was arranged by a broker; and
- understand how late charges are enforced and calculated.

Key Terms

balloon payment	**grace period**
brokered loan	**late charge**

For a further discussion of this topic, see Chapter 12 of Real Estate Finance.

Elements of a late charge

Promissory notes contain a **late charge** provision. The *late charge* provision imposes an additional charge if payment is not received by the lender when due or within a *grace period*.

To establish the right to enforce collection of a late charge, the following conditions need to be met by the lender or carryback seller:

- a *late charge provision* exists in the note [See Form 418-1 accompanying this chapter];
- a scheduled payment is *delinquent*;
- a *notice of amounts due* is delivered by the lender or carryback seller assessing the late charge and demanding its payment;

late charge
A fee imposed as an additional charge under a provision in a promissory note, lease or rental agreement when payments are not received by their due date or during a grace period.

Form 418-1

Late Payment Provisions

LATE PAYMENT PROVISIONS
Addendum to Promissory Note

NOTE: This form is used by a loan broker or escrow officer when originating a mortgage with a lender or carryback seller, to include a late payment provision in the promissory note.

DATE: ______________, 20_______, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated ________________, 20_______, at ____________________________, California,

1.2 entered into by ____, as the Payor,

1.3 in favor of ____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as ____
____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For an owner-occupied, single family residence:*
☐ Any installment on this note not received within 10 days after the due date is delinquent and will incur a late charge, on demand, in the sum of 6% of the delinquent principal and interest installment amount.

2.2 *For a broker-made/-arranged loan on any property* [Calif. Business and Professions Code §10242.5(a)]:
☐ Any installment on this note not received within 10 days of the due date is delinquent and will incur a late charge, on demand, in the sum of 10% of the delinquent principal and interest installment amount.

2.3 *On other than owner-occupied, single family residences or broker-made/-arranged loans:*
☐ If any installment on this note is not received when due, or within ______ days of the due date, the installment will be delinquent and will incur a late charge, on demand, in the sum of ☐ $________________, or ☐ _____% of the delinquent principal and interest installment amount.

2.4 *For a broker-made/-arranged loan on any property, final/balloon payment late charge* [Calif. Business and Professions Code §10242.5(c)]:
☐ If the final/balloon payment due on this note is not received within 10 days after the due date, the final/balloon payment will be delinquent and will incur a late charge on the delinquency and thereafter, on demand, for each month the final/balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.

2.5 *For a balloon payment late charge on other than owner-occupied, single family residences or broker-made/-arranged loans:*
☐ If the final/balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue at the rate of ________%.

2.6 *For compounding interest on a default on other than one-to-four residential units:*
☐ On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are received.

Payor's name: ______________________	Payor's name: ______________________
Signature: ______________________	Signature: ______________________
Payor's name: ______________________	Payor's name: ______________________
Signature: ______________________	Signature: ______________________

FORM 418-1 03-11

grace period
The time period following the due date for a payment during which payment received by the lender or landlord is not delinquent and a late charge is not due. [See **RPI** Form 550 §4.3 and 552 §4.7]

- the *dollar amount* of the late charge is within the limits set by applicable statutes and **reasonableness standards**; and
- *accounting requirements* for semi-annual and annual reports have been complied with.

The failure of an owner to pay a late charge is a **non-material breach** of the note and trust deed. As a *non-material breach*, the failure to pay late charges cannot be the sole monetary basis for initiating a foreclosure by recording a *notice of default (NOD)*.

Distinctions exist in the treatment of late charges permitted for private lender loans as compared to charges permitted for seller carryback paper.

For private lenders, late charges on loans secured by single family residences (SFRs) are treated differently than when they are secured by other types of property. Also, the amount of the late charge a private lender may impose is further controlled by whether or not the loan was made or arranged by a broker.

The negotiation of late charge provisions

Late charge provisions included in notes used by institutional lenders are generally non-negotiable. This non-negotiable status is due primarily to lender adherence to established uniformities, such as ceilings set by statute or pooling arrangements in the secondary mortgage money market.

However, the inclusion of late charge provisions in notes carried back by sellers or originated by **private lenders** are not automatic as boilerplate language but are left to negotiations.

Before a late charge provision is included in a note, the charge needs to be *agreed to*. When a late charge is referenced in a carryback note provision agreed to in a purchase agreement, escrow is instructed to include the applicable late charge provision in the note prepared for signatures. [See **RPI** Form 150 §8.1]

The provision and the late charge amount

For a **late charge provision** to be complete, it needs to include:

- the *amount* of the late charge;
- the *duration of any* **grace period** following the due date before a payment received by the lender is delinquent; and
- a *requirement for notice* from the lender to impose the late charge and demand its payment. [See Form 418-1]

Collectable losses

The reasonable amount of monetary losses collectible as a late charge include:

- the actual *out-of-pocket expenses* incurred in a reasonable collection effort; and
- the *lost use* of the principal and interest (PI) portion of the delinquent payment.

Late charge notice

To collect a late charge for the delinquent payment on a note secured by **any type of real estate**, the carryback seller or private lender is to notify the owner of the charge and *make a demand* for its payment.

Private lenders are to give notice and make a demand for the late charge in a *timely manner* by use of either:

- a billing statement or notice sent for each payment prior to its due date stating the late charge amount and the date on which it will be incurred; or
- a written statement or notice of the late charge amount due concurrent with or within ten days after mailing a notice to cure a delinquency.[1]

The notice of amounts due or the billing statement is to include the exact amount of the late charge or the formula used to calculate the charge.[2]

If the private lender fails to initiate collection of the late charge, the lender *waives* its right to collect a late charge on that payment. However, failure to comply with the late charge notice requirements on a delinquency does not waive the private lender's right to enforce the late charge provision on future delinquencies.[3]

In regards to *carryback notes*, if, on receipt of a delinquent payment, the carryback seller fails to make a demand for payment of the late charge, they waive their right to collect a late charge on that installment.[4]

Late charge grace periods on private lender mortgages

Ten days is the **minimum grace period** allowed for a private lender secured by an owner-occupied SRF, even if the homeowner agrees to a shorter grace period, or no grace period is agreed to.[5]

The late charge amount on a private lender loan which is not made or arranged by a broker and is secured by an owner-occupied SFR is limited to the greater of:

- 6% of the delinquent PI installment; or
- $5.[6]

Mailing the installment within the grace period does not qualify the payment as timely paid. The payment needs to be **actually received** by the carryback seller, lender or collection agent no later than the last day of the grace period.[7]

Made or arranged by brokers

When a licensed real estate broker makes or arranges a loan as or for a private lender, the 6% limit for late charges established for loans secured by owner-occupied SFRs does not apply. Further, reasonableness standards do not apply as well. Instead, statutes control.[8]

---

1 CC §2954.5(a)
2 CC §2954.5(a)
3 CC §2954.5(e)
4 Calif. Code of Civil Procedure §2076; CC §1501
5 CC §2954.4(a), (b)
6 CC §2954.4(a), (e)
7 **Cornwell** v. **Bank of America National Trust and Savings Association** (1990) 224 CA3d 995
8 CC §2954.4(e)

For private lender loans **made or arranged by a real estate broker**, called a **brokered loan**, and secured by any type of real estate, the late charge is limited to the greater of:

- 10% of the delinquent principal and interest payment; or
- $5.[9] [See Form 418-1 §2.2]

brokered loan
A private lender loan made or arranged by a real estate broker.

Also, if the private lender loan made or arranged by a broker contains a due date for a **final/balloon payment**, a late charge may be assessed on the final/balloon payment if it is not received within ten days after its due date. [See Form 418-1 §2.4]

balloon payment
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment. [See **RPI** Form 418-3 and 419]

Like an owner-occupied SFR loan, an installment on a private lender loan made or arranged by a broker on any type of property is not late if it is received by the lender within ten days after the installment is due.[10]

One charge per delinquency

For a private lender loan secured by an owner-occupied SFR, or one made or arranged by a broker and secured by any type of property, the private lender cannot charge more than one late charge per delinquent monthly installment, no matter how many months the payment remains delinquent.[11]

Enforcement of the late charge

Refusal or failure of an owner to pay a late charge when demanded does not justify a call of the loan or initiation of foreclosure by itself.[12]

No lender or carryback seller is entitled to foreclose on an owner who has tendered all installments which are due, but has failed to pay outstanding late charges. Collection of late charges when no other monetary breach exists needs to be enforced by means other than foreclosure.

Additionally, a *private lender* making a loan on any type of real estate is required to furnish the owner with a **semi-annual accounting** for the total amount of late charges due and unpaid during the accounting period.[13]

For late charges on a carryback note secured by property improved with only a one-to-four unit residence, the carryback seller needs to also provide the owner with an **annual accounting** statement detailing any late charges due and unpaid during the entire year.[14]

9 Calif. Business and Professions Code 10242.5(a)
10 Bus & P C §10242.5(b)
11 CC §2954.4(a); Bus & P C §10242.5(b)
12 **Baypoint Mortgage Corporation** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818
13 CC §2954.5(b)
14 CC §2954.2(a)

Chapter 62 Summary

To establish the right to enforce collection of a late charge:

- a late charge provision needs to exist in the note;
- a scheduled payment needs to be delinquent;
- a notice of amounts due has been delivered to the owner;
- the dollar amount of the late charge is within the limits set by applicable statues and reasonableness standards; and
- accounting requirements for semi-annual and annual reports have been complied with.

For a late charge provision to be complete, it needs to include:

- the amount of the late charge;
- the duration of any grace period; and
- a requirement for notice from the trust deed holder to impose the late charge and make a demand for its payment.

The late charge amount on a private lender loan which is not made or arranged by a broker and is secured by an owner-occupied SFR is limited to the greater of 6% of the delinquent principal and interest payment or $5.

For private lender loans made or arranged by a real estate broker and secured by any type of real estate, the late charge is limited to the greater of 10% of the delinquent principal and interest payment or $5.

Chapter 62 Key Terms

balloon payment .... **pg. 413**
brokered loan .... **pg. 413**
grace period .... **pg. 410**
late charge .... **pg. 409**

Quiz 12 Covering Chapters 62-67 is located on page 617.

Chapter 63

Prepayment penalties

Learning Objectives

After reading this chapter, you will be able to:

- understand how prepayment penalties were historically used by lenders to prevent the loss of interest;
- determine whether a prepayment penalty is prohibited under the Dodd-Frank Wall Street Reform and Consumer Protection Act; and
- advise on the enforceability of a prepayment penalty provision in a note secured by a trust deed containing a due-on clause.

Key Terms

Dodd-Frank Wall Street Reform and Consumer Protection Act

due-on clause

prepayment penalty

For a further discussion of this topic, see Chapter 10 of Real Estate Finance.

Debt reduction — a costly privilege

Consider an owner of real estate who wants to pay off some or the entire principal on a mortgage *before* it is due by its terms. However, the owner has previously agreed to an additional charge the lender may levy to reduce or pay off the debt, called a **prepayment penalty**.

prepayment penalty
A provision in a note giving a lender the right to levy a charge against a borrower who pays off the outstanding principal balance on a loan prior to expiration of the prepayment provision. [See **RPI** Form 418-2]

The *prepayment penalty* agreement is included in the **promissory note**. It is not a provision in the trust deed, since it relates to the payment of the debt, not the care and maintenance of the real estate.

The unscheduled prepayment of any principal on a debt before it is due is ironically considered a *privilege*, since the borrower wants to deleverage and is now able to pay off their lender. If a prepayment penalty provision is agreed to in the note, a lender can charge the owner on each exercise of the

Form 418-2

Prepayment of Principal Provisions

PREPAYMENT OF PRINCIPAL PROVISIONS
Penalties and Discounts

NOTE: This form is used by a loan broker or escrow officer when originating a mortgage with a lender or carryback seller, to include prepayment provisions in the promissory note.

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

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _________________, 20_______, at ____________________________, California,

1.2 entered into by ____, as the Payor,

1.3 in favor of ____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as ____
____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For owner-occupied, one-to-four residential units:*
☐ If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2.2 *For broker-made-arranged loans on owner-occupied, single family residences* [Calif. Business and Professions Code §10242.6(a)]:
☐ If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount amount in excess of 20% of the remaining principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on the use of any due-on clause.

2.3 *On all other residential and commercial property:*
☐ If all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due, on demand, in the amount of ____% of the principal prepaid in excess of the principal included in the regularly scheduled payments, except as prohibited by law on the use of any due-on clause.

2.4 *Discount for early payoff provision:*
☐ Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the note on payment of the sum equal to the principal remaining unpaid less a ______% discount , plus accrued interest and future advances, for the period expiring ____________, 20_______.

Payor's name: ________________________	Payor's name: ________________________
Signature: ________________________	Signature: ________________________
Payor's name: ________________________	Payor's name: ________________________
Signature: ________________________	Signature: ________________________

FORM 418-2 03-11

privilege. The owner may be charged whether the reduction is a portion or all of the principal remaining on the debt. [See Form 418-2 accompanying this chapter]

Enforceable penalties

Historically, prepayment penalties were used by lenders to prevent the loss of interest until the funds were re-lent to another borrower.

Prepayment penalties became regulated in 2010 under the **Dodd-Frank Wall Street Reform and Consumer Protection Act**.

Prepayment penalties are prohibited on mortgage loans which are not **qualified mortgages**.

Dodd-Frank Wall Street Reform and Consumer Protection Act
A 2010 enactment of significant changes to U.S. financial regulation in response to the 2007 financial crisis.

A *qualified mortgage* is any consumer loan secured by an owner- or non-owner-occupied one-to-four unit residential property.

Further, prepayment provisions are also prohibited on qualified mortgages which have:

- an *adjustable rate of interest*; or
- an *annual percentage rate (APR)* exceeding the average prime offer rate in a comparable residential mortgage loan by set quotas.

Prepayment penalties on qualified mortgages cannot exceed:

- **3%** of the outstanding balance on the mortgage during the 1st year of payment following the recording of the mortgage;
- **2%** of the outstanding balance on the mortgage during the 2nd year of payment;
- **1%** of the outstanding balance on the mortgage during the 3rd year of payment; and
- **0%** after the first three years following the recording of the mortgage.

Further, a SFR secured lender on the payoff of a consumer mortgage may only charge a **prepayment penalty** if:

- the prepayment penalty does not extend beyond *three years* after the date of the mortgage's closing;
- the prepayment penalty provision is not included in the terms of any refinancing by the same lender of the mortgage paid off;
- at closing, the borrower's total monthly payments on installment debts are less than 50% of their verified gross income; and
- the monthly payments do not change or adjust during the first four-year period after closing. [12 Code of Federal Regulations §§1026.32(d)(6)-(7)]

Due-on clause and prepayment penalties

Prepayment penalty provisions in all notes secured by a trust deed containing a **due-on clause** and encumbering an owner-occupied, one-to-four unit residential property are unenforceable if the lender or carryback seller:

- calls the mortgage due for a transfer in violation of the due-on clause;
- starts foreclosure to enforce a call under the due-on clause; or
- fails during the pendency of the sale of property subject to the mortgage to approve, within 30 days of receipt of the completed credit application from a qualified buyer, the assumption of the mortgage or carryback note.[1]

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

However, a seller carrying back a note secured by a one-to-four unit residential property can **bar prepayment** only for the calendar year of sale, if they have not already carried back more than four notes in the same year.[2]

1 12 Code of Federal Regulations §591.5(b)(2), (3)
2 CC §2954.9(a)(3)

Chapter 63 Summary

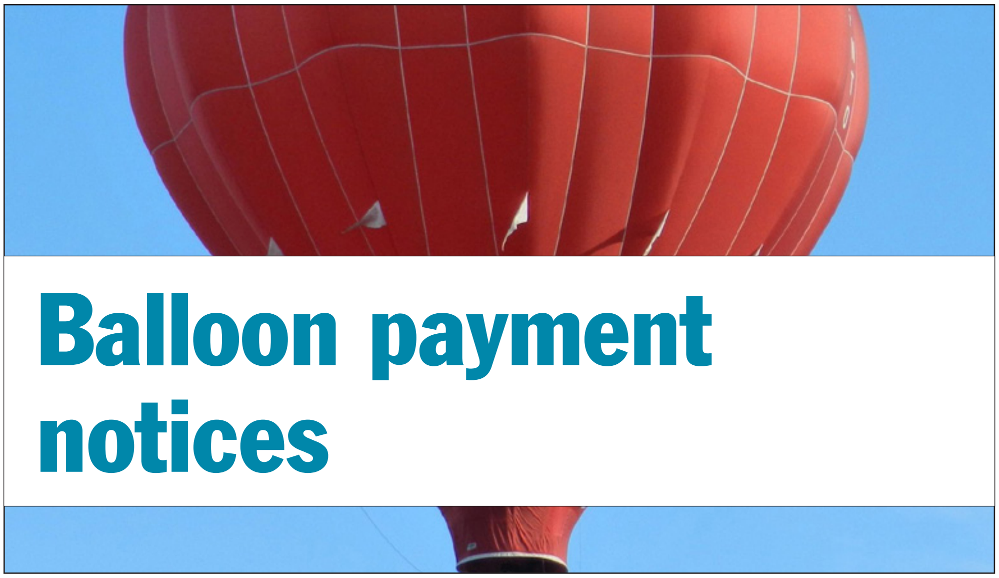
Prepayment penalties were historically used by lenders in an effort to prevent the loss of interest until the funds were re-lent to another borrower.

A property owner's right to prepay principal to reduce their debt or payoff and release the trust deed lien on their property is established by the terms of the promissory note. Further, prepayment penalties are regulated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Chapter 63 Key Terms

Dodd-Frank Wall Street Reform and Consumer Protection Act .... **pg. 417**
due-on clause .... **pg. 417**
prepayment penalty .... **pg. 415**

Quiz 12 Covering Chapters 62-67 is located on page 617.



Chapter 64

Balloon payment notices

Learning Objectives

After reading this chapter, you will be able to:

- understand what constitutes a final/balloon payment on a note;
- calculate the amount of a final/balloon payment; and
- advise on the requirements for the contents and delivery of a final/balloon payment notice.

Key Terms

balloon payment **call provision**

For a further discussion of this topic, see Chapter 13 of Real Estate Finance.

Notes containing a balloon payment

A **final/balloon payment** is any final payment on a note in an amount greater than twice the amount of any of the six regularly scheduled payments immediately preceding the balloon payment date.[1]

Final/balloon payment notes contain due date provisions calling for an accelerated final payoff of the principal in a *lump sum* amount before the note balance has been fully amortized through periodic payments. Further, a note has a balloon payment if it contains a **call provision** giving the carryback seller or lender the right to demand final payment at any time or after a specified time.[2]

Limitations on final/balloon payments in consumer mortgages

Consumer mortgages are contrasted with **business mortgages** based on the purpose for which the funds are intended to be used.

A *consumer mortgage* both:

- funds a personal, family or household purpose; and

1 CC §§2924i(d)(1), 2957(b)
2 CC §§2924i(d)(2), 2957(c)

balloon payment
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment. [See **RPI** Form 418-3 and 419]

- is secured by a one-to-four unit residential property, whether or not occupied by the borrower or their family.[1]

Final/balloon payments in consumer mortgages have become rare due to **Regulation Z (Reg Z)** rules. Mortgage lenders making consumer mortgages are mandated by Reg Z to qualify the borrower under ability-to-repay rules (ATR).

If the mortgage complies with Reg Z **qualified mortgage (QM)** standards the mortgage is *presumed compliant* with ATR rules.

However, to be classified as a QM, the mortgage needs to be fully amortized in *substantially equal* regular installments, a rule eliminating the inclusion of a final/balloon payment provision.

Final/balloon payment notice and due dates

Some mortgages with due dates require a *final/balloon payment* notice.

A **90/150-day due date notice** provision is required in notes containing a final/balloon payment provision with a term exceeding one year if:

- the note is carried back by a seller and secured by a trust deed on one-to-four residential units; or
- the note evidences a loan secured by a trust deed on an owner-occupied, one-to-four unit residential property.

call provision
A provision in a note giving the mortgage holder the right to demand full payment at any time or after a specified time or event, also called an acceleration clause. [See **RPI** From 418-3]

A due date notice is not required, unless agreed to by both parties, on transactions including:

- carryback mortgages secured by any type of real estate other than a one-to-four unit residential property, whether or not owner-occupied;
- lender mortgages secured by any type of real estate other than owner-occupied, one-to-four residential units;
- open-ended credit secured by any type of real estate, such as a *home equity line of credit (HELOC)*; and
- construction loans for any type of improvements.[2]

The due date notice is used to remind the owner of the secured property of a note's final/balloon payment. The notice, while a reminder, gives the owner an opportunity to refinance or pay off the note.

Delivery and contents of the notice

Carryback sellers and lenders need to deliver the notice to the buyer or owner of the property:

- personally; or
- by first-class certified mail to the property owner's last known address.

The notice needs to be given at least 90 days, but not more than 150 days, before the due date.[3]

1 12 Code of Federal Regulations §1026.2(a)(19)
2 CC §2924i(b)(1), (3)
3 CC §§2924i(c), 2966(a)

Form 419

Notice of Balloon Payment Date

NOTICE OF BALLOON PAYMENT DUE

NOTE: This form is used by the holder of a mortgage or their servicing agent when the mortgage note has a due date, to notify the owner making payments of the final/balloon payment date at least 90 but not more than 150 days before the payoff is due.

DATE: ________________, 20______, at ____, California.

TO: ____, the owner of real estate referred to as ____

____,

securing a promissory note dated __________________, in the original face amount of $________________.

NOTICE:

1. A final/balloon payment on this promissory note is due on ________________, 20______.
2. The approximate amount due (including all principal and interest and any other charges due between the date of this notice and the due date) is $________________.
3. Payment is to be made to (Name and address) ____
   ____
   ____
4. You have a contract right with the undersigned to refinance this final/balloon payment in accordance with the following terms:
   - 4.1 Origination or modification fee $______________.
   - 4.2 Principal amount $_____________.
   - 4.3 Interest rate ________%.
   - 4.4 Installment payments payable monthly in the amount of $_____________.
   - 4.5 Due date extended to _____________, 20_____.

Date: ____________, 20_______

Trust Deed Holder: _____________________________________

Signature _____________________________________

Address: _____________________________________

____

Phone: _____________________________________

Fax: _____________________________________

Email: _____________________________________

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If the notice is not timely delivered, the final due date is extended until 90 days after proper notice is given. No other terms of the note are affected. Thus, the accrual of interest and the schedule of periodic payments remain the same during the extended due date period.[4]

The failure to deliver the notice does not *invalidate* the note or lessen the property owner's obligation to continue making the regular periodic payments. Non-delivery of the notice merely extends the date by which the owner is obligated to pay off the note.

If the owner defaults on a payment during the due-date extension period, the noteholder may initiate foreclosure.

4 CC §§2924i(e), 2966(b)

The dollar amount of the *final/balloon payment* in a carryback transaction needs to be computed and disclosed to the buyer:

- first in a **Seller Carryback Disclosure Statement** handed to both the buyer and seller as an attachment to the purchase agreement, or for further approval before the close of escrow subject to cancellation on reasonable disapproval [See **RPI** Form 300];[1] and
- again in a written due date notice delivered at least 90 days, but not more than 150 days, before the final/balloon payment is enforced by the carryback seller. [See Form 419 accompanying this chapter]

Additionally, the carryback note prepared by escrow includes a statutory provision calling for the final/balloon payment due date notice.[2] [See **RPI** Form 418-3 §2.1]

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1 2924i (e)

2 2966

Chapter 64 Summary

A final/balloon payment is any payment on a note which is an amount greater than twice the amount of any of the six regularly scheduled payments immediately preceding the date of the final/balloon payment.

Final/balloon payments in consumer mortgages have become rare due to Regulation Z (Reg Z) rules, as they are prohibited in most qualified mortgages (QMs).

A 90/150-day due date notice provision is required in certain mortgages with terms exceeding one year and containing a final/balloon payment provision. Carryback sellers and lenders need to deliver the final/balloon payment notice to the buyer or owner of the property personally or by first-class certified mail to the property owner's last known address. The notice needs to be given at least 90 days, but not more than 150 days, before the due date.

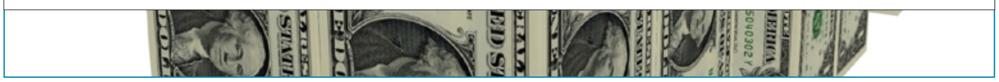
A lender or carryback seller may not foreclose if the buyer fails to make a final/balloon payment unless timely notice of the upcoming payoff was given. If the notice is not delivered on time, the final due date of the loan is extended until 90 days after proper notice is given. Non-delivery of the notice extends the date by which the owner is obligated to pay off the note but does not affect any other terms of the note.

Chapter 64 Key Terms

Quiz 12 Covering Chapters 62-67 is located on page 617.

Chapter 65

Trust deed characteristics



Learning Objectives

After reading this chapter, you will be able to:

- understand how a trust deed voluntarily imposes a lien for a debt on an ownership interest real estate;
- identify the three parties and their roles under a trust deed; and
- take steps to have a trust deed removed from title to a property.

Key Terms

beneficiary	**promissory note**
deed-in-lieu of foreclosure	**reconveyance**
guarantee	**trustee**

For a further discussion of this topic, see Chapter 14 of Real Estate Finance.

A security device and a lien

Financing involves a borrower who signs and delivers a **promissory note** to a lender or seller as *evidence of the debt* owed for money lent or credit extended. However, the *promissory note* itself is only a promise to pay as agreed. It is not a **guarantee** or other assurance the debt evidenced by the note will actually be repaid.

promissory note
A document given as evidence of a debt owed by one person to another. [See **RPI** Form 421 and 424]

A *guarantee* is an agreement entered into by a person who is not the borrower under the note, known as a **guarantor.** The guarantee agreement obligates the *guarantor* to be responsible for the borrower's performance. In essence, the guarantor agrees to **buy the note** in the event the borrower defaults. [See **RPI** Form 439]

guarantee
An assurance that events and conditions will occur as presented by the agent.

In real estate loan transactions, lenders want assurance the debt owed by the borrower will be repaid. Thus, lenders who fund real estate transactions or provide refinancing require borrowers to provide the real estate involved as **collateral** to secure the performance of the borrower's promise to pay if they default on repayment.

To secure payment of the debt by a parcel of real estate, the *security device* used is a **trust deed agreement**. The trust deed is always the preferential method used to impose a **lien** on real estate. [See Figure 1, **RPI** Form 450]

The *lien* gives the lender or carryback seller the right to foreclose on the real estate when the borrower defaults. The trust deed, by its words, purports to convey legal title to a neutral person, called a **trustee**. In law, the title is not transferred. Instead, a lien is created to encumber the owner's title and establish the property as security for the debt.

trustee
One who holds title to real estate in trust for another.

By the use of the trust artifice, title to the property is theoretically held by a *trustee* as a middleman. In other words, title is held *in trust* on behalf of the owner and for the benefit of the lender or carryback seller.

If the borrower or owner defaults on the note, the trustee is instructed by the lender to sell the property at a public auction to satisfy the debt.

A *trust deed lien* arrangement consists of:

- an identification of the parties;
- a description of the real estate liened as security;
- an identification of the primary money obligation, usually evidenced by a note, which brought about the need for security;
- the terms of the lender's security interest which is the encumbrance on the property, limited to setting out the rights and obligations of the borrower and the lender solely in regard to the real estate; and
- the borrower's signature and notary acknowledgments. [See Form 450]

Parties to the trust deed

The trust deed identifies three parties, each of whom has distinctly separate roles in the secured transaction:

- the borrower/owner (*trustor)* who voluntarily imposes the trust deed lien on their property;
- the middleman (*trustee)* who holds the power of sale over the property; and
- the lender or carryback seller (*beneficiary)* who benefits from the trust deed lien encumbering the property.

The trustor who signs and delivers a trust deed to a lender or carryback seller is the **owner** of the real estate interest encumbered. Delivery is accomplished by recording the trust deed with the **county recorder**, which *perfects* its priority on title.

The owner creating a trust deed encumbrance on real estate usually is the borrower of money or buyer of the property in a seller financed credit sale.

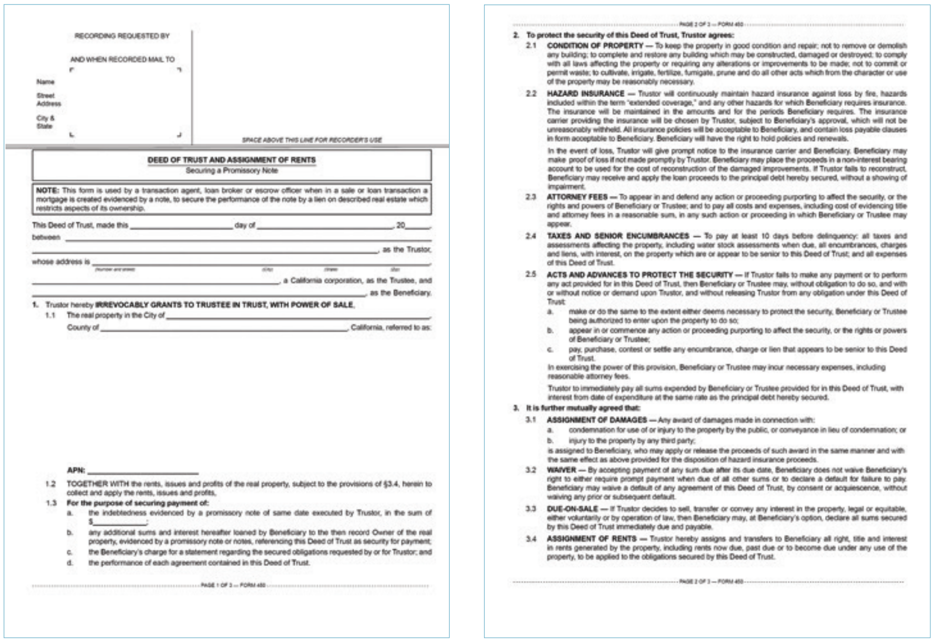
The owner's real estate interest which is encumbered can be less than the entire *fee interest*, such as:

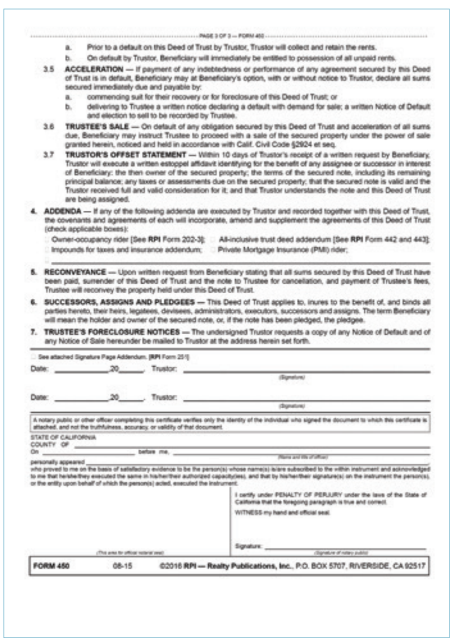
- a fractional co-ownership;
- leasehold interest;

Figure 1

Form 450

Deed of Trust and Assignment of Rents





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- life estate in the property;
- beneficial interests of creditors in existing trust deeds;
- equitable ownership rights under land sales contracts; and
- purchase rights under options to buy.

For example, a condominium owner can encumber their long-term leasehold interest, even though some other person is the fee owner of the real estate.[1]

1 Calif. Civil Code §§783, 1091, 2947

The trust deed lien created by the owner of a fractional interest in the real estate attaches only to the owner's interest in the property. It does not attach to the interests of any co-owners.[1]

If *community property* is encumbered, both spouses need to consent to the encumbrance of the community real estate interest, with the exception of attorney fees agreements in divorce proceedings.[2]

The trustee's authority

Despite the wording in the trust deed stating the trustor "hereby grants and conveys to trustee...the following real property...", the trustee receives no ownership or security interest in the real estate. Further, the trustee holds no legal right to any interest in the property.

The trustee merely receives the *authority* to carry out the activities vested in the trustee by the **power-of-sale provision** in the trust deed lien held by the beneficiary (lender).[3]

Under the trust deed, the trustee's sole responsibilities concerning the property are to:

- **auction** the property at a public sale on notice from the beneficiary; and
- **reconvey title** to the trustor (owner) and release the beneficiary's lien on instructions from the beneficiary or the trustor.

No possessory right transferred

Thus, the owner's *possessory right* to the property is never transferred to the trustee under a trust deed. The trustor, as the owner of the real estate, remains free to occupy, sell, lease or further encumber their property, subject to the existing trust deed lien. Any person other than the owner of the real estate may serve as trustee. This includes the beneficiary of the trust deed, be they the lender or carryback seller.[4]

Some private lenders name their attorney or broker as the trustee. Frequently, title and escrow companies unknowingly play the role of trustee in a particular transaction by virtue of the lender's use of general trust deed forms distributed by title companies.

Under a trust deed lien, the trustee is *non-existent* until the beneficiary elects to foreclose or release its security interest in the property. The trustee's conduct is in nearly all aspects completely controlled by statutes.[5]

When the trustee is called on by the beneficiary to carry out its duty to foreclose or reconvey, the trustee is required to act impartially. A trust deed lien does not create a trust relationship between the parties to the trust deed. The trustee is regarded as a *common agent* and bears a responsibility to both the beneficiary and the trustor to absolutely follow the strict statutory foreclosure scheme.[6]

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1 **Caito** v. **United California Bank** (1978) 20 C3d 694

2 Calif. Family Code §1102

3 **Lupertino** v. **Carbahal** (1973) 35 CA3d 742

4 More v. Calkins (1892) 95 C 435

5 **Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268; CC §2924 et seq.

6 **Kerivan** v. **Title Insurance and Trust Company** (1983) 147 CA3d 225

The beneficiary is the lienholder

The **beneficiary**, such as a lender or carryback seller, is the entity entitled to the performance of the promised activity referenced in the trust deed as the purpose for obtaining the security. This is generally the repayment of debt evidenced by a note.

beneficiary
One entitled to the benefits of properties held in a trust or estate, with title vested in a trustee or executor.

The beneficiary, like the trustee, receives no ownership interest in the property. But unlike the trustee, the beneficiary *holds an interest* in the property in the form of a lien.

Thus, the beneficiary has the power to instruct the trustee (who may be the beneficiary) to sell the secured property on behalf of the beneficiary. In turn, the trustee has authority from both the trustor and the beneficiary under the power-of-sale provision in the trust deed to sell the property in conformance with the statutory scheme at the direction of the beneficiary.[7]

Extinguishing the relationship

A trust deed ceases to exist when its purpose as security for a debt ends. Thus, once the beneficiary (lender or carryback seller) receives the full amount of money they are entitled to under the note and trust deed, any later claim of a security interest by the beneficiary is invalid.

Removing the trust deed from the title to the property on ending the debt relationship between the owner and the creditor is accomplished in one of three ways:

- **foreclosure** by issuance of a trustee's deed or sheriff's deed [See **RPI** Form 475];
- **full repayment** by reconveyance [See **RPI** Form 472]; or
- **mutual agreement** by a **deed-in-lieu of foreclosure**. [See **RPI** Form 406]

deed-in-lieu of foreclosure
A deed to real property accepted by a lender from a defaulting borrower to avoid the necessity of foreclosure proceedings by the lender. [See **RPI** Form 406]

Foreclosure of the trust deed lien is accomplished by a public auction at a trustee's sale or sheriff's sale, the proceeds of which are applied to the debt.

If the price bid at the foreclosure sale is insufficient to fully satisfy the note, the foreclosure sale terminates the trust deed lien on the property. The foreclosure sale cancels the trust deed's effect on the title on issuance of the trustee's or sheriff's deed.

Full repayment of the debt requires the beneficiary to cause the trust deed to be **reconveyed**. Once the debt is fully repaid by the trustor, the beneficiary delivers the original note to the trustee, together with a request for a reconveyance of title. In turn, the trustee records a reconveyance of the trust deed. [See **RPI** Form 472]

reconveyance
A document executed by a trustee named in a trust deed to release the trust deed lien from title to real estate, used when the secured debt is fully paid. [See **RPI** Form 472]

Request for reconveyence

On a request for reconveyance, the trustee will demand identification of the beneficiary and require the original note be marked as paid. After recording the reconveyance, the trustee will deliver the note to the owner at the owner's request.

Unless the recorded trust deed lien expires earlier, the lien expires and is no

7 Prob C §§16000, 16420(a)(1)

longer enforceable by any means after the later of:

- ten years after the final maturity date contained in the recorded trust deed; or
- 60 years after the recording of the trust deed if the final maturity date cannot be ascertained from the recorded trust deed.[8]

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8 CC §882.020

Chapter 65 Summary

The trust deed agreement is the preferential method used to impose a lien on real estate. The trust deed identifies three parties:

- the owner, called the trustor;
- the middleman, called the trustee; and
- the lender or carryback seller, called the beneficiary.

The trustee holds no legal right to any interest in the property. The trustee has the limited authority to carry out the activities vested in the trustee by the power-of-sale provision in the trust deed lien held by the beneficiary.

On the instruction from the beneficiary, the trustee's sole responsibilities concerning the property are to:

- auction the property at a public sale; or
- reconvey title to the trustor and release the beneficiary's lien.

The beneficiary, such as a lender or carryback seller, is the entity entitled to the performance of the promised activity referenced in the trust deed, such as the repayment of debt evidenced by a note. The beneficiary holds an interest in the property in the form of a lien.

The trust deed ceases to exist when its purpose as security for a debt ends. Removing the trust deed from the title to the property on ending the debt relationship is accomplished in one of three ways:

- foreclosure by issuance of a trustee's deed or sheriff's deed;
- full repayment by reconveyance; or
- mutual agreement by a deed-in-lieu of foreclosure.

Chapter 65 Key Terms

Quiz 12 Covering Chapters 62-67 is located on page 617.

Chapter 66

Assumptions: formal and subject-to

Learning Objectives

After reading this chapter, you will be able to:

- identify four procedures for a buyer to take over mortgage financing which encumbers a seller's property;
- understand the use of a beneficiary statement to confirm the amount and terms of an existing mortgage;
- determine the nonrecourse nature of a purchase-money mortgage; and
- advise a seller on the steps to be taken to reduce their risk of loss on a buyer's takeover of a recourse mortgage.

Key Terms

assumption agreement	**novation**
beneficiary statement	**purchase-money mortgage**
due-on clause	**recourse mortgage**
nonrecourse	**subject-to transaction**

For a further study of this discussion, see Chapter 23 of Real Estate Finance.

Mortgage takeover by a buyer

On the sale of real estate, financing the seller has in place as an existing encumbrance on the property may be taken over by a buyer when acquiring ownership under one of four procedures:

- a **formal assumption agreement** between the lender and the buyer;
- a **subject-to assumption agreement** between the seller and the buyer;
- a **subject-to transfer** of ownership to a buyer without an assumption agreement of any type; and
- a **novation agreement** between the lender, seller and buyer.

The subject-to transaction

A **subject-to transaction** is initially structured by use of a financing provision in a purchase agreement. The provision calls for the amount of an existing mortgage to be part of the purchase price the buyer is to pay for the property. The financing provision further states the buyer is to take title to the property *subject to* the existing mortgage. [See **RPI** Form 150 §§5 and 6]

beficiary statement

A document issued by a mortgage holder on request noting future payment schedules, interest rates and balances on a mortgage assumed by an equity purchase (EP) investor. [See **RPI** Form 415]

The seller's representation of the terms and condition of the mortgage is confirmed by the buyer during escrow on escrow's demand and receipt of the lender's **beneficiary statement**. [See **RPI** Form 415]

The buyer relies on the *beneficiary statement* for future payment schedules, interest rates and the principal balance on the mortgage they are taking over from the seller.

Unrecorded sales documents

Some buyers acquire their ownership rights under **unrecorded sales documents**, such as lease-option agreements or land sales contracts. This is done in an effort to avoid detection of a change in ownership by the lender.

due-on clause

A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

subject-to transaction

A sale of mortgaged property calling for the buyer to take title subject to the mortgage, the principal balance being credited toward the purchase price paid. Compare with formal assumption. [See **RPI** Form 156 §5]

Thus, the seller and buyer avoid conveyances, escrow, title insurance, and other customary transfer activities until the buyer originates new financing or negotiates an assumption of the existing mortgage. These unrecorded sales transactions do, however, trigger **due-on clauses** and **reassessments**. [See Chapter 67]

On a *subject-to transaction* when mortgage rates charged are comparable to or lower than the note rate on the seller's existing mortgage:

- a beneficiary statement is ordered to *confirm the mortgage amount* and its terms;
- the change of ownership conveyance is *recorded and insured*; and
- the conveyance is promptly brought to the *lender's attention* so they cannot accept payments and then later call the mortgage when rates rise, claiming the transfer went undisclosed.

Conversely, when interest rates are rising or high compared to the note rate on an existing mortgage, the lender is often not notified of a subject-to sales transaction.

However, the lender can enforce its due-on clause and call the mortgage on its **future discovery** of any sale, regardless of how the sale was structured.

Nonrecourse mortgage debt

The concern of the seller on either a subject-to or an assumption of the seller's mortgage is whether personal liability exists on the mortgage. Mortgage liability depends on whether the mortgage is:

nonrecourse

A debt secured by real estate, the creditor's source of recovery on default limited solely to the value of their security interest in the secured property.

- a **recourse mortgage**, meaning the lender may pursue the seller for a loss due to a deficiency in the value of the secured property, but only if the lender forecloses judicially; or
- a **nonrecourse mortgage**, meaning the lender may not pursue the seller for a loss on the mortgage when the property has insufficient value to satisfy the outstanding debt.

A seller has no liability for the lender's losses on a **purchase-money mortgage** taken over by a buyer under any procedure.

purchase-money mortgage
Nonrecourse mortgage financing provided by a lender as purchase-assist funding for the purchase of a one-to-four unit residential property the buyer is going to occupy, or a seller carryback note and trust deed as an extension of credit to a buyer of any type of real estate which is secured solely by the property sold. Anti-deficiency mortgage.

Purchase-money mortgages include:

- seller carryback financing on the sale of any type of real estate which becomes the sole security for the carryback note;
- a mortgage which funded the purchase of an owner-occupied, one-to-four unit residential property;[1] and
- a mortgage made for the construction of an owner-occupied, single family residence (SFR).

A lender as the holder of a purchase-money mortgage has no recourse to the borrower on a default, and is limited to foreclosing and selling the secured property as the sole source of recovery for any amounts remaining unpaid on the mortgage.[2]

On the take-over of a purchase-money mortgage by a buyer, the mortgage retains its original nonrecourse purchase-money characteristic, regardless of whether the buyer takes title subject-to or assumes the mortgage.[3]

Thus, a non-occupying buyer who takes over a purchase-money mortgage under any procedure is entitled to *anti-deficiency protection*. In contrast, purchase-assist mortgage financing originated by a non-occupying buyer of any type of residential property, including one-to-four unit residential property, is a recourse mortgage.

Recourse real estate mortgages

Recourse mortgages are all mortgages not classified as purchase-money mortgages, as reviewed above. When property is sold and title is conveyed to a buyer subject-to an existing recourse mortgage, the seller remains liable for any deficiency on the recourse mortgage if the buyer fails to pay and the lender forecloses.[4]

recourse mortgage
A mortgage debt in which a lender may pursue collection from a property owner for a loss due to a deficiency in the value of the secured property to fully satisfy the debt if the lender forecloses judicially.

Further, unless the buyer enters into an *assumption agreement* with either the seller or the lender, a subject-to buyer is not liable to either the seller or the lender for a drop in the property's value below the mortgage balance, unless the buyer commits *waste*.[5]

However, when the buyer and lender enter into an assumption agreement which significantly modifies the terms of the recourse mortgage without the seller's consent, the seller is not liable for the mortgage.[6]

Buyer-seller assumption

A seller can take steps to reduce their risk of loss on a buyer's takeover of a recourse mortgage. To do so, the seller includes a provision in the purchase agreement requiring the buyer to enter into an **assumption agreement** with the seller.

1 Calif. Code of Civil Procedure §580b
2 CCP §580b
3 **Jackson** v. **Taylor** (1969) 272 CA2d 1
4 **Braun** v. **Crew** (1920) 183 C 728
5 **Cornelison** v. **Kornbluth** (1975) 15 C3d 590; CC §2929
6 Braun, *supra*; CC §2819

assumption agreement
A promise given by a buyer to the seller or an existing mortgage holder to perform all the terms of the mortgage taken over by the buyer on the sale. [See **RPI** Form 431 and 432]

The buyer-seller assumption agreement is a promise given by the buyer to the seller to perform all the terms of the mortgage taken over by the buyer on the sale. It is agreed to in the purchase agreement and prepared in escrow. [See Form 431 accompanying this chapter]

The assumption agreement gives the seller the right to collect from the buyer the amount of any deficiency judgment a recourse lender might be awarded against the seller in a judicial foreclosure. To be enforceable, the assumption agreement is required to be in writing.[7]

Although the buyer's promise to pay the mortgage under a buyer-seller assumption agreement is given to the seller, the buyer also becomes liable under the agreement to the recourse lender under the legal doctrine of **equitable subrogation**.[8] [See Form 431 §6]

Even though the buyer takes over the primary responsibility for the recourse mortgage, the seller remains *secondarily liable* to the lender. The seller's risk of loss arises when the buyer fails to pay the recourse mortgage and there is a lack of market value remaining in the property to cover the mortgage amount.[9]

Indemnified for losses

Unlike the subject-to seller, the seller under the buyer-seller assumption agreement is entitled to be **indemnified**, meaning held harmless by the buyer for any losses the seller later incurs due to their continued liability on the mortgage taken over by the buyer.

Sales negotiations calling for the buyer to enter into an assumption agreement with the seller may also call for the buyer to secure the assumption agreement by a **performance trust deed** carried back by the seller as a lien on the property sold. [See **RPI** Form 432 and 451]

With a recorded trust deed held by the seller to secure the buyer's promise to pay the lender as agreed in the assumption agreement, any default by the buyer allows the seller to:

- demand the buyer to tender the entire balance remaining due on the assumed mortgage, subject to the buyer's right to reinstate the delinquencies; and
- proceed with foreclosure under the performance trust deed to recover the property and cure the default on the mortgage assumed by the buyer.

A buyer-seller assumption, like a subject-to transaction, does not alter the lender's right to enforce its due-on clause on discovery of the conveyances.

Novation

A lender may enter into an agreement with both the buyer and the seller for the buyer's *assumption* of the mortgage and a *release* of the seller's liability. In

7 CC §1624
8 Braun, *supra*
9 **Everts** v. **Matteson** (1942) 21 C2d 437

ASSUMPTION AGREEMENT
Unsecured and Subrogated

NOTE: This form is used by a seller's agent or escrow officer when the sale of a property calls for the transfer of title with the buyer taking over an existing mortgage, to document the buyer's unsecured promise to the seller to fully perform all terms of the mortgage.

DATE: ________________, 20_______, at ________________________________, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This assumption agreement is entered into by
1.1 ________________________________, as the Buyer,
1.2 and ________________________________, as the Seller,
1.3 regarding Buyer's acquisition of real estate referred to as ________________________________
________________________________.

2. FIRST TRUST DEED NOTE:
2.1 Buyer is acquiring title to the real estate subject to a first trust deed dated ________________,
2.2 executed by ________________________________, as The Trustor,
2.3 in which ________________________________ is the Beneficiary,
2.4 recorded on ________________, as Instrument No. ________________, in the Offical Records of ________________________ County, California, and
2.5 given to secure a promissory note of the same date for the principal sum of $________________.

3. SECOND TRUST DEED NOTE:
3.1 Buyer is acquiring title to the real estate subject to a second trust deed dated ________________,
3.2 executed by ________________________________, as the Trustor,
3.3 in which ________________________________ is the Beneficiary,
3.4 recorded on ________________, as Instrument No.________________, in the Official Records of ________________________ County, California, and
3.5 given to secure a promissory note of the same date for the principal sum of $________________.

AGREEMENT:

4. Seller hereby assigns and delegates to Buyer all rights and obligations in the above note(s) and trust deed(s).

5. Buyer hereby assumes and agrees to timely pay the debt evidenced by the above promissory note(s) and to perform all of Trustor's obligations under the trust deed(s) securing the note(s).

6. This agreement is made for the benefit of the Beneficiary(ies) of the trust deed(s) securing the note(s).

7. If Buyer or Buyer's successors default in the performance of this agreement, the whole sum of the principal and interest on the assumed indebtedness(es) will become immediately due at the option of the holder of this assumption agreement.
7.1 On default, Seller is to become subrogated to the interest of Beneficiary under the defaulted note and trust deed.

8. In any action to enforce this agreement, the prevailing party is to receive attorney fees.

I agree to the terms stated above. Date:________________, 20_______	**I agree to the terms stated above.** Date:________________, 20_______
Seller: ________________________	Buyer: ________________________
Seller: ________________________	Buyer: ________________________

FORM 431 03-11

Form 431

Assumption Agreement - Unsecured and Subrogated

exchange, the lender charges a fee together with a demand for a modification of mortgage interest rate and terms of repayment. This agreement is called a **novation** or **substitution of liability**.

On a buyer-lender assumption of a mortgage secured by an owner-occupied, one-to-four unit residential property, the lender is required to *release the seller from liability* for the mortgage assumed by the buyer.[40]

A *novation agreement* is comparable to the existing lender originating a new mortgage with the buyer, except the trust deed executed by the seller remains of record and the note remains unpaid.

novation
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

40 12 Code of Federal Regulations §591.5(b)(4)

Chapter 66 Summary

Existing financing encumbering a property may remain of record and be taken over by a buyer under a subject-to transfer, a formal assumption, a subject-to assumption or a novation agreement.

A subject-to transaction is structured by a provision in a purchase agreement calling for the principal amount of an existing mortgage to be part of the purchase price paid for the property. The lender may enforce its due-on clause by calling the mortgage on its later discovery of the sale, regardless of how the sales transaction is structured.

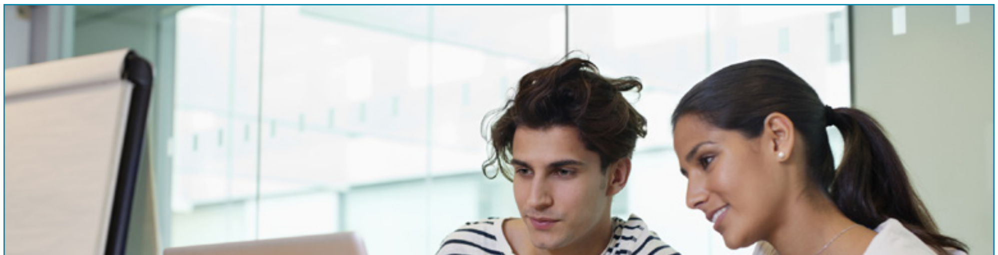
A seller is not liable for a deficiency in property value to satisfy the mortgage on foreclosure of a nonrecourse purchase-money debt taken over under any procedure by the buyer. On a recourse mortgage, the seller can reduce their risk of loss on a buyer's takeover of the mortgage by negotiating for the buyer to enter into an assumption agreement with the seller.

A buyer-seller assumption does not alter the lender's right to enforce its due-on clause on discovery but does give the seller the right to recover from the buyer any losses they may have incurred due to the lender's losses on a default and foreclosure.

The lender can enter into an agreement with both the buyer and seller for the buyer's assumption of the mortgage and a release of the seller's liability on the mortgage, called a novation. A novation agreement is comparable to the existing lender originating a new mortgage with the buyer, except the trust deed executed by the seller remains of record and the note remains unpaid.

Chapter 66 Key Terms

Quiz 12 Covering Chapters 62-67 is located on page 617.



Chapter 67

Due-on-sale regulations

Learning Objectives

After reading this chapter, you will be able to:

- understand the nature of a due-on clause in trust deeds as a restriction on the mobility of an owner's title and pricing in times of rising interest rates;
- explain ownership activities which trigger due-on enforcement by mortgage holders;
- apply the exemptions barring mortgage holders from due-on enforcement; and
- negotiate a limitation or waiver of a mortgage holder's due-on rights.

Key Terms

acceleration

due-on clause

waiver agreement

For a further discussion of this topic, see Chapter 22 of Real Estate Finance.

Mortgage holder interference is federal policy

A burden on the use and mobility of ownership is created by the existence of the **due-on clause** buried within all trust deeds held by lenders and carryback sellers.

The occurrence of an event triggering due-on enforcement automatically allows the mortgage holder to:

- **call the mortgage**, demanding the full amount remaining due to be paid immediately, also known as **acceleration**; or
- **recast** the mortgage, requiring a modification of the mortgage's terms as a condition for the mortgage holder's consent to a transfer, called a *waiver by consent*.

Economic recessions and recoveries

In times of stable or falling interest rates, mortgage holders usually permit assumptions of mortgages at the existing note rate, unless a *prepayment penalty clause* exists. Mortgage holders have no financial incentive to recast mortgages, or call and relend the funds at a lower rate when interest rates are dropping. [See Chapter 63]

acceleration
A demand for immediate payment of all amounts remaining unpaid on a loan or extension of credit by a mortgage lender or carryback seller.

However, in times of steadily rising rates, mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio. They employ title companies to advise them on recorded activity affecting title to the properties they have mortgages on. Once the due-on clause is triggered, the mortgage holder requires the mortgage to be recast at current market rates as a condition for allowing an assumption, lease or further encumbrance of the property by the owner.

Thus, real estate ownership encumbered by due-on trust deeds becomes increasingly difficult to transfer as interest rates rise. This tends to imprison owners in their home as they are unable to sell and relocate without accepting a lower price.

Due-on-sale

Due-on clauses are most commonly known as **due-on-sale** clauses. However, "due-on clause" is a more accurate term. A sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the mortgage holder's due-on clause is a sale of property which is subject to the mortgage holder's trust deed lien.

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

The due-on clause is triggered not only by a transfer using a grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, recorded or not. [See **RPI** Form 404 and 405]

Examples include a:

- land sales contract [See **RPI** Form 168];
- lease-option sale [See **RPI** Form 163]; or
- other wraparound carryback devices, such as an *all-inclusive trust deed (AITD)*. [See **RPI** Form 421]

Due-on-lease

The due-on clause is also triggered by:

- a lease with a term over three years; or
- a lease for any term when coupled with an option to buy.[1]

This interference addresses owners of commercial income property which they lease to user tenants. Typically, the owners want long-term leases which run more than three years in their term. Here, the leasing periods have to be held to three year each, the initial term, and each extension of the periods of occupancy under a lease agreement. Otherwise, the mortgage holder can call the mortgage if the initial period is more than three years, or when exercised the extension of the lease term is for more than three years.

1 12 Code of Federal Regulations §591.2(b)

Trust deed called or recast at the mortgage holder's option

Events triggering the due-on clause

Sale:

- *transfer of legal title (grant or quitclaim deed);*
- *land sales contract or holding escrow;*
- *court-ordered conveyance; or*
- *death.*

Lease:

- *lease for more than three years; or*
- *lease with an option to buy.*

Further encumbrance:

- *creation or refinance of a junior lien; or*
- *foreclosure by junior lienholder.*

Transfers not triggering due-on enforcement (owner-occupied, four-or-less residential)

- *creation of junior lien where owner continues to occupy;*
- *transfers to spouse or child who occupies;*
- *transfer into inter vivos trust (owner obtains mortgage holder's consent and continues to occupy);*
- *death of a joint tenant; or*
- *transfer on death to a relative who occupies.*

It has recently come to our attention...

Due-on-foreclosure

A senior mortgage holder may call a mortgage due on completion of the **foreclosure sale** by a junior mortgage holder on any type of real estate. A *trustee's deed* on foreclosure is considered a voluntary transfer by the owner, since the power of sale authority in the junior trust deed was agreed to by the owner of the real estate.

The due-on clause is not only triggered by the voluntarily agreed-to trustee's sale. It is also triggered by any involuntary foreclosure, such as a *tax lien sale*.[2]

Federal regulations allow due-on enforcement on **any transfer** of real estate which secures the lien, whether the transfer is voluntary or involuntary.[3]

Due-on-death exceptions

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner. However,

2 **Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423 (Disclosure: the legal editor of this publication was an attorney in this case.)

3 12 CFR §591.2(b)

as with due-on enforcement triggered by further encumbrances, narrow exceptions apply to the death of an owner who occupied a one-to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause. However, this is conditioned on the relative becoming an occupant of the property.[1]

Also, where two or more people hold title to one-to-four unit residential property as **joint tenants**, the death of one *joint tenant* does not trigger due-on enforcement.

However, at least one of the joint tenants, whether it was the deceased or a surviving joint tenant, needs to have occupied the property when the mortgage was originated. Conversely, occupancy is not required for a surviving joint tenant who qualifies for the joint tenancy exception.[2]

In all other transfers, the death of a vested owner, joint tenant or other co-owner triggers the mortgage holder's due-on clause.

Divorce and inter-family transfers

Federal due-on regulations bar due-on enforcement on the transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property.[3]

However, if the acquiring spouse chooses to lease the residential property for any period of time rather than occupy it, the mortgage holder may call or recast the mortgage.

The due-on clause is not triggered by an owner's transfer of their one-to-four unit residential property to a **spouse or child** who occupies the property.[4]

This inter-family transfer exception applies only to transfers from an owner to a spouse or child. Any transfer from a child to a parent triggers due-on enforcement.

Waiver by negotiation and by conduct

An owner wishing to enter into a transaction to sell, lease or further encumber their real estate without mortgage holder interference needs to first negotiate a **limitation or waiver** of the mortgage holder's due-on rights.

1 12 CFR §591.5(b)(1)(v)(A)]
2 12 CFR §591.5(b)(1)(iii)
3 12 CFR §591.5(b)(1)(v)(C)
4 12 CFR §591.5(b)(1)(v)(B)

Waiver agreements are trade-offs. In return for waiving or agreeing to limit the exercise of its due-on rights in the future, the mortgage holder demands consideration such as:

- additional points if an origination;
- additional security;
- principal reduction;
- increased interest;
- a shorter due date; or
- an assumption fee.

waiver agreement
An agreement in which a mortgage holder consents to the owner's present or future transfer of an interest in the mortgaged property as a waiver of the mortgage holder's due-on rights. Also known as an assumption agreement. [See **RPI** Form 431 and 432]

Chapter 67 Summary

Lenders and carryback sellers are allowed to enforce due-on sale clauses in trust deeds on most transfers of any interest in any type of real estate. The occurrence of an event which triggers due-on enforcement automatically allows the mortgage holder to call or recast the mortgage. In times of rising rates, mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio.

The due-on clause is triggered by any conveyance of legal or equitable ownership of real estate, such as a sale. A due-on clause is also triggered by:

- a lease with a term over three years;
- a lease for any term when coupled with an option to purchase;
- further encumbrance of a non-owner-occupied, one-to-four unit residential property; and
- on completion of the foreclosure sale by a junior mortgage holder or carryback seller on any type of real estate.

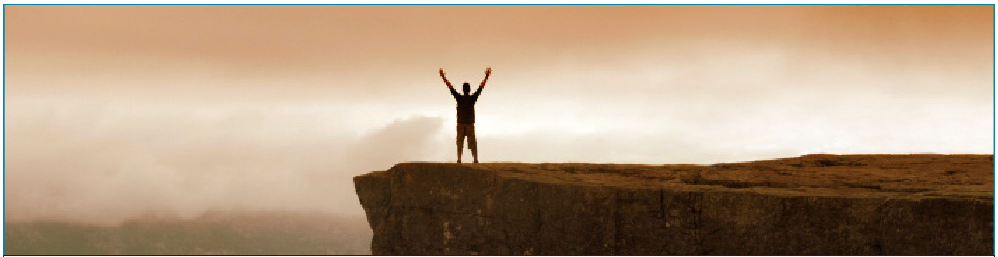
Further, transfers of real estate resulting from the death of a vested owner also trigger due-on enforcement, with some narrow exceptions based on occupancy of residential property.

Exceptions to due-on enforcement exist. Due-on enforcement based on the further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted. Similarly, the due-on clause is not triggered by an owner's transfer of property to a spouse or child who then occupies the property, or on the transfer of one-to-four unit residential property to a spouse after a divorce if the spouse occupies the property.

An owner wishing to sell, lease or further encumber their real estate without mortgage holder interference needs to first negotiate a limitation or waiver of the mortgage holder's due-on rights.

Chapter 67 Key Terms

Quiz 12 Covering Chapters 62-67 is located on page 617.



Chapter 68

Reinstatement and redemption

Learning Objectives

After reading this chapter, you will be able to:

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

Key Terms

acceleration
future advances
power-of-sale provision
redemption
reinstatement

For a further study of this discussion, see Chapter 47 of Real Estate Finance.

Nullifying the mortgage holder's call during foreclosure

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

Under the *power-of-sale provision*, the trustee records a *notice of default* (NOD) to initiate the trustee's foreclosure procedures when instructed by the beneficiary to do so. As a result of the tandem effect of the *acceleration clause*

acceleration
A demand for immediate payment of all amounts remaining unpaid on a loan or extension of credit by a mortgage lender or carryback seller.

when an NOD is recorded, all sums remaining to be paid on the note and trust deed become due and immediately payable, subject to the owner's and junior lienholder's reinstatement rights.

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

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

power-of-sale provision
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

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

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

After the NOD is recorded

redemption
A property owner or junior lienholder's right to clear title to property of a mortgage lien prior to the completion of a trustee's sale or following a judicial foreclosure sale by paying all amounts due on the mortgage debt, including foreclosure charges.

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

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

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

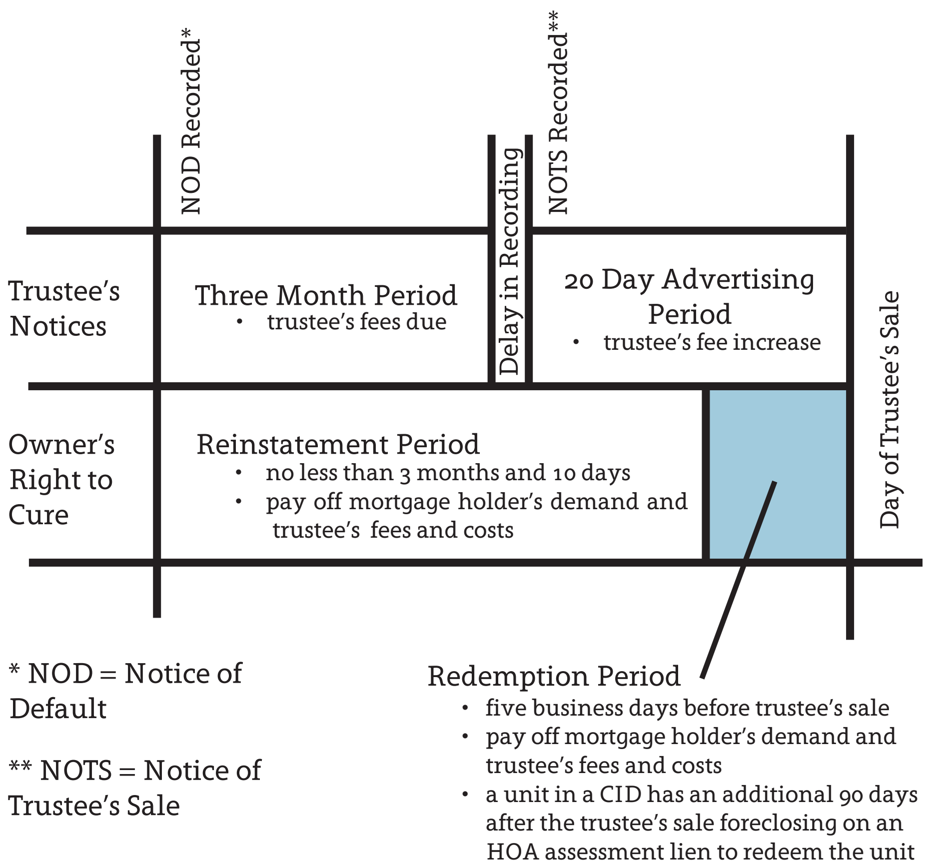
The trustee needs to begin advertising and post a **Notice of Trustee's Sale (NOTS)** at least 20 days before the date of the sale. The property may be sold by the trustee no sooner than the twenty-first day after advertising begins and the posting of notice occurs.[6] [See Figure 1]

1 Calif. Civil Code §2924c
2 CC §2903
3 CC §2924c(a)(1)
4 CC §2924c(e)
5 CC §2924
6 CC §2924f(b)

Figure 1

Periods for Notice and Reinstatement

Periods for Notices and Reinstatement



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

The owner in foreclosure is not allowed to delay the trustee's sale by requesting a postponement.[8]

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

reinstatement
A property owner or junior lienholder's right to reinstate a mortgage and cure any default prior to five business days before the trustee's sale by paying delinquent amounts due on the note and trust deed, plus foreclosure charges.

Reinstatement of the note and trust deed

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

7 CC §2924.8
8 CC §2924g

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

The mortgage holder's failure to identify or include the dollar amount of all known defaults in the NOD does not invalidate the NOTS. Further, the mortgage holder may enforce payment of any omitted defaults by recording another, separate NOD.[1]

On reinstatement of the note and trust deed, the NOD is rescinded by the trustee, removing the recorded default from the title to the property.[2]

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

Redemption

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

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

The owner's right of redemption runs until the trustee completes the bidding and announces the property has been sold. Any owner, junior lienholder, or other person with an interest in the property may satisfy the debt and redeem the property prior to the completion of the trustee's sale.[3]

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

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

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

Mortgage holder remedies on a default

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

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

- property taxes;

1 CC §2924
2 CC §2924c(a)(2)
3 CC §2903

The owner's alternatives

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

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

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

    Unless the owner can make up the de fault or have the mortgage amount "crammed down" as part of the reorganization plan, bankruptcy only delays the inevitable foreclosure. Once the automatic stay is lifted, the foreclosure sale may take place no sooner than seven calendar days later. [CC §2924g(d)]
6. ***Sale** — The owner sells the property before the trustee's sale.*

    A recorded notice of default (NOD) needs to state the owner has the right to sell their property which is in foreclosure. [CC §2924c(b)]

    In an effort to protect owners from being unlawfully deprived of the equity in their property when selling the property during the foreclosure period, special requirements exist for purchase agreements between owners and equity purchase investors on owner-occupied, one-to-four unit residential property in foreclosure. [CC §1695 et seq; see Chapter 70]

    However, selling property in foreclosure is difficult for the owner, due to time constraints and the difficulty of finding a buyer able to meet the financing needs to assume or payoff existing mortgages, cure defaults and correct the deferred maintenance on the property.
7. ***Walk** — The owner simply vacates the property when the mortgage holder completes foreclosure.*

    This is an economically viable alternative for an owner with little or no cash investment in the property, especially if payments saved during continued occupancy exceed the cash invested and the mortgage balance exceeds the property's value.

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

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

Trust deed defaults and reinstatement

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

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

Can the property owner reinstate the mortgage and retain the property by eliminating the default?

Yes! The default is monetary, entitling the owner to reinstate the mortgage by simply paying the delinquent property taxes, and the trustee's fees and charges incurred in the foreclosure proceeding.

Defaults cured only by redemption

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

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

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

Chapter 68 Summary

Trust deeds contain a boilerplate acceleration provision authorizing mortgage holders to call the mortgage after a material default on the trust deed. Similarly, the trust deed's power-of-sale provision authorizes the beneficiary to instruct the trustee to initiate a non-judicial foreclosure sale of the property.

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

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

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

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

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

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

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

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

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

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

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

Chapter 68 Key Terms

Quiz 13 Covering Chapters 68-72 is located on page 618.

Chapter 69

Trustee's foreclosure procedures

Learning Objectives

After reading this chapter, you will be able to:

- advise on an owner's rights during the different periods in the trustee foreclosure process;
- understand the pre-foreclosure workout process mandated for one-to-four unit residential property; and
- counsel buyers and owners on the procedures for a trustee's sale, including advertising, postponing, and accepting bids.

Key Terms

bona fide purchaser (BFP)
Declaration of Default and Demand for Sale
full credit bid
nonjudicial foreclosure
notice of default (NOD)
power-of-sale provision
pre-foreclosure workout
recourse mortgage
rescind
surplus funds
trustee
trustee's sale guarantee

For a further study of this discussion, see Chapter 49 of Real Estate Finance.

Power-of-sale provision

A lender or carryback seller holding a note secured by a trust deed in default has two foreclosure methods available to enforce collection of the secured debt. These two foreclosure methods are:

- a **judicial foreclosure sale**, also called a **sheriff's sale** [See Chapter 70];[1] or
- a **nonjudicial foreclosure sale**, also called a **trustee's sale**.[2]

nonjudicial foreclosure
When property is sold at a public auction by a trustee as authorized under the power-of-sale provision in a trust deed.

1 Calif. Code of Civil Procedure §726
2 Calif. Civil Code §2924

Figure 1

Excerpt from Form 450

Long Form Trust Deed and Assignment of Rents

GRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE

3.6 **TRUSTEE'S SALE** — On default of any obligation secured by this Deed of Trust and acceleration of all sums due. Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with Calif. Civil Code §2924 et seq.

power-of-sale provision
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

The key to the trust deed holder's ability to *nonjudicially foreclose* by a trustee's sale on the secured real estate is the **power-of-sale provision** contained in the trust deed. [See Figure 1]

Other security devices used to create a lien on real estate to secure a debt which may also contain a *power-of-sale provision* include:

- a land sale contract [See **RPI** Form 168];[1]
- a lease-option sale [See **RPI** Form 163 §19];
- a UCC-1 financing statement;[2] or
- the conditions, covenants and restrictions (CC&Rs) of a homeowners' association (HOA) for collection of assessments.[3]

The grant of the power-of-sale provides a private contract remedy for the **recovery of money.** The power-of-sale is voluntarily agreed to by the owner of the secured property, authorizing the secured creditor on a default to hold a nonjudicial foreclosure sale by public auction.[4]

recourse mortgage
A mortgage debt in which a lender may pursue collection from a property owner for a loss due to a deficiency in the value of the secured property to fully satisfy the debt if the lender forecloses judicially.

However, if the note evidences a **recourse debt** with a remaining balance exceeding the *fair price* of the mortgage holder's security position in real estate, the mortgage holder may choose a *judicial foreclosure*. A judicial foreclosure allows the lienholder to seek a money judgment for any deficiency in the property's value to satisfy the debt. [See Chapter 70]

However, by foreclosing under the power-of-sale provision, the lienholder avoids a costly (and potentially time consuming) court action for judicial foreclosure.

Editor's note — When a mortgage holder completes a nonjudicial foreclosure by trustee's sale, they cannot later obtain a deficiency judgment against the owner of the secured real estate. Alternatively, the owner cannot redeem the property after the mortgage holder's trustee's sale as they can after a judicial foreclosure sale. [See Chapter 70]

Who conducts the sale

A trust deed is a **security device** which imposes a lien on real estate. The trust deed creates a *fictional trust* which appears to "hold title" to the secured real estate for the benefit of the lienholder.

Thus, a trust deed has three parties:

- at least one **trustor** (the owner(s) of the secured real estate);

1 **Petersen** v. **Hartell** (1985) 40 C3d 102
2 **Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25
3 CC §1367
4 CC §2924

- a **trustee** who need not be named; and
- at least one **beneficiary** (a lender, carryback seller, HOA or other lienholder).

The trustee's sale is conducted by the *trustee* who is either:

- named in the trust deed; or
- appointed by the *beneficiary* of the trust deed at the time the beneficiary initiates the foreclosure process.

A broker, attorney, trust deed service, subsidiary of the lender, or the lender itself may be appointed at any time as the trustee.

trustee
One who holds title to real estate in trust for another.

The trustee begins foreclosure by recording a **notice of default (NOD)**. The trustee ends the process on delivery of the trustee's deed and disbursement of any sales proceeds.[5] [See Figure 2, **RPI** Form 471]

notice of default (NOD)
The notice filed to begin the nonjudicial foreclosure process. Generally, the NOD is filed following three or more months of delinquent mortgage payments.

Generally, trust deeds are prepared and distributed by title or escrow companies naming their corporation as the trustee. However, a trust deed or other security device does not need to name the trustee at all. The beneficiary later simply appoints a trustee to handle the *NOD* or reconveyance. [See **RPI** Form 450]

Also, the beneficiary may appoint a substitute trustee to replace the trustee named in the trust deed.

Pre-foreclosure workout prior to NOD

Before recording an NOD on a trust deed securing a purchase-assist mortgage on a borrower's **principal residence**, a mortgage holder needs to conduct a **pre-foreclosure workout** with the owner.

At least 30 days prior to recording an NOD, the mortgage holder needs to contact the borrower to:

- assess the borrower's financial situation;
- explore options for the borrower to avoid foreclosure;
- advise the borrower of their right to an additional meeting within 14 days to discuss their financial options;
- provide borrowers with the toll-free Department of Housing and Urban Development (HUD) phone number to find a HUD-certified housing counseling agency; and
- in the event personal or phone contact cannot be made, the mortgage holder is to exercise due diligence through further attempts to contact the borrower.

pre-foreclosure workout
Negotiations between a mortgage holder and defaulting property owner with the purpose of exploring options to avoid foreclosure.

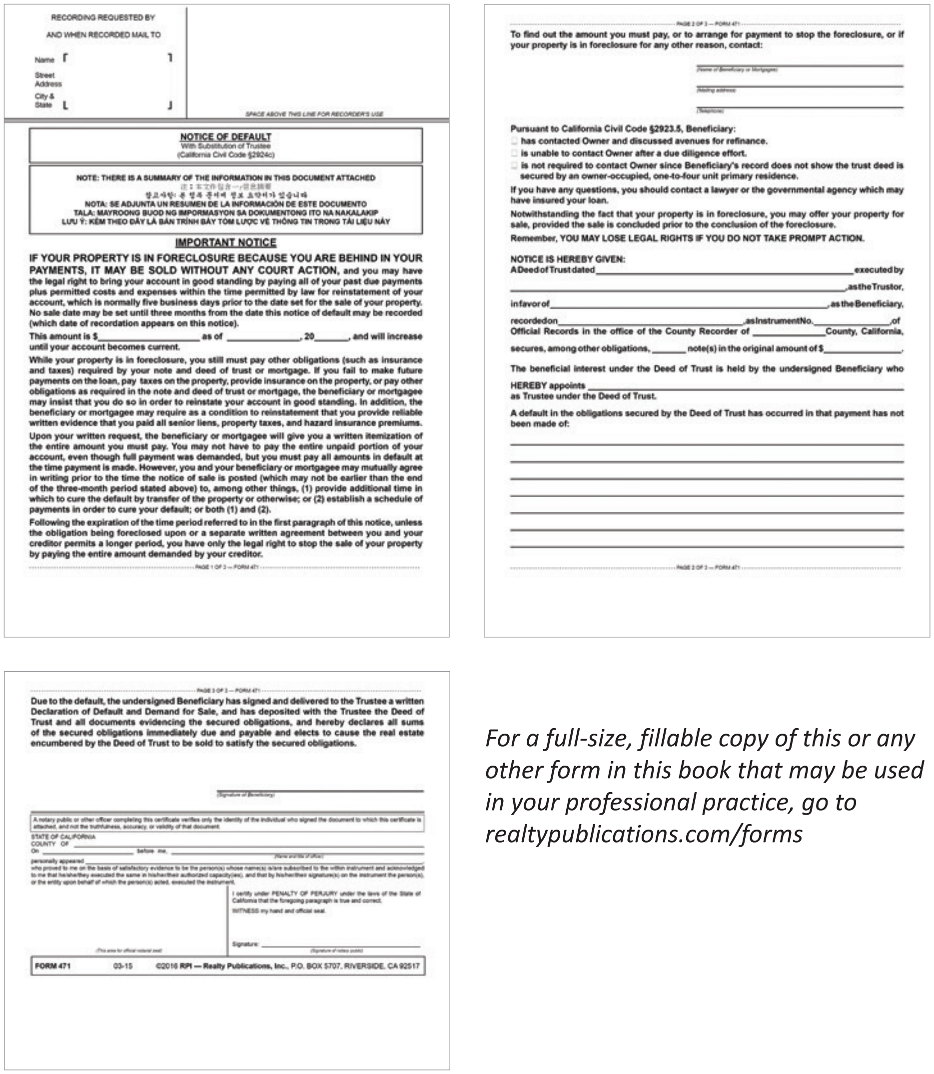
If the mortgage holder is unable to make contact with the borrower, the mortgage holder sends the borrower a certified letter, return receipt requested, containing a toll-free number with access to a representative during business hours.

5 **Bank of America National Trust & Savings Association** v. **Century Land & Water Co.** (1937) 19 CA2d 194

Figure 2

Form 471

Notice of Default with Substitution of Trustee



RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF DEFAULT
With Substitution of Trustee
(California Civil Code §2924c)

NOTE: THERE IS A SUMMARY OF THE INFORMATION IN THIS DOCUMENT ATTACHED
NOTA: SE ADJUNTA UN RESUMEN DE LA INFORMACIÓN DE ESTE DOCUMENTO
TALA: MAYROONG BUOD NG IMPORMASYON SA DOKUMENTONG ITO NA NAKALAKIP
LƯU Ý: KÈM THEO ĐÂY LÀ BẢN TRÌNH BÀY TÓM LƯỢC VỀ THÔNG TIN TRONG TÀI LIỆU NÀY

IMPORTANT NOTICE

IF YOUR PROPERTY IS IN FORECLOSURE BECAUSE YOU ARE BEHIND IN YOUR PAYMENTS, IT MAY BE SOLD WITHOUT ANY COURT ACTION, and you may have the legal right to bring your account in good standing by paying all of your past due payments plus permitted costs and expenses within the time permitted by law for reinstatement of your account, which is normally five business days prior to the date set for the sale of your property. No sale date may be set until three months from the date this notice of default may be recorded (which date of recordation appears on this notice).

This amount is $__________ as of __________, 20____, and will increase until your account becomes current.

While your property is in foreclosure, you still must pay other obligations (such as insurance and taxes) required by your note and deed of trust or mortgage. If you fail to make future payments on the loan, pay taxes on the property, provide insurance on the property, or pay other obligations as required in the note and deed of trust or mortgage, the beneficiary or mortgagee may insist that you do so in order to reinstate your account in good standing. In addition, the beneficiary or mortgagee may require as a condition to reinstatement that you provide reliable written evidence that you paid all senior liens, property taxes, and hazard insurance premiums.

Upon your written request, the beneficiary or mortgagee will give you a written itemization of the entire amount you must pay. You may not have to pay the entire unpaid portion of your account, even though full payment was demanded, but you must pay all amounts in default at the time payment is made. However, you and your beneficiary or mortgagee may mutually agree in writing prior to the time the notice of sale is posted (which may not be earlier than the end of the three-month period stated above) to, among other things, (1) provide additional time in which to cure the default by transfer of the property or otherwise; or (2) establish a schedule of payments in order to cure your default; or both (1) and (2).

Following the expiration of the time period referred to in the first paragraph of this notice, unless the obligation being foreclosed upon or a separate written agreement between you and your creditor permits a longer period, you have only the legal right to stop the sale of your property by paying the entire amount demanded by your creditor.

PAGE 1 OF 3 — FORM 471

PAGE 2 OF 3 — FORM 471

To find out the amount you must pay, or to arrange for payment to stop the foreclosure, or if your property is in foreclosure for any other reason, contact:

(Name of Beneficiary or Mortgagee)

(Mailing address)

(Telephone)

Pursuant to California Civil Code §2923.5, Beneficiary:

☐ has contacted Owner and discussed avenues for refinance.
☐ is unable to contact Owner after a due diligence effort.
☐ is not required to contact Owner since Beneficiary's record does not show the trust deed is secured by an owner-occupied, one-to-four unit primary residence.

If you have any questions, you should contact a lawyer or the governmental agency which may have insured your loan.

Notwithstanding the fact that your property is in foreclosure, you may offer your property for sale, provided the sale is concluded prior to the conclusion of the foreclosure.

Remember, YOU MAY LOSE LEGAL RIGHTS IF YOU DO NOT TAKE PROMPT ACTION.

NOTICE IS HEREBY GIVEN:
A Deed of Trust dated __________ executed by __________, as the Trustor, in favor of __________, as the Beneficiary, recorded on __________, as Instrument No. __________, of Official Records in the office of the County Recorder of __________ County, California, secures, among other obligations, _____ note(s) in the original amount of $__________.

The beneficial interest under the Deed of Trust is held by the undersigned Beneficiary who HEREBY appoints __________ as Trustee under the Deed of Trust.

A default in the obligations secured by the Deed of Trust has occurred in that payment has not been made of:

PAGE 2 OF 3 — FORM 471

PAGE 3 OF 3 — FORM 471

Due to the default, the undersigned Beneficiary has signed and delivered to the Trustee a written Declaration of Default and Demand for Sale, and has deposited with the Trustee the Deed of Trust and all documents evidencing the secured obligations, and hereby declares all sums of the secured obligations immediately due and payable and elects to cause the real estate encumbered by the Deed of Trust to be sold to satisfy the secured obligations.

(Signature of Beneficiary)

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 __________
On __________ before me, __________ (Name and title of officer)
personally appeared __________,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature: __________ (Signature of notary public)

(This area for official notarial seal)

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The stages of foreclosure

A trustee's actions under a *power-of-sale provision* are strictly controlled by California statutes. To successfully complete a trustee's foreclosure sale, the trustee and beneficiary of the trust deed are to adhere to the procedures fully detailed in the foreclosure statutes for handling a trustee's sale.[1]

The foreclosure process has three stages:

1. the **notice of default** (**NOD)** is recorded and mailed;
2. the **notice of trustee's sale (NOTS)** is recorded, posted and mailed; and
3. the trustee's sale of the real estate by auction, followed by the execution of the trustee's deed and distribution of sales proceeds.

1 **Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268

While the trustee is concerned about the three stages for processing the foreclosure, the owner of the real estate and the beneficiary are concerned primarily with two different periods of time which control payment of the debt:

- the **reinstatement period**, which runs from the recording of the NOD and ends prior to five business days before the trustee's sale; and
- the **redemption period,** which also runs from the recording of the NOD but ends with the completion of the trustee's sale of the secured property. [See Chapter 68]

Declaration of Default and Demand for Sale
A document delivered to the trustee under a power of sale provision by the mortgage holder instructing the trustee to initiate foreclosure on the secured real estate by recording a notice of default (NOD).

Trustee's sale guarantee

When a trust deed is in default and the beneficiary has chosen to foreclose, the beneficiary delivers a **Declaration of Default and Demand for Sale** to the trustee.

The declaration contains instructions directing the trustee to initiate foreclosure on the secured real estate as authorized under the power-of-sale provision contained in the trust deed. [See Figure 2, **RPI** Form 471]

Even though the trustee may have received the beneficiary's declaration of default, the trustee's foreclosure process and the periods imposing rights and obligations do not begin until the trustee or beneficiary records a notice of default (NOD).[2]

Once the NOD is recorded, the trustee is to strictly follow statutory notice requirements. To be assured the required notices are served on all the proper persons, the trustee orders a **trustee's sale guarantee** from a title company before or at the time the NOD is recorded. [See Chapter 69]

trustee's sale guarantee
A policy issued by a title insurance company to a trustee before or at the time the notice of default is recorded providing coverage for the trustee should they fail to serve notices on any party of record due to an omission in the guarantee.

The *trustee's sale guarantee* provides coverage to the trustee for failure to serve notices on any party due to an omission of that person's identity in the guarantee.

The notice of default and election to sell

When ordering a trustee's sale guarantee from a title insurance company, the trustee instructs the title company to record the NOD in the office of the county recorder in the county where the real estate is located.[3]

The NOD contains statutorily mandated statements which sets forth the **monetary default** on the note or other obligation secured by the trust deed.[4]

The NOD does not need to state the actual amounts of the *monetary defaults* on the recurring obligations. However, the NOD needs to state the nature of the present defaults on the note and the trust deed.[5]

To determine the amount needed to cure the default, the NOD directs the owner seeking to *reinstate* the trust deed or *redeem* the property to contact

2 **System Investment Corporation** v. **Union Bank** (1971) 21 CA3d 137
3 CC §2924
4 CC §2924c(b)(1)
5 CC §2924c(a)(1)(B)

the trustee. Thus, the trustee insulates the beneficiary from all direct contact with the owner or junior lienholder after the date the NOD is recorded until canceled or a trustee's sale takes place.

Delivering the NOD

Within **10 business days** after recording the NOD, two copies of the NOD are mailed to:

- the owner of the property;
- the administrator of a deceased owner's estate; and
- each person who has recorded a request to receive a copy of the NOD.[1]

Within **one month** after recording the NOD, the trustee sends a copy of the NOD by registered or certified mail and another copy by first-class mail to holders of a **recorded interest** in the secured property.

Any person interested in obtaining a copy of the NOD who will not automatically receive the notice records a **request for NOD.** The request for NOD assures the interested person they will be notified of the default. [See **RPI** Form 412]

A trustee or person depositing the NOD into the mail to give notice to others is to prepare a *proof of service* and include a copy of the form with the NOD in each mailing.[2]

Further, if the mortgage secured by the trust deed was negotiated in Spanish, the trust deed may contain a request for a Spanish-language NOD. The trustee is then obligated to serve the owner an NOD translated into Spanish.[3]

The notice of trustee's sale

A trustee or beneficiary may begin noticing the date set for the sale of a property on the day following **three months after** the NOD is recorded.[4]

The date the sale will be held may be set for any business day, Monday through Friday, between the hours of 9 a.m. and 5 p.m.[5]

In general practice, a **date down** of the trustee's sale guarantee issued to the trustee is ordered out from the title company the day before or on the day the title company records the NOTS.

The *date down* notifies the trustee of any interests recorded on the title to the property after the NOD is recorded. However, the trustee is not required to give notice of the impending trustee's sale to any person who recorded an interest in the property after the NOD was recorded.[6]

The trustee prepares an NOTS which contains:

1 **Estate of Yates** v. **West End Financial Corporation, Inc.** (1994) 25 CA4th 511; CC §2924b(b)(1)
2 CC §2924b(e)
3 CC §2924c(b)(1)
4 CC §2924
5 CC §2924g(a)
6 CC §2924b(c)(1)

- the trustee's name or their agent's name, street address and telephone number (or toll-free number if located out of state);
- the street address or common designation of the secured property;
- the county assessor's parcel number of the secured property;
- the dollar amount of the debt in default, including reasonably estimated advances for hazard insurance premiums, property taxes due and foreclosure costs; and
- a statutory statement informing the owner they are in default.[7] [See **RPI** Form 474]

Delivering the NOTS

At least **20 calendar** days before the trustee's sale, the trustee sends two copies of the NOTS to each party the trustee previously sent the NOD.[8]

To ensure the sale at a public auction is properly advertised, the notice requirements for the NOTS are more comprehensive than the notice requirements for the NOD.

In addition to mailing the notice to all interested parties of record, the trustee performs all of the following at least 20 calendar days prior to the sale:

- post a copy of the NOTS in one public place in the city of the sale, or if the sale is not to be held in a city, the judicial district in which the property is to be sold;
- post a copy of the NOTS in a conspicuous place on the property to be sold; and
- start publishing a copy of the NOTS once a week for three consecutive calendar weeks in a newspaper of general circulation in the city where the property is located.[9]

Sold to the highest bidder

A trustee's sale is a **public auction** by private agreement where the property is sold to the highest bidder.[10]

The trustee's sale is held in the county where the secured real estate is located.[11]

Before the auction begins, the trustee may:

- demand all prospective bidders to show evidence of their financial ability to pay as a precondition to recognizing their bids; and
- hold the prospective bidders' amounts to be bid.[12]

A bidder at auction can tender their bid amount in U.S. dollars in the form of:

- cash;

7 CC §2924f
8 CC §2924b(c)(3)
9 CC §2924f(b)(1)
10 CC §2924h
11 CC §2924g(a)
12 CC §2924h(b)(1)

- a cashier's check drawn on a state or national bank;
- a check issued by a state or federal thrift, savings and loan association (S&L), savings bank or credit union; or
- a cash equivalent designated by the trustee in the NOTS, such as a money order.[1]

Each bid made at a trustee's sale is an **irrevocable offer** to purchase the property. However, any subsequent higher bid cancels a prior bid.[2]

The trustee's sale is considered final on the trustee's *acceptance* of the last and highest bid.[3]

Once the highest bid has been accepted by the trustee, the trustee may require the successful bidder to immediately deposit the full amount of the final bid with the trustee.[4]

If the successful bidder tenders payment by a check issued by a credit union or a thrift, the trustee can refrain from issuing the trustee's deed until the funds become available.[5]

Failure to deliver payment of a bid

rescind
The cancellation of a contract which restores the parties to the same position they held before they entered into the contract.

If a successful bidder tenders payment by check and the funds are not available for withdrawal:

- the trustee's sale is automatically **rescinded**; and
- the trustee will send the successful bidder a *notice of rescission* for failure of consideration.[6]

To hold a new trustee's sale auction, the trustee sets a new trustee's sale date and records, serves and publishes a new NOTS. The new NOTS is to follow all the same statutory requirements as the original NOTS.

The successful bidder who fails to tender payment when demanded is liable to the trustee for all resulting damages, including:

- court costs;
- reasonable attorney fees; and
- the costs for recording and serving the new NOTS.[7]

Bids by the beneficiary, a credit

full credit bid
The maximum amount the foreclosing mortgage holder may bid at a trustee's sale without adding cash, equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses.

The beneficiary is frequently the only bidder at the trustee's sale. Thus, the beneficiary automatically becomes the successful bidder.

The beneficiary may bid without tendering funds up to an amount equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses. This amount is called a **full credit bid.**[8]

1 CC §2924h(b)(1)
2 CC §2924h(a)
3 CC §2924h(c)
4 CC §2924h(b)(2)
5 CC §2924h(c)
6 CC §2924h(c)
7 CC §2924h(d)
8 CC §2924h(b)

If the beneficiary is the successful bidder under a *full credit bid*, the trustee retains possession of the beneficiary's note (or other evidence of the secured debt) in exchange for the trustee's deed to the property.

The beneficiary is not required to bid the full amount of the indebtedness to acquire the property at the trustee's sale. The beneficiary can bid an amount below the full amount of the debt, called an **underbid**.

Conveyance by a trustee's deed

On the completion of a trustee's sale, the trustee uses a **trustee's deed** to transfer title to the property on to the successful bidder at the auction.

When a buyer other than the beneficiary purchases the property for value and without notice of title or trustee's sale defects, the buyer is considered a **bona fide purchaser (BFP).** The title received by the third-party BFP is clear of any interest claimed by the owner, lienholders or tenants whose interests are junior to the foreclosed trust deed.[9]

Surplus funds

The price paid for property by the successful bidder at a trustee's sale occasionally exceeds the amount of debt and costs due under the foreclosed trust deed. The excess amounts are called **surplus funds**.

The trustee has a duty to distribute the *surplus funds* to the junior lienholders and the owner(s). The gross proceeds from the trustee's sale are distributed in the following order:

- to pay the costs and expenses of the trustee's sale, including trustee's fees or attorney fees;
- to pay the indebtedness secured by the property in default, including advances made by the beneficiary;
- to satisfy the outstanding balance of junior lienholders of the property, distributed in the order of their priority; and
- to the owner, the owner's successor-in-interest or the vested owner of record at the time of the trustee's sale.[10]

bona fide purchaser (BFP)
A buyer who purchases a property for valuable consideration in good faith without notice or knowledge of pre-existing encumbrances or conditions affecting their right to full ownership.

surplus funds
The price paid for property by the successful bidder at a trustee's sale in excess of the amount of debt and costs due under the foreclosed trust deed.

9 **Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605
10 CC §2924k(a)

Chapter 69 Summary

A trust deed is a security device which imposes a lien on real estate. A power-of-sale provision in the trust deed allows the deed holder to nonjudicially foreclose by a trustee's sale. By foreclosing using the power-of-sale provision, the holder of a lien avoids a court action for judicial foreclosure.

A trustee's sale is conducted by a trustee either named in the trust deed or appointed by the beneficiary at the start of the foreclosure process.

The trustee initiates nonjudicial foreclosure by recording and serving a notice of default (NOD). Before recording an NOD on a one-to-four residential property, a mortgage holder conducts a pre-foreclosure workout with the owner to explore options to avoid foreclosure and provide financial counseling to the owner.

Copies of the NOD are sent to the owner and each person who has requested a copy within 10 business days after it was recorded, and to recorded junior interests in the property within one month.

A trustee or beneficiary may begin noticing the date set for the sale of a property by posting and serving a notice of trustee's sale (NOTS) on the day following three months after the day the NOD is recorded. If the billing address of the defaulting owner is different from the secured property's address, residential tenants of the property are served with a 90-day notice to vacate.

Copies of the NOTS are sent to each party who received copies of the NOD at least 20 calendar days before the trustee's sale. The NOTS is also posted in a public place in the city of the sale, posted in a conspicuous place on the property to be sold, and published in a local newspaper for three consecutive weeks prior to the sale.

A trustee's sale is held in the county where the secured real estate is located. A trustee's sale is a public auction where the property is sold to the successful bidder. The sale is considered final on the trustee's acceptance of the last and highest bid.

On completion of a trustee's sale, the trustee uses a trustee's deed to convey title to the successful bidder. A successful bidder without notice of title or sale defects is considered a bona fide purchaser (BFP) and takes title clear of any claims to the property on interests junior to the foreclosed trust deed.

Chapter 69 Key Terms

Quiz 13 Covering Chapters 68-72 is located on page 618.

Chapter 70

Judicial foreclosure

Learning Objectives

After reading this chapter, you will be able to:

- distinguish foreclosure proceedings as either judicial or nonjudicial;
- discuss the procedural process of a judicial foreclosure;
- advise a client of their right to reinstate a mortgage in default or redeem a property following a judicial foreclosure sale; and
- calculate any deficiency in value an owner may owe a mortgage holder after a property has been sold at a judicial foreclosure sale.

Key Terms

certificate of sale	**litigation guarantee**
fair value hearing	**money judgment**
foreclosure decree	**nonjudicial foreclosure**
judicial foreclosure	**probate referee**
levying officer	**recourse mortgage**
lis pendens	

For a further study of this discussion, see Chapter 43 of Real Estate Finance.

Deficient property value; recourse paper

When a mortgage is in default, the mortgage holder's *collection efforts* are limited to judicial or non-judicial activities, both of which are very structured. If the note evidences a **recourse debt**, the mortgage holder may recover against both the property and the named borrower.

To initiate either type of collection effort, the mortgage holder needs to first *exhaust the security* by foreclosing on the real estate. The mortgage holder's security interest in a property is exhausted when the mortgage holder completes a foreclosure sale on the property. Further, the mortgage holder's security interest is wiped out by a senior trust deed holder's foreclosure.

recourse mortgage
A mortgage debt in which a lender may pursue collection from a property owner for a loss due to a deficiency in the value of the secured property to fully satisfy the debt if the lender forecloses judicially.

Only when the note evidences a *recourse debt* may the mortgage holder pursue a money judgment against the borrower for any deficiency in the property's value to fully satisfy the debt.[1]

Foreclosure is an activity comprised of notices and an auction to sell real estate. Foreclosure of the property eliminates the *right of redemption* held by the owner and any persons holding junior interests in the property. [See Chapter 69]

nonjudicial foreclosure
When property is sold at a public auction by a trustee as authorized under the power-of-sale provision in a trust deed.

A trust deed holder may foreclose on a property in one of two ways:

- **judicial foreclosure**, under mortgage law, also called a **sheriff's sale**;[2] or
- **nonjudicial foreclosure**, under the power-of-sale provision in the trust deed, also called a **trustee's sale**.[3] [See Chapter 69]

Judicial foreclosure versus nonjudicial foreclosure

Judicial foreclosure is the court-ordered sale by public auction of the secured property. The process can last from eight months to multiple years before it is completed.

Alternatively, when a trust deed holder *nonjudicially forecloses* by a trustee's sale, the property is sold as authorized by the trust deed provisions at a public auction, called a **trustee's sale**. [See Chapter 69]

judicial foreclosure
The court-ordered sale by public auction of the mortgaged property. Also known as a sheriff's sale.

Trustee's sales are considerably less expensive and quicker than judicial foreclosures. A judicial sale requires the filing of a lawsuit, which includes:

- litigation expenses;
- appraisals; and
- attorney fees.

money judgment
An award for money issued by a court resulting from a lawsuit for payment of a claim.

However, when the value of a secured property drops below the balance owed on a *recourse debt*, the mortgage holder may elect to foreclose by judicial action. A judicial foreclosure is the only foreclosure method which allows a mortgage holder to obtain a **money judgment** against the borrower for any deficiency in the value of the secured property to fully satisfy a recourse debt.[4]

Suing to foreclose

The first step in a judicial foreclosure is filing a complaint in the Superior Court of the county where the property is located. The foreclosure complaint names as defendants the original borrowers named in the trust deed as the trustor or in the trust deed note. The complaint also names anyone else holding a recorded interest in the secured property junior to the foreclosing mortgage holder's trust deed lien.

litigation guarantee
A title insurance policy which lists all parties with a recorded interest in a property and their addresses of record, ensuring that all persons with a recorded interest in a property are named and served in litigation.

The mortgage holder foreclosing judicially needs to obtain a **litigation guarantee** of title insurance. The *litigation guarantee* lists all parties with a recorded interest in the property and their addresses of record. The guarantee

1 Calif. Code of Civil Procedure §726
2 CCP §725a
3 Calif. Civil Code §2924
4 CCP §580d

further ensures that persons with a recorded junior interest in the property are named and served. Thus, their interest is also eliminated from title by the judicial foreclosure sale.

lis pendens
A notice recorded for the purpose of warning all persons that the title or right to possession of the described real property is in litigation.

At the time the lawsuit is filed, the foreclosing mortgage holder records a **Notice of Pending Action** against the secured property, also called a **lis pendens**.

The *lis pendens* places a cloud on the title of the secured property, giving notice of the judicial foreclosure action and subjecting later acquired interests to the results of the litigation.

The foreclosure decree

Until the court enters a judgment ordering the sale of the secured property, called a **foreclosure decree**, the borrower has the right to bring the delinquencies current. A foreclosure decree ends the *reinstatement period*. [See Chapter 69]

foreclosure decree
A court judgment ordering the sale of mortgaged property.

A *foreclosure decree* orders the sale of the real estate to satisfy:

- the outstanding debt; and
- cover foreclosure sale expenses incurred by the mortgage holder.[5]

The foreclosure decree also states whether the borrower will be held personally liable for any deficiency in the property's **fair market value (FMV)** to satisfy the debt owed.[6] FMV is never determined by the amount of the high bid at the judicial foreclosure sale.

Notice of Levy

A judicial foreclosure sale is conducted by a court-appointed receiver or sheriff, called a **levying officer**.

levying officer
A court-appointed receiver or sheriff who conducts a judicial foreclosure sale.

After the judicial foreclosure sale is ordered by the court, the foreclosing mortgage holder is issued a writ of sale by the court clerk. The *writ of sale* authorizes the receiver or sheriff to record a notice of levy. Both describe the property to be sold and state the levy is against the security interest the mortgage holder holds in title to the property under its trust deed lien.[7]

The receiver or sheriff who conducts the sale records the writ of sale and the notice of levy in the county where the property is located. The receiver or sheriff also mails the writ of sale and the notice of levy to the owner and any occupant of the property.[8]

The notice of judicial sale

Similar to the notice of trustee's sale used in a nonjudicial foreclosure, the receiver's or sheriff's **notice of sale** states the necessary details of the auction, such as the:

- date;
- time; and

5 CCP § 726(a), (b)
6 CCP §726(b)
7 CCP §712.010
8 CCP §700.010

- location of the sale.[1]

When a deficiency judgment is sought by the foreclosing mortgage holder, the notice of judicial sale also states:

- the property is being sold subject to the borrower's right of redemption; and
- the amount of the secured debt, plus accrued interest and foreclosure costs.[2]

If a *money judgment* for any deficiency is prohibited, as occurs with a *nonrecourse debt*, the receiver or sheriff waits at least 120 days after service of the notice of levy before proceeding to notice the judicial sale.[3]

However, if the mortgage holder seeks a deficiency judgment, no waiting period applies before noticing the sale. The receiver or sheriff may notice the judicial sale immediately after the decree is issued.[4]

At least 20 days before the sale, the notice of judicial sale is:

- served on the borrower personally or by mail;[5]
- mailed to any person who has recorded a request for a notice of judicial sale;[6]
- posted in a public place in the city or judicial district where the property is located, and on the property itself; and
- published weekly in a local newspaper of general circulation.[7]

Highest bidder acquires the property

The public sale held by a court-appointed receiver or sheriff is conducted as an auction. The property is sold to the highest bidder.[8]

Payment at the public sale is made in cash or by certified check at the time of the sale. The foreclosing mortgage holder is entitled to a credit bid up to the full amount of the debt owed. However, amounts over $5,000 permit a credit transaction.[9]

If the successful bidder fails to pay the amount bid, the receiver may sell the property to the highest bidder at a subsequent sale. The defaulting bidder is liable for interest, costs and legal fees for their failure to pay their bid.[10]

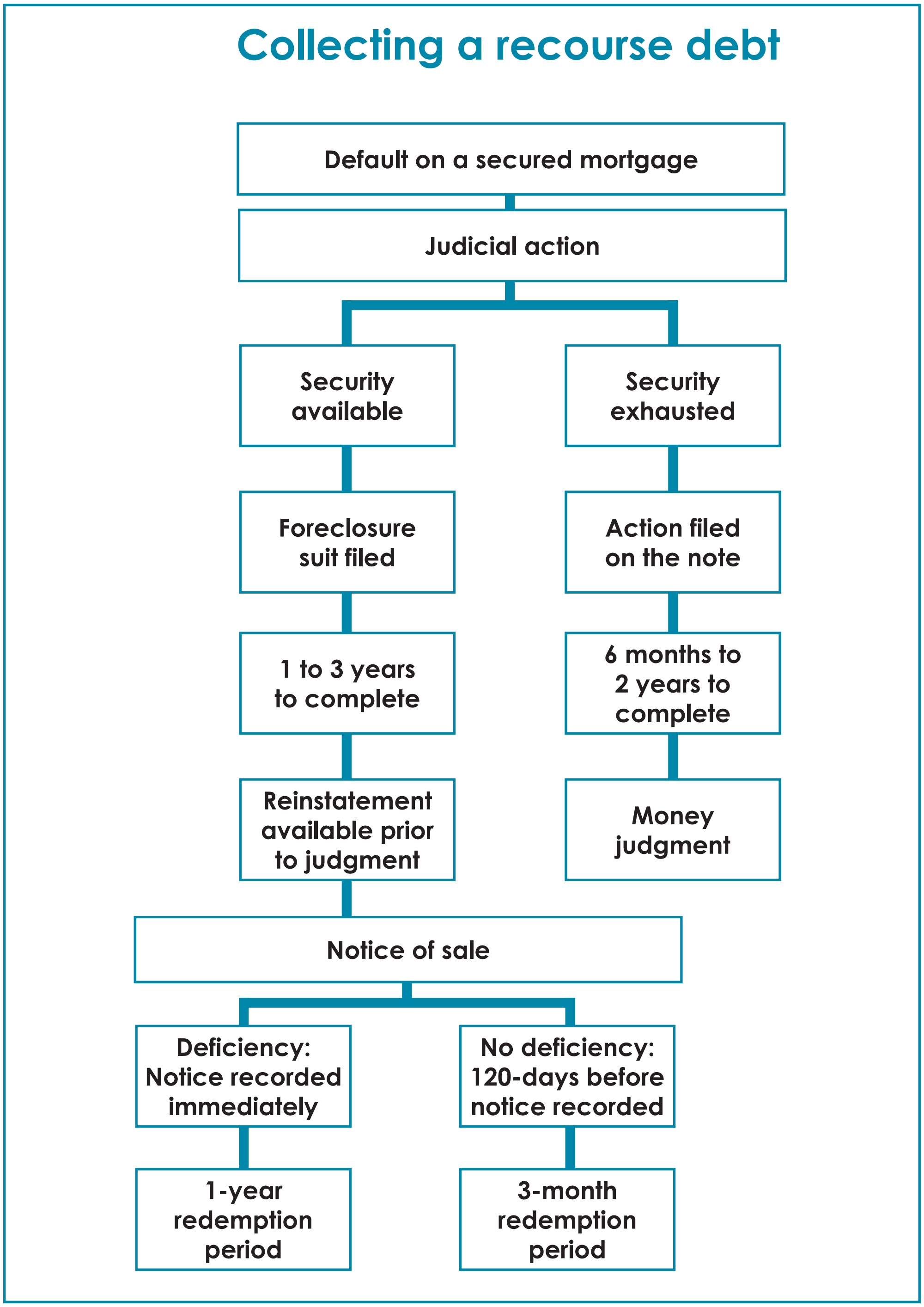
The foreclosing mortgage holder is often the highest — or only — bidder at a judicial sale. When intending to seek a deficiency judgment, the mortgage holder needs to **bid no less** than an amount it believes the court will set as the *FMV* of the property. Any successful bids for less than the property's FMV on the date of the sale will generate an uncollectible loss on the mortgage for the mortgage holder.[11]

---

1 CCP §701.540(a)
2 CCP §729.010(b)(1)
3 CCP §701.545
4 CCP §729.010(b)(2), (3)
5 CCP §701.540(c)
6 CCP §701.550(a)
7 CCP §701.540(g)
8 CCP §701.570
9 CCP §701.590(a), (c)
10 CCP §701.600
11 Luther, *supra*

Figure 1

Collecting a recourse debt



Judicial sale completed

A **certificate of sale** is issued to the successful bidder on the completion of a judicial sale.

Although the bidder purchased the property at the public auction, they will not become the owner of the property or be able to take possession of it until the applicable **redemption period** expires.[12] [See Chapter 69]

The *certificate of sale* reflects the owner's continuing right to redeem the property and avoid losing it to the highest bidder.[13]

certificate of sale
A certificate issued to the successful bidder on the completion of a judicial sale of a property.

12 CCP §729.090
13 CCP §729.020

Redemption follows foreclosure

On a judicial foreclosure, if a trust deed secures a mortgage holder's purchase-assist mortgage on a buyer-occupied, one-to-four unit residence, or a seller carryback note as a lien solely on the property sold no matter its use, the property owner:

- is not liable for any deficiency in the property value to fully satisfy the debt;[1] and
- has **three months** after the judicial sale to redeem the property by paying off the entire debt and costs.[2]

However, if the owner is liable on a recourse debt for a deficiency in the property's value, the owner has up to **one year** after the judicial sale to redeem the property.[3]

The property can only be redeemed by the owner or the owner's **successor-in-interest** since all junior lienholders are wiped out by the judicial foreclosure sale.

Successors-in-interest to the owner are lienholders or buyers who acquire the owner's interest in the property by deed prior to the judicial foreclosure sale.[4]

The **redemption price** for the owner (or successor) to recover the property sold at a judicial foreclosure sale is the total of:

- the price paid for the property by the highest bid at the judicial foreclosure sale (even if it is less than the property's FMV on that date);
- taxes, assessments, insurance premiums, upkeep, repair or improvements to the property paid by the successful bidder; and
- interest on the above amounts at the legal rate on money judgments (10%) from the date of the payments through the date the redemption amount is tendered in full.[5]

On redemption, the owner (or successor) is entitled to:

- an offset for any net rents collected by the mortgage holder under an *assignment of rents provision* in the trust deed; and
- an offset for the rental value of the premises for any period of time the successful bidder occupied the property following the sale.[6]

If the property is not redeemed by the owner or successor within the redemption period, the sale is final.[7]

1 CCP §580b
2 CCP §729.030
3 CCP §729.030
4 CCP §729.020
5 CCP §729.060
6 CCP §§729.060, 729.090
7 CCP §729.080

Obtaining a deficiency judgment

The remaining balance owed on a note may be greater than the *fair price* of the mortgage holder's security interest in the real estate. The spread when the fair price is lower than the balance due is the *deficiency* in the value of the property to cover the debt.

A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by anti-deficiency statutes. The mortgage holder will be awarded a money judgment for any deficiency in value at a hearing following the foreclosure sale. At the **fair value hearing**, noticed within three months after the foreclosure sale, the amount of the deficiency is set by the court.[8]

fair value hearing
The court proceeding at which a money judgment is awarded for any deficiency in the secured property's fair market value (FMV) at the time of the judicial foreclosure sale to fully satisfy all debt obligations owed the mortgage holder.

The amount awarded as a deficiency judgment is based on the debt owed on the date of the judicial foreclosure sale, and the *greater* of:

- the FMV of the property on the date of the foreclosure sale, minus any amounts owed on liens senior to the trust deed being foreclosed, the result setting the *fair price* of the mortgage holder's security interest; or
- the amount bid for the property at the judicial foreclosure sale.[9]

The mortgage holder is awarded a money judgment for the portion of the debt not covered by the fair price of the mortgage holder's secured position on title, or the price bid at the sale if it is higher.

The mortgage holder and borrower present evidence at the fair value hearing to establish the property's FMV on the date of the foreclosure sale. The court may appoint an appraiser, called a **probate referee**, to advise the court on the property's FMV.[10]

probate referee
An appraiser appointed by the court in a judicial foreclosure action to advise the court on a property's fair market value (FMV) on the date of the judicial foreclosure sale.

8 CCP §§580a, 726(b)
9 CCP §580a
10 CCP §§580a, 726(b)

Chapter 70 Summary

Judicial foreclosure is the court-ordered sale by public auction of the secured property. A judicial foreclosure is the only foreclosure method which allows a mortgage holder holding a recourse debt to obtain a money judgment against the borrower for any deficiency in value of the secured property to satisfy the debt.

The first step in a judicial foreclosure is filing a complaint in the Superior Court of the county where the property is located. At the time the lawsuit is filed, the foreclosing mortgage holder records a Notice of Pending Action against the secured property, also called a lis pendens, to cloud title of the secured property.

Until a foreclosure decree ordering the sale is issued by the court, the borrower has the right to reinstate the mortgage by bringing any delinquencies in the note and trust deed current.

If the borrower does not reinstate the mortgage, the court will then appoint a sheriff to conduct the sale by recording a writ of sale and notice of levy.

At least 20 days before the sale, the notice of judicial sale is:

- served on the borrower personally or by mail;
- mailed to any person who has recorded a request for a notice of judicial sale;
- posted in a public place in the city or judicial district where the property is located, and on the property itself; and
- published weekly in a local newspaper of general circulation.

The sheriff's sale is conducted as a public auction and the property is sold to the highest bidder. A certificate of sale is issued to the successful bidder on the completion of the judicial sale.

The successful bidder will not become the owner of the property until the redemption period expires. The owner can redeem the debt by paying the redemption price.

A money judgment for the deficiency in the property value to fully satisfy the debt is available to the mortgage holder if not barred by anti-deficiency statutes. The mortgage holder is awarded a money judgment at a fair value hearing following the foreclosure sale.

Chapter 70 Key Terms

certificate of sale .... **pg. 463**
fair value hearing .... **pg. 465**
foreclosure decree .... **pg. 461**
judicial foreclosure .... **pg. 460**
levying officer .... **pg. 461**
lis pendens .... **pg. 461**
litigation guarantee .... **pg. 460**
money judgment .... **pg. 460**
nonjudicial foreclosure .... **pg. 460**
probate referee .... **pg. 465**
recourse mortgage .... **pg. 460**

Quiz 13 Covering Chapters 68-72 is located on page 618.

Chapter 71

The homeowner is covered: an anti-deficiency primer

Learning Objectives

After reading this chapter, you will be able to:

- apply anti-deficiency rules available to a buyer to avoid mortgage holder claims of personal liability for payment of nonrecourse mortgage obligations;
- advise homeowners on California's anti-deficiency protections available to them on trust deed notes, refinancing, mortgage modifications and short sales.

Key Terms

anti-deficiency
purchase-money debt
short pay-off

For a further study of this discussion, see Chapter 45 of Real Estate Finance.

Protected: nonrecourse mortgage debt

Mortgage debt under California's **anti-deficiency** statutes is broken into two types of obligations. All mortgage debt is categorized by responsibility for payment as either:

- **recourse**; or
- **nonrecourse**. [See Chapter 69 and 70]

Nonrecourse debt is created by statute covering mortgages in two sets of facts:

- **purchase-money debt** of any priority on title (first, second or even third trust deed), is a mortgage which funded the purchase or construction of a homebuyer's one-to-four unit owner-occupied residence; or

anti-deficiency
California legislation limiting a mortgage holder's ability to recover losses on a default when the mortgaged property's value is insufficient to satisfy the mortgage debt.

purchase-money debt
A mortgage which funds the purchase or construction of a one-to-four unit owner-occupied residence, also called a nonrecourse debt.

- **seller financing**, also called a *credit sale*, *installment sale* or *carryback paper,* on the sale of any type of real estate when the debt is secured solely by the property sold.[1]

A mortgage holder holding a nonrecourse mortgage may not pursue the homeowner personally to collect for a deficiency in the secured property's value to fully pay off the nonrecourse debt following any type of foreclosure, **judicial** or **nonjudicial**. [See Chapter 69 and 70]

Recourse debt is any mortgage other than mortgages classified as nonrecourse debt. A mortgage holder may only pursue a homeowner for a loss on a recourse mortgage due to a deficiency in the price of the secured property through *judicial foreclosure*, and then only if:

- the court-appraised value of the property at the time of the judicial foreclosure sale is less than the debt; and
- the bid is for less than the debt owed.[2]

Refinanced purchase-money debt: recourse or not?

Refinanced purchase-money debt only retains its purchase-money nonrecourse status if:

- the mortgage holder of the original purchase-money debt is the refinancing mortgage holder;[3]
- the refinanced debt is substantially the same debt as the original purchase-money debt;[4] and
- the refinanced debt is secured by the same property as the original purchase-money debt.[5]

In absence of any of the three conditions, the refinanced debt is considered *recourse debt* subject to a mortgage holder's money judgment for any deficiency in the value at the time of the judicial foreclosure sale.

What about mortgage modifications?

The same logic is used when considering whether the modification of a purchase-money mortgage retains its nonrecourse status. If the modified mortgage is secured by the same property as the original purchase-money mortgage, modification of payments, interest rates or due dates do not change the purchase-money status of the modified mortgage.[6]

The extension of nonrecourse status to the mortgage holder's continuation of the same debt under different terms for repayment is important. Taxwise, nonrecourse status for a mortgage means any debt forgiven on the modification is exempt from taxation as cancellation of debt income.

Additionally, a mortgage holder may not require a homeowner to *waive* their anti-deficiency protection as a condition of granting a mortgage

1 Calif. Code of Civil Procedure §580b
2 CCP §580a
3 **Union Bank** v. **Wendland** (1976) 54 CA3d 393
4 **DeBerard Properties, Ltd.** v. **Lim** (1999) 20 C4th 649
5 **Goodyear** v. **Mack** (1984) 159 CA3d 654
6 DeBerard, *supra*

modification when the mortgage remains secured by the same property. The result would simply be a magic trick performed by the mortgage holder to flip nonrecourse into recourse status on a default — an unenforceable departure from the legislative intent of anti-deficiency statutes.[7]

Special rules for short sales

Anti-deficiency protection has also been extended to homeowners who negotiate **short payoffs (short sales)** with their mortgage holder*s* and close a short sale to dispose of their homes.

Regardless of the recourse or nonrecourse status of the mortgage, a mortgage holder who agrees to accept a *shortpay* from an owner-occupant on the sale of a one-to-four unit residential property is barred from seeking a money judgment for any loss incurred on the short sale.[8]

short payoff
A sale in which the lender accepts the net proceeds at closing in full satisfaction of a greater amount of mortgage debt.

7 **Palm** v. **Schilling** (1988) 199 CA3d 63
8 CCP §580e

Chapter 71 Summary

There are two kinds of mortgage debt established by California's anti-deficiency statutes: nonrecourse or recourse debt.

Nonrecourse debt is:

- purchase-money debt of any priority which funded the purchase or construction of a homebuyer's one-to-four unit owner-occupied residence; or
- seller carryback paper when the debt is secured solely by the property sold.

A mortgage holder holding a nonrecourse debt may not pursue the homeowner for a deficiency in the secured property's value following a judicial or nonjudicial foreclosure, unless the owner maliciously injures the property causing its value to drop.

Refinanced purchase-money debt only retains its purchase-money nonrecourse status if:

- the mortgage holder of the original purchase-money debt is the refinancing mortgage holder;
- the refinanced debt is substantially the same debt as the original purchase-money debt; and
- the refinanced debt is secured by the same property as the original purchase-money debt.

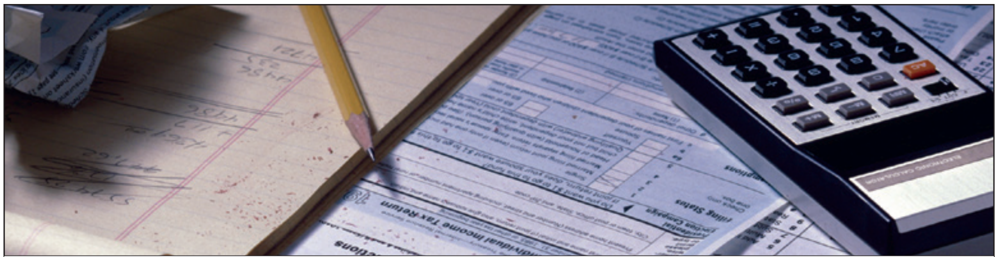
If a modified mortgage is secured by the same property as the original purchase-money mortgage, modification of payments, interest rates or due dates do not change the purchase-money status of the modified mortgage.

Regardless of the recourse or nonrecourse status of the mortgage, a mortgage holder who agrees to accept a short payoff from an owner-occupant of a one-to-four unit residential property is barred from seeking a money judgment against the owner for any loss incurred on the short sale.

Chapter 71 Key Terms

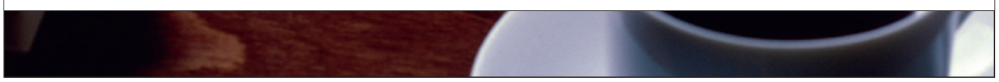
anti-deficiency .... **pg. 467**
purchase-money debt .... **pg. 468**
short pay-off .... **pg. 469**

Quiz 13 Covering Chapters 68-72 is located on page 618.



Chapter 72

Home mortgage interest deductions



Learning Objectives

After reading this chapter, you will be able to:

- understand the government policies encouraging tenants to become homeowners through the mortgage interest tax deduction (MID);
- distinguish when interest paid on a home equity mortgage secured by a principal or second residence is tax deductible;
- advise buyers on the ceiling thresholds for mortgage interest deductions; and
- determine a buyer's income tax reduction due to interest paid on mortgages for the purchase or improvement of a principal residence or second home by use of a tax analysis form.

Key Terms

adjusted gross income (AGI)	**mortgage interest deduction (MID)**
fair market value (FMV)	**points**
home equity mortgage	**principal residence**
itemized deductions	**qualified interest**
	second home

For a further discussion of this topic, see Chapter 1 and 2 of Tax Benefits of Ownership.

Two residences, two deductions

The federal government has a long-standing policy of encouraging residential tenants to become homeowners. The incentive provided by the government to individual tenants comes in the form of a reduction in the income taxes they pay. To qualify, they need to take out a mortgage to **finance the purchase** of a residence or a vacation home.

For a residential tenant considering their income taxes, the monthly payment on a purchase-assist home mortgage is not just a substitute for their monthly rent payment — it also reduces their combined state and federal income taxes.

A buyer's agent representing prospective buyers in their purchase of a single family residence (SFR) needs to be able to intelligently discuss this tax reduction incentive. With knowledge about allowable ownership deductions and tax bracket rates, they will be better able to persuade tenants to buy based on the full range of financial benefits of homeownership.

The MID deduction rule

home equity mortgage
A junior mortgage encumbering the value in a home remaining after deducting the principal on the senior mortgage from the market value of the home.

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.

principal residence
The residential property where the homeowner resides a majority of the year.

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.

Two categories of mortgages exist to control the deduction of interest paid on any mortgages secured by the principal residence or second home, which include:

- interest on the balances of *purchase or improvement mortgages* up to a combined principal amount of $750,000; and
- interest on all other mortgage amounts up to an additional $100,000 in principal, called **home equity mortgages**.

As a tax loophole for personal use expenditures, the home **mortgage interest deduction (MID)** rule for income tax reporting allows mortgaged homeowners to deduct from their adjusted gross income (AGI) the interest paid on first and second homes to reduce their taxable income. The mortgage interest is reported as an **itemized deduction**, if:

- the mortgages funded the **purchase price** or paid for the **cost of improvements** for the owner's principal residence or second home; and
- the mortgages are secured by either the owner's **principal residence** or **second home**.[1]

Without the MID rule, interest paid on a mortgage which funded the purchase or improvement of a principal residence or second home is not deductible.

Also, interest paid on *home equity mortgages* secured by the property owner's principal residence or second home is deductible when the funds are used for the purchase, construction or substantial improvement of the property.

The mortgage interest deductions for the first and second home reduce the property owner's **taxable income**, and thus reduces the amount of tax they will pay. As an *itemized deduction,* the accrued interest paid is subtracted from the owner's AGI under both the *standard income tax (SIT)* and the *alternative minimum tax (AMT)* reporting rules. In contrast, the other income tax loophole for real estate property tax deductions on the first and second homes applies only to reduce the owner's SIT, not their AMT.

1 Internal Revenue Code §163(h)

INDIVIDUAL TAX ANALYSIS (INTAX)

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

NOTE: This form is used by an agent when negotiating a sale or partial §1031 transaction for a client, to prepare an estimate for review and provide advice on any income tax liability generated by the proposed transaction.

Date: ____________, 20____
Client: ____________
Prepared by: ____________

Items	Standard Income Tax (SIT)	Alternative Minimum Tax (AMT)
1. ADJUSTED GROSS INCOME (AGI):		
1.1 Salary/professional fees/wages . . . .(+) $____		(+) $____
1.2 Trade or business income/loss . . . . (+/-) $____		(+/-) $____
1.3 Sale of business property profit/loss . . . . (+/-) $____		(+/-) $____
1.4 Rental operating income and profit . . . . (+) $____		(+) $____
1.5 Business related rental operating loss . . . . (-) $____		(-) $____
1.6 Loss spillover of rental sales . . . .(-) $____		(-) $____
1.7 Investment category income and profits . . . .(+) $____		(+) $____
1.8 Investment category capital losses (up to $3,000) . (-) $____		(-) $____
1.9 Retirement, pension and annuity plans. . . . . (-) $____		(-) $____
1.10 **ADJUSTED GROSS INCOME** . . . . $____		$____
2. REAL ESTATE RELATED DEDUCTIONS:		
2.1 First/second home interest ($1,100,000 loan cap) . (-) $____		(-) $ NONE
2.2 Property taxes on residences. . . . .(-) $____		____
2.3 $25,000 rental loss deduction. . . . .(-) $____		(-) $____
2.4 **TOTAL REAL ESTATE RELATED DEDUCTIONS**. . . . . .(-)$____		(-) $____
3. OTHER DEDUCTIONS AND EXEMPTIONS:		
3.1 Medical and dental. . . . .(-) $____		(-) $ NONE
3.2 State income taxes . . . . (-) $____		____
3.3 Other deductions (charitable contributions, etc.) . . .(-) $____		(-) $ NONE
3.4 Personal exemption . . . .(-) $ NONE		____
3.5 AMT exemption . . . . ____		(-) $____
3.6 **TOTAL OTHER DEDUCTIONS AND EXEMPTIONS** . . . (-)$____		(-) $____
4. TAXABLE INCOME (line 1.10 minus lines 2.4 and 3.6) . . . $____		$____
5. TAX BATCHING:		
5.1 Net profits and short term losses . . . . (+/-) $____		$____
5.2 Ordinary income (line 4 minus line 5.1 but not less than zero) . . . . $____		$____
(a) Tax: See SIT and AMT tax bracket rates for line 5.2. . . . . $____		$____
5.3 Unrecaptured depreciation gain . . . . $____		
(b) Tax: 15% in lowest bracket; 25% on balance. . . . . $____		$____
5.4 Long-term capital gain . . . .$____		
(c) Tax: 5% in lowest bracket; 15% on balance. . . . . $____		$____
(Tax: 5.2, 5.3 and 5.4 combined are not to exceed line 4)		
6. INCOME TAX - the **greater** amount of . . . (lines a, b, or c) $____		or (lines a, b, or c) $____

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Form 351

Individual Tax Analysis (INTAX)

Purchase/ improvement mortgages

Interest paid on mortgages and carryback credit arrangements originated to purchase or substantially improve an owner's first or second home is deductible on combined principal balances of up to $750,000 for an individual and for couples filing a joint return if the mortgage is secured by either home.

Thus, if the mortgage funds are used to acquire, construct, or further improve a principal residence or *second home*, and the mortgage funds collectively exceed $750,000, only the interest paid on $750,000 of the mortgage balances is deductible under this part of the MID rule.

second home
An individual's alternative residence where they do not reside a majority of the year.

To qualify home improvement mortgages for interest deductions, the new improvements need to be **substantial**. Improvements are *substantial* if they:

- add to the property's market value;
- prolong the property's useful life; or
- adapt the property to residential use.

Mortgage funds spent on repairing and maintaining property to keep it in good condition and maintain its value do not qualify as funding for substantial improvements.[1]

Further additional deductions are permitted for interest paid on the excess mortgage amounts, up to an additional $100,000. Interest on this additional principal qualifies for deduction as interest paid on a *home equity mortgage*.

Refinancing limitations

If an owner refinances a purchase/improvement mortgage, the portion of the refinancing funds used to finance the payoff qualifies as a purchase/improvement mortgage for future interest deductions. However, interest may only be written off as a purchase/improvement mortgage on the amount of refinancing funds used to pay off the **principal balance** on the existing purchase/improvement mortgage, unless the excess monies funded the further improvement of the home.

For example, consider an owner who borrows $200,000 to fund the purchase of their principal residence. The mortgage balance is paid down to $180,000 and the owner refinances the residence, paying off the original purchase/improvement mortgage. However, the new mortgage is for a greater principal amount than the payoff demanded on the original mortgage.

In this scenario, interest on only $180,000 of the refinance mortgage is deductible as interest paid on a purchase or improvement mortgage, unless:

- the excess funds generated by the refinance are used to improve the residence; or
- the excess mortgage amount qualifies as a home equity mortgage under its separate ceiling of $100,000 in principal.

$100,000 home equity mortgages

Interest on mortgage amounts secured by the first or second home may not qualify for the purchase/improvement home mortgage interest deduction. This will be due either to a different use of the mortgage proceeds, or the $750,000 mortgage limitation.

The interest on qualifying home equity mortgages is deductible by a couple as interest paid on amounts up to $100,000 in principal.

1 IRC §163; Temporary Revenue Regulations §1.163-8T

For married persons filing separately, the cap for the principal amount of equity mortgages on which interest may be deducted is limited to $50,000, half of the joint $100,000 ceiling.[2]

Home equity mortgages are typically junior encumbrances, but also include excess proceeds from a refinance which:

- do not qualify as purchase/improvement funds; or
- exceed the $750,000 ceiling.

The proceeds from home equity mortgages may be used for any purpose, including personal uses unrelated to the property.

Property value ceiling

Interest paid on any portion of a mortgage balance which exceeds the **fair market value (FMV)** of a residence is not deductible. In practice, the *FMV* rule applies almost exclusively to home equity mortgages. This includes refinancing proceeds of a greater amount than the balance paid off on the purchase/improvement mortgage that was refinanced.[3]

fair market value (FMV)
The price a reasonable, unpressured buyer would pay for property on the open market.

The FMV of each residence is presumed to be the original amount of the purchase price, plus any improvement costs. Thus, any future drop in property value below the balance remaining on a purchase-assist mortgage does not affect the interest deduction.[4]

Qualifying the principal residence and second home

To qualify for the MID, the mortgages need to be secured by the **principal residence** or **second home**.

A *principal residence* is an individual's home where the homeowner's immediate family resides a majority of the year, also called the **primary residence** or **first home**. The principal residence is close to the homeowner's place of employment and banks which handle the homeowner's accounts, and its address is used for tax returns.[5]

A *second home* is any residence selected by the owner from year to year, including:

- real estate;
- mobile homes;
- recreational vehicles; and
- boats.

If the second home is **rented out** for portions of the year, the interest qualifies for the home mortgage interest deduction if the owner occupies the property for more than 14 days or 10% of the number of days the residence is rented, whichever number is greater.[6]

2 IRC §163(h)(3)(C)(ii)
3 IRC §163(h)(3)(C)(i)
4 Temp. Rev. Regs. §1.163-10T
5 IRC §163(h)(4)(A)(i)(I)
6 IRC §280A(d)(1)

If the owner does not rent out their second home at any time during the year, the property qualifies for the home mortgage interest deduction whether or not the owner occupies it.[1]

Taking the deductions

Interest deductions on home mortgages are only allowed for interest which has **accrued and been paid**, called **qualified interest**.[2]

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 exist on the total amount of all deductions the homeowner may claim. Conversely, business, rental or investment interest are adjustments that reduce 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, by *itemized deduction phaseout*, and on any tax credits available to the owner.[3]

The points of interest

Points paid to a lender to originate a mortgage are considered *prepaid interest* for both tax and financial purposes. One point equals 1% of the mortgage amount. Points essentially buy down the mortgage's *par rate* in the market to the note rate, fixed for the life of the mortgage. Alternatively, no points means a higher *par rate of interest* will be the nominal note rate.

adjusted gross income (AGI)
The total of the taxpayer's reportable income and losses from all three income categories.

As prepaid interest, general tax rules limit its deduction to an annual fraction of the points paid as the interest accrues annually over the life of the mortgage. Thus, each year the owner may deduct that year's accrued portion of the points from AGI to reduce the owner's income tax. When the mortgage is fully prepaid, any remaining unaccrued prepaid interest is then deducted. However, homeowners have another specific loophole to this prepaid interest rule.

points
A fee charged by a lender as prepaid interest which in turn reduces the note rate on the mortgage, with a point equaling 1% of the amount of the mortgage.

As an exception to the life-of-mortgage accrual reporting, and thus a loophole to avoid taxes, the entire amount of the points paid on mortgages that assist in the purchase or improvement of an individual's principal residence is allowed as a *personal deduction* in the year the mortgage originated.

The immediate deduction for all points paid in connection with these homeowner mortgages is another government subsidy, part of the overall policy to encourage homeownership in lieu of renting.[4]

The points deduction exception for a principal residence does not include points paid on mortgages secured by a second homes such as the ownership of a vacation residence.

1 IRC §163(h)(4)(A)(iii)
2 IRC §163(h)(3)(A)
3 IRC §163(a), (h)(2)(A)
4 IRC §461(g)(2)

Further, the deductibility of the mortgage points in the year paid, instead of over the life of the mortgage, depends on who paid the points — the buyer, the seller or the lender.

Deductible points

To deduct the points in the year they are paid, the purchase-assist or improvement mortgage needs to be **secured by** a buyer's or homeowner's principal residence.

Likewise, points paid by a buyer to finance the purchase or improvement of a second residence need to be deducted as they accrue over the life of the mortgage. For example, points paid on a purchase-assist mortgage for a vacation home, payable monthly with a 30-year amortization, will be deductible 1/360th for each month of the tax year as the prepaid interest accrues.

Mortgage costs incurred and paid by the owner to originate a purchase or improvement on any type of real estate are **capitalized** by the owner. Thus, mortgage costs are added to, and become part of, the owner's **cost basis** in the property and are not deducted as interest

Mortgage charges are non-recurring costs incurred to acquire or improve property, not daily recurring interest which may be deducted as it accrues and is paid.[5]

Capitalized costs for originating a mortgage on property other than the first and second home are partly recovered by annual depreciation deductions, and fully recovered when the property is sold.

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5 **Lovejoy** v. **Commissioner of Internal Revenue Service** (1930) 18 BTA 1179

Chapter 72 Summary

The federal government encourages residential tenants to become homeowners by allowing them to reduce their income taxes if they finance the purchase of a residence or vacation home. Under the mortgage interest deduction (MID) tax scheme, the interest accrued and paid on mortgages funding the purchase price or cost of improvements for a principal residence or second home is deductible from the homeowner's AGI as an itemized deduction which reduces the owner's taxable income and in turn their income tax.

Interest may be deducted from AGI to lower taxable income on:

- purchase or improvement mortgages up to $750,000; and
- home equity mortgages up to $100,000.

Interest paid on home equity mortgages secured by a principal or second residence is also deductible.

When an owner refinances a purchase or improvement mortgage, interest may only be written off on the amount of refinancing funds used to pay off the principal balance of the original mortgage.

Interest paid on any portion of a mortgage balance which exceeds the fair market value of a residence is not deductible. In practice, the FMV rule applies almost exclusively to home equity mortgages.

Points paid to a lender to originate a mortgage are subject to different deductibility criteria than standard interest. As prepaid interest and under the general rule of deductibility, only the fraction of the points paid which accrues annually over the life of the mortgage may be deducted against that year's income. A specific exception exists for points on mortgages for principal residences which may be fully deducted in the year paid.

Chapter 72 Key Terms

Quiz 13 Covering Chapters 68-72 is located on page 618.

Chapter 73

Property management licensing

Learning Objectives

After reading this chapter, you will be able to:

- identify conduct requiring licensing for property managers and their employees;
- differentiate between activities which require a license and activities which do not require a license; and
- distinguish state-mandated licensing from third-party marketing designations.

Key Terms

certified CID manager **contingency fee**

For a more intensive study of this content, see Chapter 7 of Real Estate Property Management.

When is a DRE license required?

Consider an individual who owns and operates income-producing real estate, called a **landlord**. As the owner-operator, they:

- locate and qualify tenants;
- prepare and sign occupancy agreements;
- deliver possession of the premises;
- contract for property maintenance;
- collect rent;
- pay expenses and mortgages; and
- serve any notices and initiate any *unlawful detainer (UD)* actions to evict tenants.

Does the owner-operator need a Department of Real Estate (DRE) broker license to perform these activities?

No! The owner of income-producing real estate does not need a real estate broker license to operate as a principal. The owner-operator is not acting on behalf of someone else as their agent when managing their own property.[1]

Editor's note — Here, the generic term "agent" refers to anyone who acts on behalf of another.

Hiring of another

On the other hand, if the owner-operator decides to hire an individual to take over the general management of the apartment complex, the individual employed to act as property manager under normal business circumstances is to be licensed by the DRE as a California real estate broker.

A broker has the authority to act in the capacity of a property manager on behalf of the landlord by virtue of their DRE license alone. There is no special "property management" license or endorsement required under California law, other than a DRE broker license.

An individual or corporation is to hold a broker license if they perform or offer to perform any of the following services on behalf of another in exchange for a fee:

- listing real estate for rent or lease;
- marketing the property to locate prospective tenants;
- listing prospective tenants for the rental or lease of real estate;
- locating property to rent or lease;
- selling, buying or exchanging existing leasehold interests in real estate;
- managing income-producing properties; or
- collecting rents from tenants of real estate.[2]

An individual employed by a broker to perform any of the above services will also be licensed by the DRE, either as a broker or sales agent.

Unlicensed vs. licensed activities

Administrative and non-discretionary duties performed by a salaried employee of a broker (or landlord) who manages transient housing or apartment complexes are exempt from real estate licensing requirements while the employee is under the broker's supervision and control.[3]

Thus, an employee hired to assist the broker in the rental and leasing of residential complexes, other than single family units, may be either:

- licensed; or
- unlicensed.

Unlicensed performance

Unlicensed employees of a broker or landlord may perform tenant-related negotiations, such as:

- showing rental units and facilities to prospective tenants;

1 Calif. Business and Professions Code §10131(b)
2 Bus & P C §10131(b)
3 Bus & P C §10131.01(a)

- providing prospective tenants with information about rent rates and rental and lease agreement provisions;
- accepting tenant screening fees;
- accepting signed lease and rental agreements from tenants; and
- accepting rents and security deposits.[4]

Licensed performance

Licensed employees may perform any activities unlicensed employees perform. However, licensed employees are additionally able to perform activities relating to contacts with the landlord, as opposed to the tenant, about the leasing, care of the property and accounting.

Activities which licensed employees of the broker may perform include:

- landlord-related solicitations;
- entering into property management or leasing agent agreements with the landlord;
- rental or lease negotiations;
- care and maintenance of the property;
- marketing of the unit or space; and
- accounting.

Other licensing exceptions

A person is not required to have a real estate broker license when they are acting:

- as an attorney performing management as part of their legal services;[5] or
- under court appointment, such as a receiver or bankruptcy trustee.[6]

Individuals managing property without a license and without qualifying for an exemption will not be able to enforce collection of the fee they were to receive.[7]

Resident managers

Apartment complexes with 16 or more units will have a **resident manager**.[8]

Apartment building management has special licensing rules distinguishing resident managers from nonresident property managers and their other employees.

A *resident manager* is employed by either the landlord or the broker who manages the apartment building or complex. The resident manager lives on the premises as a requirement of their employment. A resident manager does not need a real estate license to manage the apartment complex.[9]

4 Bus & P C §10131.01(a)(1)
5 Bus & P C §10133(a)(3)
6 Bus & P C §10133(a)(4)
7 Bus & P C §10137
8 25 Calif. Code of Regulations §42
9 Bus & P C §10131.01(a)(1)

Contingent fees and bonus awards

If a landlord is a corporation, limited liability company (LLC) or partnership, any officer of the entity may manage the entity's property without a broker license. However, the unlicensed officer may not receive any **contingency fees** or extra compensation based on achievement, production or occupancy factors during their management of the property. They are to be salaried or on wages. The same rules apply to resident managers.[1]

A common "licensing" misconception

A broker license gives the licensee authority to manage any property. However, the license does not automatically confer on the broker the designation of **certified common interest development (CID) manager**. It is not mandatory under state law for a broker to be "certified" to manage a common interest development, but some employers may request it.

contingency fee
An incentive bonus paid upon successfully completing or hitting certain benchmarks, or received as compensation on the occurrence of an event.

certified CID manager
A non-required professional designation certifying an individual has met legislated educational requirements specific to managing common interest developments.

The benchmark third-party professional certification is the Certified Community Association Manager. This certification is issued by the California Association of Community Managers. This designation is not an issue involving the DRE. However, the minimum educational criteria for becoming a certified CID manager are set by California law.[2]

Further, it is a widely held misconception that property managers are required to hold a **Certified Property Manager (CPM)** membership with the Institute of Real Estate Management (IREM) to perform property management activities.

The CPM designation is a non-required unofficial designation bestowed by a private non-regulatory organization. Brokers and agents may earn them by completing private coursework and submitting proof of experience in property management.

1 Bus & P C §10133(a)(1)
2 Bus & P C §§11502. 11503

Chapter 73 Summary

An individual or corporation is to hold a broker license if they perform or offer to or perform any property management services on behalf of another for a fee. An individual employed by the broker to perform activities related to contacts with the landlord is to hold a broker or sales agent license.

However, several licensing exemptions exist. A broker who manages apartment complexes or the landlord may hire unlicensed staff to perform administrative and non-discretionary duties. Resident managers, attorneys, bankruptcy trustees, and (to an extent) those who hold power of attorney are not required to be licensed.

Chapter 73 Key Terms

Quiz 14 Covering Chapters 73-78 is located on page 619.

Chapter 74

A property manager's responsibilities

Learning Objectives

After reading this chapter, you will be able to:

- recognize and act on a property manager's responsibilities; and
- implement a property manager's best practices in fulfilling their professional responsibilities.

Key Terms

goodwill
property profile
prudent investor standard
start-up fee
trust account
trust funds

For a further discussion of this topic, see Chapter 9 of Real Estate Property Management.

An evolving standard of conduct

Property management is an economically viable and personally rewarding real estate service permitted for real estate licensees. Serious brokers and agents often turn their attention from residential sales to the specialized and more disciplined industry of property management.

A broker's primary objective as a *property manager* is to:

- oversee the maintenance of rental property;
- fill vacancies with suitable tenants;
- collect rent; and
- account to the landlord.

Thus, a property manager needs to have time and experience to actively oversee and operate all rental properties entrusted to their management.

In California, an individual who acts as a property manager on behalf of another for a fee is required to hold a valid Department of Real Estate (DRE) broker license. Any licensed agent or broker associate involved acts on behalf of their broker.[1] [See Chapter 73]

Duty of care

The duty of care a property manager owes a landlord is the same duty of care a broker in real estate sales owes their sellers and buyers. As a property manager, the broker is an agent acting in capacity of a trustee on behalf of the landlord. Sales agents acting on behalf of the broker perform property management services as authorized by the broker.

A property manager's real estate license may be revoked or suspended if the property manager demonstrates negligence or incompetence in performing their management tasks. This includes any negligence in the supervision of their employees, such as the property manager's licensed employees.[2]

To be successful in the property management field, a broker is to first acquire knowledge and experience required to adequately perform their tasks.

Owners can measure how capable a broker will be at handling their properties by judging the caliber of the broker's management skills. Most owners look to hire an experienced property manager with well-earned credentials and a competent staff who will perform to the landlord's expectations.

Other indicators that a property manager can successfully handle rental property include:

trust account
An account separate and apart and physically segregated from a broker's own funds, in which the broker is required by law to deposit all funds received for clients.

- prior experience handling and reporting **trust account** activities;
- a knowledge of current programs used to record and track activity on each property managed by the property manager; and
- a competent staff to perform office and field duties and to quickly respond to both the landlord's and the tenants' needs.

Management obligations owed the landlord

A property manager's obligations to a landlord include:

- holding a broker license;
- diligently performing the duties of their employment;
- sufficient oversight of the broker's employees acting on behalf of the landlord;
- handling and accounting for all income and expenses produced by the property;
- contracting for services, repairs and maintenance on the property as authorized;
- monitoring utility services provided by the landlord;
- advertising for prospective tenants;
- showing the property and qualifying tenants;

1 Calif. Business and Professions Code §§10130, 10131(b)
2 Bus & P C §§10177(g), 10177(h)

- negotiating and executing rental and lease agreements;
- responding in a timely manner to the needs of the tenants;
- evaluating rental and lease agreements periodically;
- serving notices on tenants and filing *unlawful detainer* (UD) actions as needed;
- performing regular periodic property inspections; and
- keeping secure any personal property.

Other activities of a manager

In addition to these tasks, the property manager also needs to:

- confirm or obtain general liability and workers' compensation insurance sufficient to protect the landlord, naming the property manager as an additionally insured;
- only obligate the landlord to agreements authorized by the landlord;
- maintain the property's earning power, called **goodwill**;
- hire and fire resident managers and other on-site employees as needed;
- comply with all applicable codes affecting the property; and
- notify the landlord of any potentially *hazardous conditions* or *criminal activities* affecting the health and safety of individuals on or about the property.

prudent investor standard
A property management standard reflecting the expectations of a well-informed investor for efficient and effective management of rental income and expenses.

The prudent investor standard

A property manager has a duty to employ a higher standard of conduct regarding the operation of a property than a typical landlord might apply. This standard is called the **prudent investor standard**.

A prudent investor is a person who has the knowledge and expertise to determine the wisest conduct for reasonably managing a property. The *prudent investor standard* is the minimum level of competency which can be expected of a property manager by a landlord.

Property analysis to understand the tasks

To conduct property operations in compliance with the prudent investor standard, a property manager considers the following factors:

- the *type of the property* and its niche in the market;
- the *socioeconomic demographics* of the area surrounding the property's location;
- the *competition* currently existing in the local market;
- the current *physical condition* of the property; and
- the *existing liens* on the property.

Critical curb appeal

The current physical condition (curb appeal) of the property reflects the attitude of the ownership towards tenants. A property manager needs to analyze the repairs, maintenance, landscaping and improvements needed to improve the property's visual appearance and ambiance. Then, they can determine the amount of cost involved for the upgrade and the amount of rent increase the upgrades will bring in.

A prospective tenant's immediate concern when viewing rental property will be the lure of the landscaping, the freshness of interior and exterior paint and the overall care and tidiness of the premises. More importantly, existing tenants stay or leave based on these observances.

Title profile analysis avoids surprise

It is good practice for the property manager to run a cursory **title check** on the property they intend to manage.

A *title check*, commonly called a **property profile**, is supplied online by title companies. A property profile will confirm:

- how ownership is vested and who has authority to employ management;
- the liens on the property and their foreclosure status;
- any use restrictions affecting tenants; and
- comparable sales figures in the area.

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

Any discrepancy between information provided by the landlord and a property profile report is to be cleared with the landlord prior to taking over management of the property.

Due diligence and the paper trail

A property manager's efforts to locate tenants are documented on a **file activity sheet** maintained for each property. This paper trail is evidence the property manager has diligently pursued activities leading to the renting of the property. Keeping a file activity sheet reduces the risk of claims that the property manager failed to diligently seek tenants or operate the property.

For example, any advertisements placed by the property manager focus on and clearly identify the property to be rented. Since the advertisement identifies the property, the landlord can be properly billed for the expense of the advertisement. Whenever an advertisement is placed, a purchase order is prepared, whether or not the paperwork is given to the publisher or printer.

As in any business, a purchase order contains the dates the advertisement is to run, the advertising copy, which vendor (newspaper or printer) it was placed with and the property to be charged. This billing referencing the purchase order is a written reminder to the property manager of their activity and which landlord to charge. Computer programs for bookkeeping provide for the entry, control and printout of this data.

The goal in property management is to make a diligent effort to locate a tenant and rent the property as quickly as possible.

Failing to set or keep appointments to meet with prospective tenants is inexcusable neglect. Prospective tenants respond to an advertisement. Thus, the property manager needs to be available to show them the property, unless the property has a resident or on-site manager.

Property inspections by the manager

A property manager's frequent, well-documented inspections of property are nearly as important as their accurate accounting of income and expenses through their *trust account*. Inspections determine the:

- physical condition of the property;
- availability of habitable units or commercial space; and
- use of the leased premises by existing tenants.

There are several key moments when a property manager makes an inspection of the property:

1. *When the property manager and landlord enter into a property management agreement.*

   Any deferred maintenance or defect which might interfere with the renting of the property is to be discussed with the landlord. The property manager resolves the discrepancy by either correcting the problem or noting it is to be left "as is."

2. *When the property manager rents to a tenant.*

   A walk-through is conducted with a new tenant prior to giving them occupancy. The property's condition is noted on a condition of premises addendum form and signed by the tenant. [See **RPI** Form 560]

3. *During the term of the lease.*

   While the tenant is in possession, the property is periodically inspected by the property manager to make sure it is being properly maintained. Notes on the date, time and observations are made in the property management file. File notes are used to refresh the property manager's memory of the last inspection, order out maintenance and evidence the property manager's diligence.

4. *Two weeks prior to the tenant vacating.*

   Residential property is inspected prior to termination of possession if the tenant requests a *joint pre-expiration inspection* after receiving the mandatory landlord's notice of right to a wear and tear analysis. [See **RPI** Form 567-1]

5. *When the tenant vacates.*

   The property's condition is compared against its condition when first occupied by the tenant. Based on any differences in the property's condition, a reasonable amount can be deducted from the tenant's **security deposit** for corrective repairs. These deductions are to be documented when accounting for the return of the deposit.

6. *When the broker returns management and possession of the property back to the landlord or over to another management firm.*

   Documenting all property inspections helps avoid disputes with the landlord or tenants regarding the condition of the property when possession or management was transferred to and from the property manager.

The property's condition is noted on a form, such as a condition of property disclosure, and approved by the property manager and the landlord. The property manager keeps a copy in the property's file as part of the paper trail maintained on the property. [See **RPI** Form 304]

Inspections that coincide with key events help establish who is responsible for any deferred maintenance and upkeep, or for any damage to the property.

Periodic review of the leases

On entering into a *property management agreement*, a broker conducts a comprehensive review of all lease and rental agreement forms used by the landlord, including changes and the use of other forms proposed by the broker.

Also, the competent property manager prepares a worksheet containing the dates of lease expirations, rent adjustments, tenant sales reports, renewal or extension deadlines, and grace periods for rent payments and late charges. Computer programs have made this tracking easier.

Periodic evaluations by the property manager of existing leases and rental agreements are undertaken to minimize expenses and maximize rental income. Vacant units are evaluated to determine the type of tenant and tenancy desired (periodic versus fixed-term), how rents will be established and which units consistently under-perform.

Maintenance and repairs as a responsibility

Obtaining the *highest rents available* requires constant maintenance and repair of the property. The property manager is responsible for all the maintenance and repairs on the property while employed by the landlord. This responsibility still exists if the property manager delegates the maintenance of the units to the tenants in lease agreements.

Thus, the property manager's knowledge of the property's condition prior to entering into a property management agreement is required in order to properly ascertain what maintenance and repairs need to be made or will be deferred.

The responsibility for maintenance includes:

- determining necessary repairs and replacements;
- contracting for repairs and replacements;
- confirming completion of repairs and replacements;
- paying for completed repairs and replacements; and

- advising the landlord about the status of repairs and replacements in a monthly report.

Earnings from all sources disclosed

A property manager needs to disclose to their employing landlord any financial benefit the property manager receives from:

- maintenance or repair work done by the property manager's staff; or
- any other materials purchased or services performed.

To eliminate the risk of accepting undisclosed profits, the property manager makes a written disclosure of any ownership interests or fee arrangements they may have with vendors performing work, such as landscapers, plumbers, etc.

Any undisclosed profit received by the property manager for work performed by the property manager or others on the landlord's property is improperly received and needs to be returned to the landlord. [See Form 119 accompanying this chapter]

Additionally, the landlord can recover any other brokerage fees they have already paid when the property manager improperly or intentionally takes an undisclosed profit while acting as the landlord's agent.[3]

Goodwill is value maintained or lost

The way a property is operated develops **goodwill** with tenants. Economically, *goodwill* equates to the earning power of the property. A property manager in the ordinary course of managing property will concentrate on increasing the intangible image — goodwill — of the property.

goodwill
The intangible image or opinion held about a property which affects its earning power.

Goodwill is maintained when the property manager:

- cares for the appearance of the property;
- maintains an appropriate tenant mix (without employing prohibited discriminatory selection); and
- gives effective and timely attention to the tenants' concerns.

The manager who fails to promptly complete necessary repairs or correctly maintain the property may be impairing the property's goodwill built up with tenants and the public. Allowing the property or the tenancies to deteriorate will expose the property manager to liability for the decline in revenue.

Reserves and deposits in the trust account

To accommodate the flow of income and expenditures from the properties and monies they manage, the property manager maintains a **trust account** in their name, as trustee, at a bank or financial institution.[4]

3 **Jerry** v. **Bender** (1956) 143 CA2d 198
4 10 Calif. Code of Regulations §2830

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

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

A property manager is required to deposit all funds collected on behalf of a landlord into a *trust account* within three business days of receipt. These funds are called **trust funds**.

Trust funds collected by a property manager include:

- security deposits;
- rents;

- cash reserves; and
- start-up fees.[5]

start-up fee
A flat, one-time fee charged by a property manager for the time and effort taken to become sufficiently familiar with the operations of the property to commence management.

Generally, a property manager receives a cash deposit as a reserve balance from the landlord. The sum of money includes a **start-up fee**, a cash reserve for costs and the tenants' security deposits.

A *start-up fee* is usually a flat, one-time management fee charged by the property manager to become sufficiently familiar with the property and its operations to commence management activities.

The cash reserve is a set amount of cash the landlord agrees to maintain as a minimum balance in the broker's trust account. The cash reserve is used to pay costs incurred when costs and mortgage payments exceed income. Security deposits are additional to the client's cash reserves.

The security deposits are accounted for separately from other funds in the trust account, though this is not required. Security deposits belong to the tenant and are to be returned, less reasonable deductions, with an accounting within 21 days after a residential tenant's departure, or 30 days after a commercial tenant's departure.[6] [See Chapter 78]

Manager's trust account supervision

To avoid jeopardizing the status of the property manager's license due to a mishandling of the trust account, the property manager is to:

- deposit the funds received, whether in cash, check or other form of payment, within three business days;[7]
- keep trust fund account records for three years after the transaction;[8]
- keep a separate ledger or record of deposits and expenditures itemized by each transaction and for each landlord;[9] and
- keep accurate trust account records for all receipts and disbursements.[10]

Accounting to the landlord

Tied to the property manager's duty to properly maintain their trust account is the duty to account to the landlord.

All landlords are entitled to a statement of accounting no less than at the end of each calendar quarter (i.e., March, June, September and December).

The accounting is to include the following information:

- the name of the property manager;
- the name of the landlord;
- a description of the services rendered;
- the identification of the trust fund account credited;

5 Bus & P C §10145(a); Department of Real Estate Regulations §2832
6 Calif. Civil Code §1950.5(g)(1); 1950.7(c)(1)
7 DRE Reg. §2832
8 Bus & P C §10148
9 DRE Reg. §2831.1
10 DRE Reg. §2831

- the amount of funds collected to date;
- the amount disbursed to date;
- the amount, if any, of fees paid to field agents or leasing agents;
- the overhead costs; and
- a breakdown of the advertising costs, a copy of the advertisement, the name of the newspaper or publication and the dates the advertisement ran.

Also, the property manager needs to give a full accounting when the property management agreement expires or is terminated. Any discrepancy or failure by the property manager to properly account for the trust funds will be resolved against them and in favor of the landlord. Even if the property manager's only breach is sloppy or inaccurate accounting, they are responsible as though misappropriation and commingling occurred.

Chapter 74 Summary

A property manager employs a higher standard of conduct regarding their operation of a property than a typical landlord might. The property manager also applies this higher standard of conduct when overseeing the maintenance of rental property, filling vacancies with suitable tenants, collecting rent and accounting to the landlord.

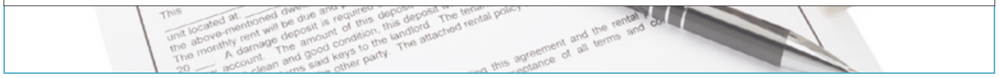
All trust accounts need to be maintained in accordance with standard accounting procedures. A property manager is to diligently manage all accounts to avoid claims of mishandling. The property manager is also responsible for providing a statement of account to the landlord.

Chapter 74 Key Terms

Quiz 14 Covering Chapters 73-78 is located on page 619.

Chapter 75

Residential rental and lease agreements



Learning Objectives

After reading this chapter, you will be able to:

- negotiate the various terms for occupancy under residential rental or lease agreements; and
- identify the features of periodic, month-to-month residential rental or lease agreements.

Key Terms

addendum	**rental market**
credit application	**waterbed addendum**

For an additional discussion of the materials presented in this chapter, see Chapter 50 of Real Estate Property Management.

A review of periodic vs. fixed-term tenancies

Residential landlords and tenants typically enter into either a **fixed-term lease agreement** or a **periodic rental agreement**. Residential periodic tenancies frequently take the form of month-to-month rental agreements.

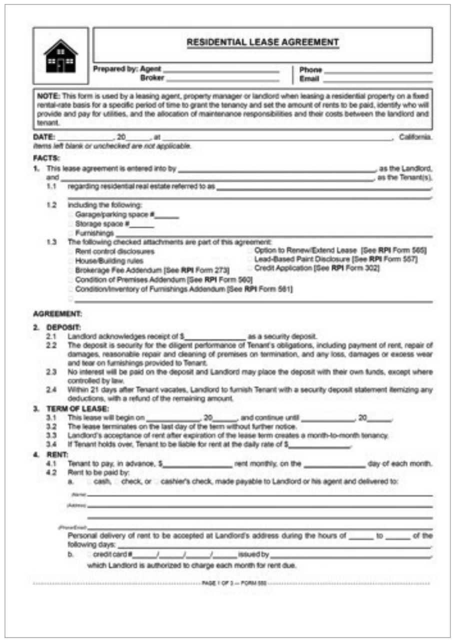
Residential rental and lease agreements both grant the tenant the right to possession. Both impose the same rights and obligations regarding maintenance of the property on the landlord and tenant. However, the tenant's expectation of continued occupancy and their obligation to pay future rent differs between a rental agreement and a lease agreement.

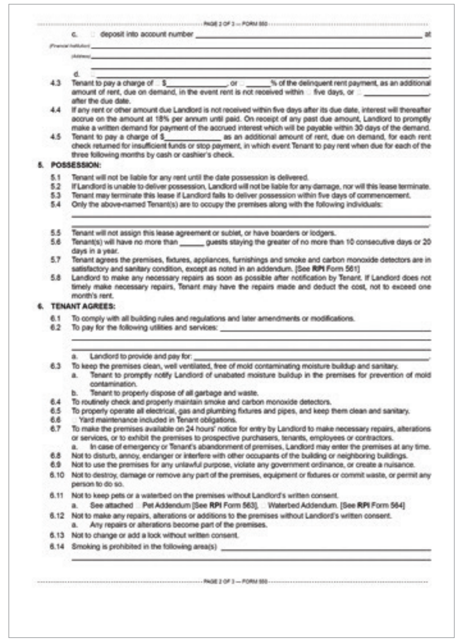
Recall that a *month-to-month rental agreement* runs for an indefinite period of time. It automatically renews monthly, and on the same terms, until modified or terminated by notice. [See **RPI** Form 551 §3]

Figure 1

Form 550

Residential Lease Agreement





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Periodic tenancies can be terminated by either the landlord or the tenant on 30 days' written notice. However, a landlord needs to give the tenant at least 60 days' written notice if the tenant's occupancy has exceeded one year.[1]

On the other hand, a *lease agreement creates* a tenancy that continues for a fixed period. At the end of the fixed-period, both the tenant's right of possession and the lease agreement expires. The terms of the lease set the expiration date, and no further notice is required. [See Figure 1, Form 550 §3]

1 Calif. Civil Code §1946

Unlike a periodic tenancy, the lease agreement does not automatically renew, unless an option to renew or extend has been written into the lease agreement and exercised.

Rental market influences

The **rental market** is the market environment in which landlords seek tenants (and vice versa). The condition of the *rental market* is determined by:

- the population of prospective tenants;
- the number of properties competing for these tenants; and
- the comparative position of the property and its amenities in relation to competing properties.

rental market
The market environment in which landlords seek tenants and tenants seek landlords for the occupancy of property. The rental market sets the amount of rent a property will command on any given day.

The *rental market* sets the amount of rent a residential landlord is able to charge for occupancy.

Generally, tenants on month-to-month rental agreements pay higher amounts of rent for a unit than do tenants with fixed lease agreements. Month-to-month tenants pay a premium for the privilege of being able to vacate the premises on 30 days' notice, without liability exposure for future rents. This privilege held by the tenant contributes to the landlord's uncertainty about their income and costs of tenant turnover.

Tenants typically pay lower rents when they enter into a lease. In stable rental markets characterized by a normal rate of turnover, the longer the lease, the lower the rent as the landlord is assured a steady income flow for the duration of the lease term.

However, rent is subject to adjustments for future price inflation, local appreciation and management operational decisions. During weak market periods of generally high vacancy rates, price-competitive landlords favor using month-to-month rental agreements rather than leases. When rents begin to rise, landlords can adjust rents quickly by serving the proper notice of a change in rental terms. [See Chapter 77]

Lease negotiations on expiration

A landlord cannot alter the terms of a lease agreement during the life of the lease without consideration and the tenant's consent.

To extend the tenant's occupancy under a soon-to-expire lease, the landlord contacts the tenant and offers to enter into:

- another lease agreement; or
- a month-to-month rental agreement.

If the tenant desires to remain in possession when their lease expires, the amount of rent a landlord can demand is limited only by negotiations, economic forces in the rental market and the tenant's cost of relocation (which can be substantial).

As an alternative, a landlord can proactively negotiate and grant options to renew or extend a lease at the same time they initially negotiate the terms of the lease agreement. [See **RPI** Form 565]

Requisites to accepting tenants

On locating a prospective tenant for a residential unit, the landlord needs to establish the prospect's creditworthiness. To accomplish this, the tenant begins by filling out a **credit application** before entering into either a rental or lease agreement. [See **RPI** Form 302]

credit application
A document prepared by a prospective tenant which includes a provision authorizing the investigation and receipt of information on the applicant's creditworthiness. [See **RPI** Form 302]

The *credit application* is referenced and attached as an addendum to any rental or lease agreement entered into by the landlord and tenant. The landlord uses the authorization granted by the tenant in the credit application to verify the:

- tenant's rental history;
- employment;
- credit standing; and
- check-writing history.

If a prospective tenant has a poor credit rating or none at all, yet meets the landlord's rent-to-income ratio requirements, the landlord might seek assurances in addition to the maximum *security deposit* allowed. These assurances may include:

- a *co-signer* on the lease; or
- a *guarantee agreement* executed by a creditworthy individual. [See **RPI** Form 553-1]

Occasionally a tenant defaults on their rent or otherwise causes the landlord to incur a loss greater than the security deposit. With these assurances, the landlord can make a demand for payment of the loss on the co-signer or the guarantor since both are liable.

Condition of premises addendum

A residential landlord has the statutory duty to maintain the rented premises. Similarly, a residential tenant has the statutory duty to refrain from damaging the premises.

To avoid disputes over who is responsible for any damage to the premises, the residential landlord and tenant complete and sign a **condition of premises addendum** before the tenant is given possession. [See **RPI** Form 560]

Before a tenant takes possession, the landlord or resident manager inspects the unit with the tenant, known as a *walk-through*. Together, the landlord or resident manager and the tenant use a *condition of premises* addendum to note:

- the premises is in satisfactory condition;
- any existing damage to the premises observed before the tenant takes possession; and

- any repairs the landlord is to make to the premises.

If the unit is furnished, the landlord and tenant complete and sign an additional form on their walk-through called a *condition of furnishings addendum*. The condition of furnishings addendum confirms:

- the inventory of furnishings located in the unit;
- the current condition of the furnishings; and
- the tenant's acceptance of the furnishings. [See **RPI** Form 561]

At the end of the tenancy, the condition of premises addendum is reviewed during the *pre-expiration inspection* to help establish tenant responsibility for excess wear and tear to the unit rented. [See **RPI** Form 567-3]

Pet and waterbed addendum

Any provisions agreed to but not included in the boilerplate provisions of pre-printed lease or rental agreements can be included in an addendum. The **addendum** is then referenced in the body of the rental or lease agreement.

addendum
An attachment to a contract, rental or lease agreement for incorporating any provision agreed to but not included in the boilerplate provisions of the agreement. [See **RPI** Form 250]

One such addendum is the *pet addendum*. If a landlord allows pets, they often:

- impose restrictions on the type or size of the pet; and
- require the landlord's written consent to keep the pet on the premises. [See **RPI** Form 551 §6.9 and Form 550 §6.9]

The landlord and tenant can sign and attach a pet addendum stating:

- the type of pet and its name;
- the security deposit to be charged for the pet (but limited as part of the maximum security deposit allowed) [See Chapter 78]; and
- the tenant's agreement to hold the landlord harmless for any damage caused by the pet. [See **RPI** Form 563]

A landlord cannot prohibit a disabled person from keeping a specially trained guide dog on the premises.[1] [See Chapter 7]

Additionally, a landlord who allows pets may not:

- favor declawed or devocalized animals in any advertisement;
- refuse to rent to a tenant because their pet has not been declawed or devocalized; or
- require tenants' pets to be declawed or devocalized as a condition of renting the property.[2]

Editor's note — Although landlords may not favor declawed or devocalized pets, they may still protect against property damage or noise by including a lease provision barring specific pet behavior or prohibiting pets altogether.

waterbed addendum
An addendum to a rental or lease agreement setting the additional security deposit and insurance coverage the tenant will provide the landlord to keep a waterbed on the premises. [See **RPI** Form 564]

1 CC §54.1(b)(5)
2 CC §1942.7

Lease agreements and month-to-month rental agreements also prohibit a tenant from keeping a waterbed or other liquid-filled furnishings on the premises without addendums providing the landlord's written consent. [See **RPI** Form 551 §6.9 and Form 550 §6.9]

When a tenant has a waterbed, the landlord may require the tenant to sign a **waterbed addendum**. [See **RPI** Form 564]

Non-smoking addendum

To prohibit smoking under rental or lease agreements, landlords are required to include a provision specifying the areas on the property where smoking is prohibited. Alternatively, landlord may use a *non-smoking addendum* to prohibit smoking on the premises. [See **RPI** Forms 550, 551 and 563-1]

To prohibit smoking under existing rental agreements entered into before January 1, 2012, the landlord is to notify tenants by delivering a written 30-day notice of change in rental terms. The no-smoking condition is enforceable on the expiration of the 30-day notice period. [See **RPI** Form 570]

Other addenda

Other addenda which may be made part of a residential rental or lease agreement include:

- house or building rules; and
- any *rent control* disclosures required by local rent control ordinances.

A residential landlord seeking to sell a property may also grant the tenant an option to purchase the property. [See **RPI** Form 161]

Terms of residential occupancy

Residential tenants typically provide a *security deposit* to the landlord to cover the cost to clean the unit or remedy any damage caused to the unit beyond reasonable wear and tear. [See **RPI** Form 551 §2 and Form 550 §2; see Chapter 78]

In return for the use and possession of the premises, the tenant pays the landlord rent until expiration of the lease, or periodic tenancy. The tenant agrees to pay a late charge if rent is not paid on the due date, or within the established *grace period*. [See **RPI** Form 551 §4 and Form 550 §4; see Chapter 79]

Also, the number of guests the tenant may have in their unit and the period of time over which their guests may visit is limited. [See **RPI** Form 551 §5.6 and Figure 1, Form 550 §5.6]

The tenant agrees to comply with all building or project rules and regulations established by any existing *covenants, conditions and restrictions (CC&Rs)* controlling use of the unit, or the landlord. [See **RPI** Form 551 §6.1 and Form 550 §6.1]

The landlord and tenant agree who will pay or how they will share the financial responsibility for the unit's utilities. For example, landlords of apartment buildings or complexes often retain the responsibility of providing water to the units. [See **RPI** Form 551 §6.2 and Form 550 §6.2]

In both rental and lease agreements, tenants agree to hold the landlord harmless from all liability for damages caused by the tenant or their guests. An insurance policy provided by the tenant and naming the landlord as an additional insured is to be considered. [See **RPI** Form 551 §7.1 and Form 550 §7.1]

Statutory rights and duties

Residential lease agreements and month-to-month rental agreements often contain redundant provisions that restate the landlord's and tenant's statutory rights and duties.

For example, the rental agreement reiterates the landlord's statutory obligation to furnish a tenant with:

- a security deposit refund;
- notice of the right to a joint pre-expiration inspection of the unit and delivery of an itemized statement of repairs/cleaning ; and
- a statement of security deposit accounting and an itemization of any deductions. [See **RPI** Form 551 §2.4 and Form 550 §2.4; see Chapter 78]

Also, rental agreements often advise tenants of their limited statutory right to make necessary repairs to the premises and deduct the cost from the rent. This situation arises when the landlord fails to make the repairs the tenant has brought to the landlord's attention. [See **RPI** Form 551 §6.2 and Figure 1, Form 550 §6.2]

A rental or lease agreement may prohibit a tenant from:

- using the premises for an unlawful purpose;
- creating a nuisance; and
- committing waste. [See **RPI** Form 551 §6.7, §6.8 and Form 550 §6.7, §6.8]

Even if the lease or rental agreement does not restate these statutory prohibitions, a tenant who carries on any of these prohibited activities can be evicted with a three-day written notice to quit. [See **RPI** Form 576; see Chapter 80]

Chapter 75 Summary

A fixed-term lease agreement creates a tenancy that continues for a fixed period. A month-to-month rental agreement runs for an indefinite period of time. It automatically renews monthly, and on the same terms, until modified or terminated by notice.

Tenants typically pay lower rents when they enter into a fixed-term lease. In stable rental markets, the longer the lease, the lower the rent.

Any provisions agreed to but not included in the boilerplate provisions of pre-printed lease or rental agreements can be included in an addendum to the rental or lease agreement, such as a pet, waterbed or non-smoking addenda.

Chapter 75 Key Terms

Quiz 14 Covering Chapters 73-78 is located on page 619.

Chapter 76

Commercial lease agreements

Learning Objectives

After reading this chapter, you will be able to:

- distinguish the various types of commercial lease agreements and use them to meet the objectives of the landlord and tenant; and
- determine whether the tenant or the landlord is responsible for paying property operating expenses and attending to the care and maintenance of the leased premises under lease agreement provisions.

Key Terms

ad valorem taxes
attorney fee provision
choice-of-law provision
full-service gross lease
gross lease
heirs, assigns and successors clause
net lease
pure-net lease
reasonable certainty
reversionary interest
triple-net lease

For an additional discussion of the materials presented in this chapter, see Chapter 41 of Real Estate Property Management.

The conveyance of a leasehold

A lease agreement is a **contract of conveyance** entered into by a landlord and tenant. The lease agreement addresses tenant and landlord obligations, such as the payment of money and the care of the real estate.

The lease agreement also conveys a possessory interest in real estate, called a *leasehold estate*, or simply a *lease*.[1]

1 Calif. Civil Code §761(3)

By entering into a lease agreement and delivering possession to the tenant, the landlord conveys the exclusive right to occupy a parcel of real estate, or space in a parcel, for a fixed period of time. The continued right to occupy the real estate is conditioned on the tenant's performance under two sets of provisions in the lease agreement:

- one calling for the payment of rent; and
- the other calling for any maintenance of the property delegated to the tenant.

On expiration of the lease term, the right of possession to the real estate reverts to the landlord. During the lease term when the tenant holds the right to possession, the landlord, as the owner of the fee simple, holds a **reversionary interest** in the leased parcel or space.

reversionary interest
A future interest a person retains on the grant of property which reverts to the person on the occurrence of an event.

Once the landlord and tenant have entered into a lease agreement, the right of possession of the leased real estate is controlled by landlord/tenant law, not contract law.

The rent provisions in the lease agreement evidence the debt the tenant has contracted to pay to the landlord over the term of the lease. If the tenant breaches a material provision in the lease agreement, the landlord may prematurely regain possession of the real estate by forfeiting the tenant's leasehold interest and right of possession.

However, forfeiture of the tenant's right of possession does not automatically cancel the underlying lease agreement, the contract rights. The lease agreement calling for the tenant to pay rent and other amounts for the duration of the lease term remains intact.

Validity of the lease agreement form

A lease agreement conveying a term of occupancy exceeding one year needs to be written to be enforceable. This is a requirement of the *statute of frauds*.[1]

The provisions contained in a lease agreement fall into one of three categories of activities:

- *conveyance* of the leasehold interest
- the lease debt, called *rent*; and
- responsibility for *care* and *maintenance* of the leased premises. [See Figure 1, **RPI** Form 552]

Editor's note — Many variations of the commercial lease exist. Which of these the landlord and tenant choose depends on the specifics of the tenancy. ***Realty Publications, Inc. (RPI)*** *offers numerous lease agreements tailored to common variations in commercial lease agreements, including:*

- *Single Tenant Gross Lease [See* ***RPI*** *Form 552];*
- *Multi-Tenant Gross Lease [See* ***RPI*** *Form 552-1];*
- *Single Tenant Net Lease [See* ***RPI*** *Form 552-2];*

1 CC §1624(a)(3)

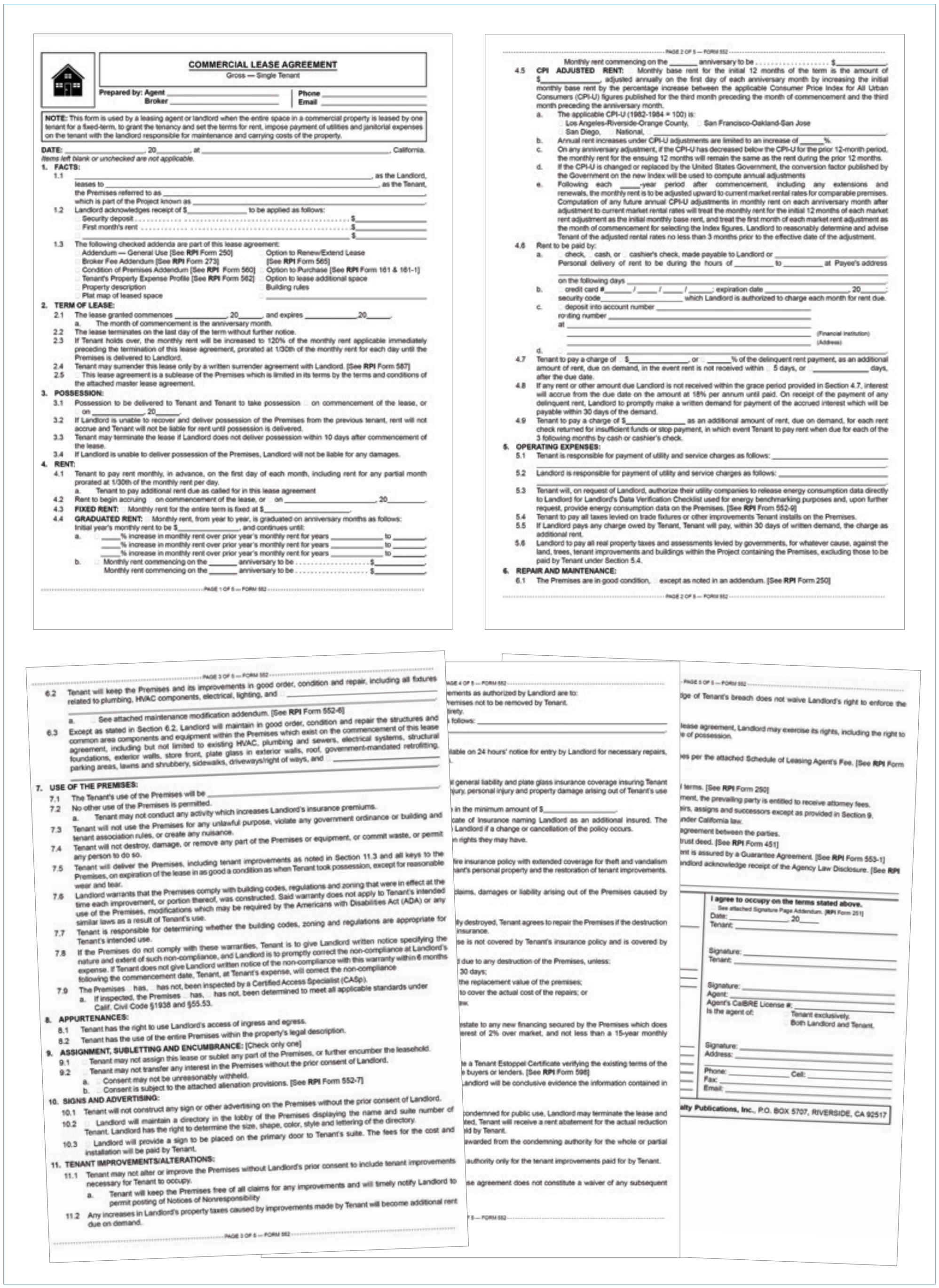

Figure 1

Form 552

Commercial Lease Agreement

Gross — Single Tenant

- *Multi-Tenant Net Lease [See **RPI** Form 552-3];*
- *Percentage Lease [See **RPI** Form 552-4]; and*
- *Month-to-Month Tenancy [See **RPI** Form 552-5].*

To be valid, a lease agreement needs to:

- designate the *size* and *location* of the leased premises with *reasonable certainty*;

- set forth a *term* for the tenancy conveyed; and
- state the *rental amount*, and its time, place and manner of payment.[1]

A broker, representing the landlord or tenant, uses either a *letter of intent (LOI)* or an *offer to lease* to initiate and document lease negotiations prior to entering into the lease agreement itself. [See **RPI** Form 556]

The actual lease agreement is prepared and signed after its terms and conditions have been negotiated and agreed to in the LOI or offer to lease.

The contents of a lease agreement

A commercial lease agreement form has five sections:

- *identification* of the parties and the premises, and the conveyance and term of the lease;
- the terms for payment of *rent* and other amounts owed, collectively called the *rent provisions*;
- the provisions setting forth the responsibility for *care and maintenance* of the leased property, collectively called the *use-maintenance provisions*;
- *miscellaneous provisions* for circumstances specific to the transaction; and
- the *signatures* of the parties.

The *identification* section of a real estate lease agreement includes:

- the names of the landlord and the tenant;
- a description of the leased premises;
- words of conveyance transferring the leasehold interest in the property;
- a receipt for prepaid rents and the security deposit; and
- a list of the addenda which contain exhibits or additional terms. [See **RPI** Form 552 §1.3]

Proper identification of the parties

Each party to a lease agreement needs to be properly identified. On the lease agreement form, the identification of the tenant indicates how their ownership of the lease conveyed will be vested.

When the fee ownership interest of the landlord is community property, both spouses need to consent to agreements leasing the community property for a fixed term exceeding one year. If not, the community is not bound by the lease agreement.

Also, if challenged within one year after commencement by the nonconsenting spouse, the tenant cannot enforce the conveyance of the leasehold right.[2]

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1 **Levin** v. **Saroff** (1921) 54 CA 285

2 Calif. Family Code §1102

In addition to individuals, business entities which may own or lease property include:

- corporations and out-of-state entities qualifying as a corporation such as business trusts;
- limited liability companies (LLCs);
- partnerships, general or limited;
- real estate investment trusts (REITs);
- nonprofit organizations; and
- governmental agencies.

Individuals who sign a lease agreement on behalf of the landlord or the tenant need to have the *capacity and the authority* to act on behalf of and bind the landlord or tenant.[3]

Premises identified with certainty

The commercial lease agreement needs to describe the premises to be leased so the premises can be located with **reasonable certainty**. A description is *reasonably certain* if it furnishes a "means or key" for a surveyor to identify the parcel's location.[4]

reasonable certainty The degree of certainty expected from a reasonable person.

If the premises is a building or a space in a building, the common street address, including the unit number, is a sufficient description to identify the premises.

If the premises is not easily identified by its common address, a plot map or floor plan should be included as an addendum to the lease agreement identifying the space rented.

Addenda to the lease agreement

The terms common to commercial leases are contained in the provisions of a regular lease agreement form.

However, the terms and conditions unique to the leasing of a particular type of commercial tenancy are handled in an **addendum** attached to the lease agreement.

When inconsistencies arise between provisions in the pre-printed lease agreement and an attached addendum, the provisions in the addendum control. Also, any handwritten or typewritten provisions added to an agreement control over conflicting pre-printed or boilerplate provisions.[5]

Addenda occasionally attached to a commercial lease agreement include:

- terms unique to the type of property leased;
- a property description addendum, such as a plot map or site plan;
- a structural or tenant improvement agreement;
- a condition of premises addendum [See **RPI** Form 560];

3 CC §§2304; 2307
4 **Beverage** v. **Canton Placer Mining Co.** (1955) 43 C2d 769
5 **Gutzi Associates** v. **Switzer** (1989) 215 CA3d 1636

- maintenance modification addendum [See **RPI** Form 552-6];
- a building rules addendum;
- an option or right of first refusal to renew or extend [See **RPI** Form 566];
- a brokerage fee addendum [See **RPI** Form 273];
- a tenant leasehold subordination agreement regarding a future mortgage [See **RPI** Form 552-8];
- a non-disturbance and attornment provision;
- a signage or tenant association agreement;
- an option or right of first refusal to lease additional space;
- authority to sublease or assign [See **RPI** Form 552-7]; and
- an option or right of first refusal to buy. [See **RPI** Form 161 and Form 579]

If the lease agreement is for a sublease of the premises, a copy of the master lease is referenced and attached to the lease agreement. [See **RPI** Form 552 §2.4]

The term of the tenancy

A commercial lease agreement is a contract to rent real estate for a fixed term. The lease agreement indicates the dates on which the lease term commences and expires.[1] [See **RPI** Form 552 §2.1]

The date for delivery and acceptance of possession are addressed separately from the date of the lease agreement. The date of the lease agreement is solely for the purpose of identifying the document. [See **RPI** Form 552 §2.1]

On expiration of the lease term on the date stated in the lease agreement, the tenant's right to possession automatically terminates. The tenant vacates the property on or before the lease expiration date unless further occupancy agreements exist. No further notice is required from the landlord or tenant to terminate the tenancy.[2]

However, a *holdover tenancy*, also called a **tenancy at sufferance**, is created when:

- the tenant remains in possession after the lease term expires without the exercise of an option to renew or extend the tenancy; and
- the landlord refuses to accept further rent payments.

The holdover tenancy ends when the tenant vacates or is evicted.

A holdover rent provision in the lease agreement calls for a set dollar amount of rent to accrue daily during the holdover period. The rent is due and payable on demand after the tenant vacates or is evicted.

The daily rent is usually significantly higher than the fair market rate, a *penalty rate* for the unlawful detainer of possession. As a result, holdover rent

1 CC §761(3)
2 CC §1933

is considered unreasonable if sought as an award in an *unlawful detainer (UD)* action. An UD action allows only market rent rates for the holdover period. [See **RPI** Form 552 §2.3]

The landlord can initiate UD proceedings to evict the holdover tenant immediately on expiration of the lease term.[3]

Delivery and acceptance of possession

Lease agreement provisions set the date the tenant is to take possession of the leased premises. They also address the consequences when a landlord fails to deliver the premises to the tenant as agreed. [See **RPI** Form 552 §5]

The tenant is given the opportunity to terminate the lease agreement if possession is not delivered within the agreed-to number of days after commencement of the lease.

A landlord sometimes fails to deliver possession to the tenant due to their inability to recover the premises from a previous tenant or complete tenant or structural improvements. To cover this risk, the lease agreement states the tenant is not liable for rent payments until possession is delivered. [See **RPI** Form 552 §5.2]

Brokerage fees

The responsibility for paying brokerage fees for leasing services is controlled by compensation provisions in:

- an *authorization to lease*;
- a *property management agreement*;
- an *offer to lease* or *LOI*; or
- the lease agreement itself.

This redundancy allows the broker to enforce payment of the brokerage fees in case the prior documents did not include a commitment from either the tenant or the landlord to pay the brokerage fees. [See **RPI** Forms 552 §24.1 and 113]

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]

Miscellaneous provisions

An **attorney fee provision** enables the landlord to recover costs incurred to enforce payment of rent or evict the tenant. Regardless of how an *attorney fee provision* is written, the prevailing party in litigation is entitled to be awarded their fee.[4] [See **RPI** Form 552 §25.2]

The **heirs, assigns and successors clause** binds those who later take the position of the landlord or tenant to the existing lease (or rental) agreement through a(n):

- grant;
- assignment; or

heirs, assigns and successors clause
A clause in a lease agreement which binds those who later take the position of landlord or tenant to the existing agreement. [See **RPI** Form 552 §23.3]

3 CCP §1161(1)
4 CC §1717(a)

choice-of-law provision
A clause which sets the state law applicable in the event of a dispute. [See **RPI** Form 552 §23.4]

- assumption.[1] [See **RPI** Form 552 §25.3]

A **choice-of-law provision** in the lease agreement assures application of California law when a dispute arises between the tenant and the landlord. [See **RPI** Form 552 §25.4]

Application of California law in disputes over property located in California adds stability to the legal expectations of the landlord and tenant. It also produces greater commercial certainty in real estate transactions and stabilizes property values.

The economics of commercial leases

A tenant who acquires a leasehold interest in commercial real estate agrees to be obligated for none, some or all of the operating costs of the real estate, as rent due. These expenses are incurred by the tenant in addition to payment of the base rent and periodic rent adjustments.

Editor's note — Residential lease agreements rarely require the tenant to undertake the full care and maintenance of the premises. Usually, residential tenants always have the obligation to prevent excessive wear and tear.

Typically, the longer the term of the commercial lease, the more extensive the shift of ownership costs and responsibilities to the tenant, including:

ad valorem taxes
Real estate taxes imposed on property based on its assessed value. [See **RPI** Form 552-2 §5.1]

- property operating expenses;
- all or future increases in real estate taxes, called **ad valorem taxes**;
- hazard insurance premiums;
- repair and maintenance; and
- the risk of an increase in interest payments on an adjustable rate mortgage (ARM) encumbering the property.

Expenses incurred

When a long-term lease obligates the tenant to pay for all expenses incurred in the ownership and operation of the property, the tenant incurs the expenses in one of two ways:

- directly, where the tenant contracts for services and pays the cost, including taxes and insurance premiums; or
- indirectly, when the landlord incurs the expenses and then bills the tenant for payment, such as *common area maintenance charges (CAMs)*.

gross lease
A commercial lease specifying that the tenant pays for their utilities and janitorial fees, but unless modified is not responsible for any other care, maintenance or carrying costs of the property. [See **RPI** Form 552 and 552-1]

The responsibility for the payment of operating costs is reflected in the reference to commercial leases as either:

- a **gross lease**; or
- a *net lease*.

Variations and modifications exist for both types of leases.

1 **Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309

Leasing agents have no universally accepted definitions or guidelines for titles they use to identify the economics of a lease and the classifications for leases are forever changing. Often, agents clarify with each other the type of lease their clients intend to enter into.

A commercial lease is typically called a *gross lease* if the tenant pays for their utilities and janitorial fees, but is not responsible for any other care, maintenance or carrying costs of the property.

When the landlord of an office building retains the responsibility for payment of all costs of care and maintenance, including the tenant's utilities and janitorial services, the lease used is referred to as a **full-service gross lease**.

full-service gross lease
A commercial lease specifying that the landlord retains the responsibility for payment of all costs of care and maintenance, unless modified, including the tenant's utilities and janitorial services. [See **RPI** Form 552 and 552-1]

Conversely, a commercial lease that transfers to the tenant the obligation to pay some or all of the costs and responsibilities of ownership, in addition to utilities and janitorial services, is referred to as a *modified gross lease* or **net lease**.

net lease
A commercial lease which transfers to the tenant the obligation, unless modified, to pay all of the costs of ownership in addition to utilities and janitorial services. [See **RPI** Form 552-2 and 552-3]

A lease becomes more net (and less gross) for the landlord as they shift more ownership responsibilities and operating costs to the tenant.

The modified gross or net lease is the most commonly used commercial lease agreement. Significant supply and demand changes alter bargaining positions during business cycles and in turn shift the responsibility for property operating costs through negotiations.

Another type of lease is the **triple net lease**, sometimes referred to as a *net-net-net lease*. A *triple net lease* passes the responsibility for all costs and maintenance of the property to the tenant, either directly or through CAMs. Under a triple net lease, the landlord is only responsible for capital improvements, such as replacement of structural components.

triple net lease
A commercial lease which passes the responsibility for all costs and maintenance of the property to the tenant. [See **RPI** Form 552-2 and 552-3]

When a tenant assumes absolutely all ownership duties under a lease agreement, and the landlord merely collects rent payments without concern for their management of the property, the lease is called a **pure-net lease**.

pure-net lease
A commercial lease in which a tenant assumes absolutely all the obligations of ownership. [See **RPI** Form 552-2 and 552-3]

Chapter 76 Summary

A lease agreement is a contract entered into by a landlord and tenant addressing the tenant's primary responsibilities: the payment of money and the care of the real estate. The lease agreement also acts to convey a possessory interest in real estate to the tenant. By entering into a lease agreement and delivering possession to the tenant, the landlord conveys to the tenant the exclusive right to occupy a parcel of real estate, or space in a parcel, for a fixed period of time. On expiration of the term of the lease, the right of possession to the real estate reverts to the landlord.

Chapter 76 Summary

A lease agreement is a contract entered into by a landlord and tenant addressing the tenant's primary responsibilities: the payment of money and the care of the real estate. The lease agreement also acts to convey a possessory interest in real estate to the tenant. By entering into a lease agreement and delivering possession to the tenant, the landlord conveys to the tenant the exclusive right to occupy a parcel of real estate, or space in a parcel, for a fixed period of time. On expiration of the term of the lease, the right of possession to the real estate reverts to the landlord.

The provisions contained in a written lease agreement fall into one of three categories of activities:

- conveyance of the leasehold interest;
- the money obligation of the tenant, a debt called rent; and
- responsibility of the tenant and the landlord for care and maintenance of the leased premises and other property operating expenses.

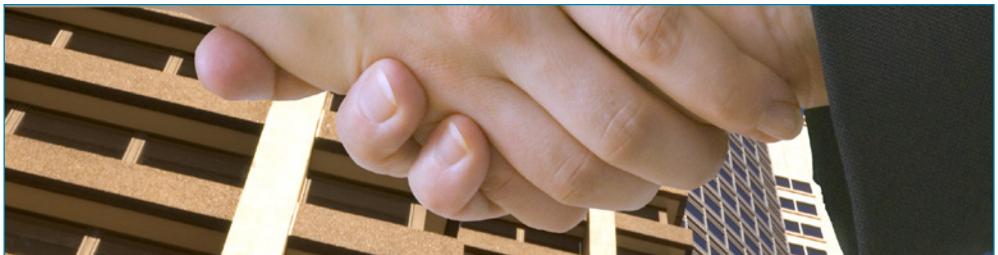
A commercial lease agreement form has five main sections:

- identification of the parties and the premises, and the conveyance and term of the lease;
- the terms for payment of rent and other amounts owed, collectively called rent provisions;
- the provisions setting forth the responsibility for care and maintenance of the leased property, collectively called the use-maintenance provisions;
- miscellaneous provisions for circumstances specific to the transaction; and
- the signatures of the parties.

A lease agreement conveying a term of occupancy exceeding one year is required to be written to be enforceable.

Chapter 76 Key Terms

Quiz 14 Covering Chapters 73-78 is located on page 619.



Chapter 77

Changing terms on a month-to-month tenancy

Learning Objectives

After reading this chapter, you will be able to:

- apply the rules a landlord adheres to when changing the terms of a month-to-month tenancy; and
- observe the proper procedure for serving the tenant with a notice of change in rental terms.

Key Terms

notice of change in rental terms

notice of intent to vacate

For an additional discussion of the materials presented in this chapter, see Chapter 22 of Real Estate Property Management.

Notice to change rental terms

All conditions in a residential or commercial month-to-month rental agreement may be changed on written notice by the landlord. This notice is commonly referred to as a **notice of change in rental terms**.

The most common notice of change in rental terms requires a 30-*day notice period*. However, a 60-*day notice* period is required for rent increases greater than 10% or greater.[1] [See **RPI** Form 570 and 574]

notice of change in rental terms
Written notice served on the tenant noting changes in the terms or conditions of a month-to-month rental agreement. [See **RPI** Form 570 and 574]

Editor's note — Conditions in a rental or lease agreement are also commonly referred to as provisions, clauses, terms, conditions, addenda, covenants, etc.

For example, a residential or commercial landlord under a month-to-month rental agreement can increase the rent, or shift repair and maintenance obligations to the tenant, by serving a 30-day *notice of change in rental terms*. [See **RPI** Form 570]

1 Calif. Civil Code §827

To be enforceable, a notice of change in rental terms needs to be served in the same manner as a three-day notice to pay rent or quit.

In contrast to the rights of a landlord, a month-to-month tenant has no ability to alter the terms of the rental agreement, other than to terminate the tenancy and vacate. Only the landlord may unilaterally change the terms in a rental agreement.[1]

In *rent control communities*, a landlord or property manager needs to be fully apprised of how rent control ordinances affect their ability to alter provisions in leases and rental agreements.

The notice period needs to run

A landlord or property manager may serve the tenant under a periodic rental agreement with a notice of change in rental terms on any day during the rental period.

Once a notice of change in rental terms is served on a periodic tenant, the new terms stated in the notice immediately become part of the tenant's rental agreement.[2]

However, the new rental terms stated in the notice do not take effect until expiration of the 30-day notice.

Notice periods for increasing rent

If a residential or commercial landlord under a month-to-month rental agreement desires to increase rent, the length of the notice period depends on the amount of the rent increase.

To determine whether a 30-day or 60-day notice is required, the landlord compares the increased rent sought with the lowest rent amount paid by the tenant during the last 12 months.

If the total increase in rent is 10% or less of the lowest amount of rent paid during the previous 12 months, the landlord may serve the tenant with a 30-day notice of change in rental terms.

However, if the total increase in rent is more than 10%, the landlord needs to serve the tenant with a 60-day notice of change in rental terms.[3]

For instance, consider a residential landlord charging a month-to-month tenant a rent of $1,000 per month. The landlord has not increased the tenant's rents during the last 12 months, but now seeks to increase the rent by $100 per month. Since the total rent increase is 10%, the landlord serves the tenant with a 30-day notice.

Now consider another landlord and tenant. In the last 12 months, the landlord increased the tenant's monthly rent from $950 to $1,000. The

1 CC §827; CC §1946

2 CC §827

3 CC §827

landlord currently seeks to increase the rent by an additional $100. The requested increase of $100 (totaling $1,100) is compared to lowest amount of rent paid during the last 12 months — $950.

Since the total increase in rent is now 15.8%, the landlord serves the tenant with a 60-day notice of a change in rental terms.

Tenant responses to a change

On being served with a notice of a change in rental terms, the month-to-month tenant has three options:

- remain in possession and comply with the new rental terms;
- serve the landlord with a 30-day **notice of intent to vacate** and continue paying rent, including pro rata rent, through the end of the 30-day period to vacate [See **RPI** Form 572]; or
- remain in possession, refuse to comply with the rental terms, and raise defenses, such as *retaliatory eviction*, in the resulting unlawful detainer (UD) action.

notice of intent to vacate
A tenant's notice to the landlord signifying their intent to vacate the leased property. [See **RPI** Form 571 and 572]

If the change in terms is a rent increase, the tenant owes pro rata rent at the new rate for the days after the rent increase becomes effective through the date the tenant's notice to vacate expires. The pro rata rent is payable in advance on the due date for the next scheduled payment of rent, usually the first.

Rent control restrictions

Most rent control ordinances allow a landlord or property manager to increase the rent to:

- obtain a fair return on their investment;
- recover the cost of capital improvements to the property; and
- pass through the cost of servicing the debt on the property.

Thus, without further authority from the rent control board, a landlord may increase rent in one of three ways:

- increase rent by the maximum percentage set by local ordinance;
- increase rent by the maximum percentage of the consumer price index (CPI) as set by local ordinance; or
- increase rent by the maximum amount previously set by the local rent control board.

Landlords of newly constructed units or individual units may establish their own rent rates, within limitations, if they are subject to rent control ordinances established prior to 1995.

Chapter 77 Summary

All conditions in a residential or commercial month-to-month rental agreement may be changed on written notice by the landlord, but not the tenant. To be enforceable, the notice needs to be served on the tenant in the same manner as a three-day notice to pay rent or quit.

A residential or commercial landlord or property manager may serve a notice of change in rental terms on any day during the rental period. For rent increases of 10% or less, a 30-day notice is required. For rent increases greater than 10%, a 60-day notice is required. The new rental terms stated in the notice do not take effect until expiration of the notice.

Chapter 77 Key Terms

Quiz 14 Covering Chapters 73-78 is located on page 619.

Chapter 78

Security deposits and pre-expiration inspections

Learning Objectives

After reading this chapter, you will be able to:

- notify a residential tenant of their right to request a joint pre-expiration inspection of their unit prior to vacating;
- apply the differing residential and commercial security deposit refund requirements; and
- provide an itemized statement of deductions to account for recoverable expenses and any interest accrued the landlord is to pay on the security deposit.

Key Terms

final inspection

joint pre-expiration inspection

security deposit

statement of deficiencies

For an additional study of this topic, see Chapter 19 of Real Estate Property Management

Both commercial and residential landlords prudently require a tenant to pay the first month's rent and make a security deposit as a requisite to entering into a rental or lease agreement. [See **RPI** Form 550 and 552]

The **security deposit** provides a source of recovery for money losses incurred by the landlord due to a tenant default on monetary obligations agreed to in the rental or lease agreement. Tenant monetary obligations include:

security deposit
A source of funds to pay tenant obligations owed the landlord on the tenant's default in the rental or lease agreement. [See **RPI** Form 550 §2.1 and 552 §1.2]

- paying rent;
- reimbursing the landlord for expenses incurred due to the tenant's conduct;
- maintaining the premises during occupancy; and

- returning the premises in the same level of cleanliness as existed at the time possession was initially taken, less ordinary wear and tear.

The amount of security deposit the residential landlord may demand and receive is controlled by law. Further, the amount of any security deposit is greatly influenced by the current condition of the local residential and non-residential market. If competition is tight, a landlord may be forced to lower the security deposit amount demanded, if not the rent, to attract tenants.

Aggressively competitive landlords are less likely to require a security deposit. However, this exposes them to an increased risk of loss if the tenant defaults.

Residential security deposits: not rents, not fees

To protect residential tenants from abuse, California public policy limits the amount of security deposits a residential landlord may demand and collect from a tenant.

Residential landlords are prohibited from demanding or receiving a security deposit greater than the amount of **one month's rent** — regardless of whether the unit is furnished or unfurnished.[1]

In addition, a residential landlord is limited to collecting one month's advance rent, the first month's rent. This amount is exclusive of in the security deposit limit.

Thus, for residential rental properties, all monies paid to the landlord in addition to the first month's rent are considered part of the security deposit, except screening fees and waterbed administrative fees.

Landlords often try to "mask" refundable security deposit funds by giving them names such as "nonrefundable deposit", "cleaning charge" or "last month's rent." However, any advance funds in excess of the first month's rent, screening fees and waterbed administrative fees, no matter how the fees are characterized by the residential landlord, are classified as security deposits, subject to the above limits.[2]

A residential landlord has limited authority to also demand and collect a pet deposit as part of the maximum security deposit allowed if the tenant is permitted to keep one or more pets in the unit. However, the total advance funds, including the pet deposit, may still not exceed the above limits.[3]

Any funds received and legally recharacterized as a security deposit are refundable when the tenant vacates, less permissible deductions.

Precise standards of setting the deposit

The amount of a residential security deposit demanded of all prospective tenants needs to be uniform based on either the amount of the rent charged or the tenant's creditworthiness.

1 Calif. Civil Code §1950.5(c)
2 CC §§1940.5; 1950.5(b), (c); 1950.6
3 CC §1950.5(c)

If the security deposit is based on a tenant's creditworthiness, the landlord needs to establish clear and precise standards for the different levels of creditworthiness (such as credit scoring) they use in the selection of tenants. Further, the security deposit amount set for each level of creditworthiness is to be applied to every prospective tenant who falls within each level.[4]

Further, a landlord cannot require higher security deposits for tenants with children than for tenants without children as this is a prohibited discriminatory activity. Any increase in a security deposit for larger versus smaller families is also a prohibited discriminatory practice.[5] [See Chapter 7]

Commercial security deposits

A commercial landlord has the discretion to set security deposit amounts under a rental or lease agreement without limitations. Amounts set for commercial deposits are generally based on the tenant's type of operations and the accompanying risks of damage they pose to the leased property.

For instance, a small services firm may pay an amount equal to one month's rent as a security deposit, to cover a default in rent. On the other hand, a photography studio which uses chemicals in its rendering of services may be asked to pay an amount equal to two or more month's rent.

The problematic last month's rent

When the availability of unfurnished residential units is tight, residential landlords often require all prospective tenants to advance the maximum permissible amount of rent and security deposit. Landlords charge maximum amounts upfront in hopes of preventing less solvent tenants from renting their units.

For residential rentals, the first and last month's rent are legally recharacterized as the first month's rent and a security deposit equal to one month's rent.[6]

Commercial landlords typically require an advance payment of both the first and last month's rent on a lease. They do so without considering that an advance payment of the last month's rent is economically equivalent to a security deposit, as is mandated by residential rental rules.

Proprietor treatment of security deposits

Security deposits are held by the landlord as impounds. The funds belong to the tenant who advanced them and are to be accounted for by the landlord.[7]

However, while the security deposit belongs to the tenant, a landlord may commingle the funds with other monies in a general business account. No trust relationship is established when a landlord holds a tenant's security deposit.[8]

4 24 CFR §100.60(b)(4)

5 Calif. Government Code §12955(a); 24 Code of Federal Regulations §100.65

6 CC §1950.5(c)

7 CC §§1950.5(d); 1950.7(b)

8 **Korens** v. **R.W. Zukin Corporation** (1989) 212 CA3d 1054

Without a trust relationship, the landlord's receipt of a security deposit does not obligate them to pay interest on the security deposit for the period held. However, some local rent control ordinances require residential landlords to pay tenants interest at or below bank savings account rates on their security deposits.

Joint pre-expiration inspections and the deposit

A residential landlord is to notify a tenant in writing of the tenant's right to request a **joint pre-expiration inspection** of their unit prior to the tenant vacating the unit.

joint pre-expiration inspection
An inspection conducted by a residential landlord or the property manager to advise a tenant of the repairs the tenant needs to perform to avoid deductions from their security deposit. [See **RPI** Form 567-1]

Editor's note — The notice of right to request a joint pre-expiration inspection needs to also contain a statement notifying residential tenants of their right to reclaim abandoned personal property.

However, unless the tenant requests an inspection after receiving the notice, the landlord and their agents are not required to conduct an inspection or prepare and give the tenant a statement of deficiencies before the tenancy expires and the tenant vacates.

The notice requirement does not apply to tenants who remain in possession after the expiration of a three-day notice to pay/perform or quit.

The purpose for the *joint pre-expiration inspection*, also called an **initial inspection**, is to require residential landlords to advise tenants of the repairs or conditions the tenant needs to perform or maintain to avoid deductions from the security deposit.

When a residential tenant requests the pre-expiration inspection in response to the notice, the *joint pre-expiration inspection* is to be completed no earlier than two weeks before the expiration date of:

- the lease term; or
- a notice to vacate initiated by either the landlord or the tenant.[9] [See Form 567-1 accompanying this chapter]

Ideally, the notice advising the tenant of their right to a joint pre-expiration inspection is given to the tenant at least 30 days prior to the end of the lease term. In the case of a rental agreement, the *inspection rights notice* is provided immediately upon receiving or serving a 30-day notice to vacate.

A period of 30 days allows the tenant time to request and prepare for the inspection. After the inspection, the tenant has time to remedy any repairs or uncleanliness the landlord observes during the inspection. Thus, the tenant is provided time to avoid a security deposit deduction.

When the landlord receives the tenant's oral or written request for a pre-expiration inspection, the landlord serves a written 48-hour *notice of entry* on the tenant stating:

- the purpose of entry as the pre-expiration inspection; and
- the date and time of the entry.

9 CC §1950.5(f)(1)

Expiration of notice

Following expiration of the 48-hour notice of entry served on the tenant, the landlord may inspect the property whether or not the tenant is present, unless the tenant has previously withdrawn their request for the inspection.

On completion of the joint pre-expiration inspection, the landlord needs to give the tenant an itemized **statement of deficiencies**. In it, the landlord specifies any repairs or cleaning which need to be completed by the tenant to avoid deductions from the security deposit.

Also, the itemized *statement of deficiencies* is to contain the contents of subdivisions (b) and (d) of Calif. Civil Code §1950.5. [See Form 567-3 accompanying this chapter]

statement of deficiencies
A document a residential landlord presents to a vacating tenant specifying any repairs or cleaning to be completed by the tenant to avoid deductions from the security deposit. [See **RPI** Form 567-3]

The landlord's pre-expiration inspection statement needs to be prepared at the time of the inspection and delivered to the tenant by either:

- handing the statement directly to the tenant if they are present at the inspection; or
- leaving the statement inside the premises at the time of the inspection if the tenant is not present.[10]

If the tenant chooses to withdraw their request for an inspection after submitting it, the landlord needs to send a memo to the tenant confirming the tenant's decision to withdraw. [See **RPI** Form 525]

Residential deposit refund requirements

Within a window period of 21 days after a residential tenant vacates, the residential landlord is to:

- complete a **final inspection** of the premises;
- refund the security deposit, less reasonable deductions; and
- provide the tenant with an *itemized statement of deductions* taken from the security deposit.[11] [See **RPI** Form 585]

final inspection
An inspection of the premises conducted by the landlord within 21 days after a residential tenant vacates the property. [See **RPI** Form 585]

Also, the residential landlord is to attach copies of receipts, invoices and/or bills to the itemized statement showing charges incurred by the landlord that were deducted from the security deposit.[12]

If repairs by the landlord are not completed and the costs are unknown within 21 days after the tenant vacates, the landlord may deduct a good faith estimated amount of the cost of repairs from the tenant's security deposit.

This estimate is stated on the itemized security deposit refund statement. This statement is to disclose the name, address and telephone number of any person or entity providing repair work, materials or supplies for the incomplete repairs.[13]

10 CC §1950.5(f)(2)
11 CC §1950.5(g)
12 CC §1950.5(g)(2)
13 CC §1950.5(g)(3)

Form 567-1

Notice of Right to Request a Joint Pre-Expiration Inspection

Page 1 of 2

NOTICE OF RIGHT TO REQUEST
A JOINT PRE-EXPIRATION INSPECTION

NOTE: This form is used by a property manager or landlord when a residential tenant will be vacating their unit, to notify the tenant of their right to request a joint pre-expiration inspection of the premises they occupy and receive a statement of deficiencies itemizing the repairs and cleaning necessary to be remedied or eliminated by the tenant to avoid a deduction of their costs from the security deposit.

DATE: ______________, 20______, at ____, California.
To Tenant: ____
Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or lease agreement
1.1 dated __________________, at ________________________________, California,
1.2 entered into by ________________________________, as the Tenant,
1.3 and ________________________________, as the Landlord,
1.4 regarding real estate referred to as ________________________________,
1.5 which tenancy expires ________________, 20_______.

NOTICE:

2. You are hereby advised of your right to request and be present at a pre-expiration inspection of the premises you occupy, and at the time of the inspection, be given Landlord's itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deduction from your security deposit. [See **RPI** Form 567-3]
2.1 The purpose for the inspection and the statement of deficiencies is to give you the opportunity to remedy or eliminate the itemized deficiencies before vacating to avoid a deduction of their cost from your security deposit.
2.2 The inspection, if requested by you, may be scheduled no earlier than two weeks before the expiration of your tenancy, and is separate from Landlord's final inspection and accounting for your security deposit within 21 days after you vacate.
2.3 If you do not request a pre-expiration inspection, no inspection will be made prior to the final inspection after you vacate.

3. You may request an inspection at any time after you are given this notice by preparing the form attached to this notice and giving it to Landlord or their agent.
3.1 On Landlord's receipt of your request, Landlord will attempt to set a mutually agreeable date and time for the inspection.
3.2 On Landlord's receipt of your request, you will be given a written 48-hour notice of entry advising you of the date and time scheduled by Landlord for the inspection.

4. On completion of the scheduled inspection, whether or not you are present, Landlord or their agent will hand you or leave on the premises a copy of an itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deductions from your security deposit, unless you remedy or eliminate them prior to your vacating on or before your tenancy expires.
4.1 Once you have requested an inspection you may withdraw the request at any time prior to the inspection.

5. **Notice:** State law permits former Tenants to reclaim abandoned personal property left at the former address of the Tenant, subject to certain conditions. You may or may not be able to reclaim property without incurring additional costs, depending on the cost of storing the property and the length of time before it is reclaimed. In general, these costs will be lower the sooner you contact your former Landlord after being notified that property belonging to you was left behind after you moved out.

Date: ______________, 20_____
Landlord/Agent: ____________________ CalBRE #: ____________

Signature: ________________________________
Address: ________________________________
____
Phone: ____________________ Cell: ________________
Fax: ________________________________
Email: ________________________________

PAGE 1 OF 2 — FORM 567-1

The refund statement

Then, within 14 days after completion of repairs or final receipt of bills, invoices or receipts for the repairs and materials, the landlord is to deliver to the tenant a final itemized security deposit refund statement with attached receipts and invoices.[14]

It is not necessary for the landlord to provide copies of receipts, bills or invoices for repair work or cleaning to the tenant if:

14 CC §1950(g)(3)

PAGE 2 OF 2 — FORM 567-1

NOTICE OF RIGHT TO REQUEST
A JOINT PRE-EXPIRATION INSPECTION

DATE: ______________________, 20______, at ______________________________________, California.
To Landlord:

1. I, the Tenant, hereby request an inspection at the earliest possible date and time during the two-week period prior to the expiration or termination of my tenancy.
2. The dates I prefer for an inspection during normal business hours include ______________________________
3. I understand you will give me a 48-hour notice prior to the inspection.
   Address of the premises ______________________________
   Tenant's name ______________________________

Signature ______________________________
Daytime telephone number ____________________
Email ____________________

Form 567-1

Notice of Right to Request a Joint Pre-Expiration Inspection

Page 2 of 2

- the total deduction from the security deposit to cover the costs of repairs and cleaning is equal to or less than $125; or
- the tenant signs a waiver of their right to receive bills when or after notice to terminate their tenancy is given.[15]

If the residential landlord is not required to provide copies of receipts to the tenant, the tenant may still request copies of receipts for repair work or cleaning within 14 days after receipt of the itemized security deposit refund statement. The landlord is then to provide copies of the documents within 14 days after receipt of the tenant's request.[16]

Editor's note — Residential security deposits may be refunded to the tenant electronically by mutual agreement between the landlord and the tenant. The itemized statement of deductions from the security deposit, with copies of receipts, may be delivered via email.[17]

Reasonable deductions from the deposit

Reasonable deductions from a residential tenant's security deposit include:

- any unpaid rent, including late charges and bounced check charges incurred and requested on a proper demand;
- recoverable costs incurred by the landlord for the repair of damages caused by the tenant;
- cleaning costs to return the premises to the level of cleanliness as existed when initially leased to the tenant, less wear and tear; and

15 CC §1950.5(g)(4)
16 CC §1950.5(g)(5)
17 CC §1950.5

Form 567-3

Statement of Deficiencies on Joint Pre-Expiration Inspection

Page 1 of 2

STATEMENT OF DEFICIENCIES
ON JOINT PRE-EXPIRATION INSPECTION

NOTE: This form is used by a property manager or landlord when conducting a joint pre-expiration inspection of a leased premises, to provide the tenant an itemization of the repairs and cleaning necessary to be remedied or eliminated by the tenant to avoid a deduction of their costs from the security deposit.

DATE: ______________, 20______, at ____, California.
To Tenant: ____
Items left blank or unchecked are not applicable.

FACTS:

1. On this date, a pre-expiration inspection was conducted by Landlord on the premises and appurtenances which are the subject of a rental or lease agreement
- 1.1 dated ______________, at ____________________________________, California,
- 1.2 entered into by ____________________________________, as the Tenant(s), and ____________________________________, as the Landlord,
- 1.3 regarding real estate referred to as ____________________________________
____________________________________.
- 1.4 ☐ Tenant was present and given a copy of this statement prepared and signed by Landlord or their agent.
- 1.5 ☐ Tenant was not present and a copy of this statement prepared and signed by Landlord or their agent was left inside the premises.

2. The tenancy under the rental or lease agreement expires on ______________, 20______, by which date you are to vacate the premises.

3. NOTICE TO TENANT:
- 3.1 You have until the date for expiration of your tenancy to remedy or eliminate the repairs and cleaning specified in this Statement of Deficiencies to avoid the deduction from your security deposit of the cost to repair and clean the identified deficiencies.
- 3.2 Unobservable conditions or conditions which occur after the pre-expiration inspection requiring repair and cleaning will be deducted from your security deposit after the final inspection by Landlord or their agent.

STATEMENT OF DEFICIENCIES:

4. The following itemized list of identified deficiencies in repairs and cleaning will be the basis for deductions from your security deposit, unless remedied or eliminated by you prior to vacating and later confirmed by Landlord or their agent during a final inspection after you vacate.
- 4.1 Damage to the premises and appurtenances caused by Tenant or their guests, other than ordinary wear and tear, which needs to be repaired are listed as follows: ____________________________________
____________________________________.
- 4.2 Cleaning which needs to be performed to bring the premises up to the level of cleanliness which existed on commencement of the tenancy is listed as follows: ____________________________________
____________________________________.

PAGE 1 OF 2 — FORM 567-3

- costs to replace or restore furnishings provided by the landlord if agreed to in the lease. [18]

The landlord may not deduct from a tenant's security deposit the costs they incur to repair defects in the premises which existed prior to the tenant's occupancy. To best avoid tenant claims that defects were pre-existing, a joint inspection of the unit and written documentation of any defects is completed before possession is given to the tenant.[19] [See **RPI** Form 560]

18 CC §§1950.5(b); 1950.7(c)
19 CC §1950.5(e)

5. The following recitals are excerpts from Civil Code §1950.5 regarding security deposits:

5.1 1950.5(b) As used in this section, "security" means any payment, fee, deposit or charge, including, but not limited to, any payment, fee, deposit, or charge, except as provided in Section 1950.6, that is imposed at the beginning of the tenancy to be used to reimburse the landlord for costs associated with processing a new tenant or that is imposed as an advance payment of rent, used or to be used for any purpose, including, but not limited to, any of the following:

(1) The compensation of a landlord for a tenant's default in the payment of rent.

(2) The repair of damages of the premises, exclusive of ordinary wear and tear, caused by the tenant or by a guest or licensee of the tenant.

(3) The cleaning of the premises upon termination of the tenancy necessary to return the unit to the same level of cleanliness it was in at the inception of the tenancy. The amendments to this paragraph enacted by the act adding this sentence shall apply only to tenancies for which the tenant's right to occupy begins after January 1, 2003.

(4) To remedy future defaults by the tenant in any obligation under the rental agreement to restore, replace, or return personal property or appurtenances, exclusive of ordinary wear and tear, if the security deposit is authorized to be applied thereto by the rental agreement.

5.2 1950.5(d) Any security shall be held by the landlord for the tenant who is party to the lease or agreement. The claim of a tenant to the security shall be prior to the claim of any creditor of the landlord.

Date: _____________, 20_____
Landlord/Agent: _______________ CalBRE#: ____________

Signature: _______________________________
Address: _________________________________
____
Phone: __________________ Cell: ____________
Email: ___________________________________

Form 567-3

Statement of Deficiencies on Joint Pre-Expiration Inspection

Page 2 of 2

Commercial deposit refund rules

A commercial lease does not need to set forth:

- the circumstance under which a tenant's security deposit will be refunded; or
- a time period within which a landlord will refund a tenant's security deposit. [See **RPI** Form 552]

However, a commercial landlord is to refund the security deposit within 30 days after the transfer of possession of the property from the tenant to the landlord, if:

- a refund period is not agreed to; and
- the commercial landlord takes no deductions from the security deposit.

Permissible deductions from the security deposit include unpaid rent, cost of cleaning or repairs.

Unless otherwise stated in the rental or lease agreement, the commercial landlord is prohibited from deducting additional costs from the security deposit for "key money" or to cover attorney's fees incurred in preparing, altering or renewing the lease or rental agreement.[20]

Unlike the residential landlord, the commercial landlord is not required to provide tenants with an itemized statement of deductions when the security

20 CC §1950.8(b)

deposit is refunded. However, a prudent commercial landlord provides tenants with an itemized statement when they vacate, unless a full refund is made.

An accounting avoids the inevitable demand for documentation which arises when a tenant does not receive a full refund of their security deposit. A commercial landlord who, in bad faith, fails to comply with the refund requirements is liable to the tenant for up to $200 in penalties.[21]

---

21 CC §1950.7(f)

Chapter 78 Summary

The security deposit provides a source of recovery for money losses incurred due to a tenant's default on obligations agreed to in the rental or lease agreement.

The amount of security deposit the residential landlord may demand and receive is controlled by code. On a commercial landlord's entry into a rental and lease agreement, security deposit amounts may vary at the landlord's discretion.

A residential landlord is to notify a tenant in writing of the tenant's right to request a joint pre-expiration inspection of their unit prior to the tenant vacating the unit. The joint pre-expiration rules require residential landlords to advise tenants of the repairs or conditions the tenant needs to perform or maintain to avoid deductions from the security deposit.

Chapter 78 Key Terms

Quiz 14 Covering Chapters 73-78 is located on page 619.

Chapter 79

Delinquent rent and the three-day notice

Learning Objectives

After reading this chapter, you will be able to:

- properly implement the rules for use of a three-day notice to pay rent or quit; and
- understand the consequences of notices to pay rent or quit served on tenants.

Key Terms

delinquency	**incurable breach**
due date	**material breach**
grace period	**minor breach**

For a further study of this topic, see Chapter 25 of Real Estate Property Management.

Default, notice and cure or vacate

A tenant, residential or commercial, defaults on their rental or lease agreement by failing to:

- pay rent and any other amounts due and called for in the rental or lease agreement; or
- perform nonmonetary obligations called for in the rental or lease agreement.

The rules covered in this chapter for use of the three-day notice apply to both residential and commercial tenancies, unless specifically stated to be residential or commercial.

When a tenant does not timely pay rent, the landlord may make a demand on the tenant to cure the default or vacate the premises within three days, called a **three-day notice to pay rent or quit**. [See Form 575 accompanying this chapter and **RPI** Form 575-1]

Editor's note — Other three-day notices to quit are discussed in Chapter 80.

The *three-day notice* states the exact amount of:

- delinquent rent unpaid; and
- other delinquent amounts owed to the landlord and unpaid.

The three-day notice contains a *declaration of forfeiture provision*. It states the tenant's failure to pay the delinquent rent before the notice expires gives the landlord the right to possession of the property.

material breach
A significant contractual breach that prevents the completion of the agreed upon activity.

However, only a **material breach** allows the landlord to forfeit the tenant's right of possession. A forfeiture of possession does not interfere with the landlord's right to collect rents under the rental or lease agreement. A forfeiture does not also cancel the agreements.

minor breach
Failure to pay late charges, interest penalties, bad check charges or security deposits.

Failure to pay rent or perform other significant obligations called for in the rental or lease agreement is a *material breach*. Conversely, the tenant's failure to pay late charges, interest penalties, bad check charges or security deposits are **minor breaches**, which do not justify a three-day notice to cure or quit.[1]

Thus, a UD action cannot be based on a *minor breach* by the tenant.

incurable breach
Nonmonetary defaults in leases or mortgages that cannot be cured or undone. [See **RPI** Form 577]

Some nonmonetary defaults by a tenant cannot be cured. These are known as **incurable breaches**. Incurable breaches include:

- *waste* to the premises;
- *alienation* of the leasehold; or
- *significant* criminal activity which has occurred on the property.

The landlord's remedy for an incurable breach is to serve notice on the tenant to quit the premises within three days after service. The tenant has no alternative but to vacate. Here, a declaration of forfeiture provision accompanying the three-day notice is unnecessary, and if included, is ineffective since the failure cannot be cured and the tenancy cannot be reinstated.[2]

Three days between notice and UD

After a landlord serves a tenant with a three-day notice to pay rent or quit, containing a declaration of forfeiture provision, the tenant needs to cure the breach in three calendar days to avoid a forfeiture of possession and eventual eviction. The first day in the three-day period is the day after service of the notice.[3]

---

1 **Keating** v. **Preston** (1940) 42 CA2d 110
2 CCP §1161(4)
3 Calif. Civil Code §10

Form 575

Three-Day Notice to Pay Rent or Quit

THREE-DAY NOTICE TO PAY RENT OR QUIT
With Rent-Related Fees

NOTE: This form is used by a property manager or landlord when a tenant defaults on amounts due under a rental or lease agreement, to notify the tenant of the amount of the delinquent rents and related fees payable within three days or vacate and deliver possession.

DATE: ____________________, 20 ______, at ______________________________, California.
To Tenant: ______________________________
Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or lease agreement
1.1 dated ____________________, at ______________________________, California,
1.2 entered into by ______________________________, as the Tenant,
1.3 and ______________________________, as the Landlord,
1.4 regarding real estate referred to as ______________________________
______________________________.

NOTICE:

2. You are in breach of the payment of amounts due under the rental or lease agreement.
3. Within three (3) days after service of this notice you are required to either:
3.1 Pay rent and other amounts now due and unpaid in the **Total Amount** of . . . . $____________
representing rent for the periods of
____________________, 20_____ to ________________, 20______ . . . . Amount $______________
____________________, 20_____ to ________________, 20______ . . . . Amount $______________
____________________, 20_____ to ________________, 20______ . . . . Amount $______________
and amounts due for
☐ returned check fees of . . . .$______________
☐ late charge fees of . . . . $______________
☐ common area maintenance (CAM) of . . . . $______________
☐ association assessments of . . . . $______________
☐ property taxes of . . . .$______________
☐ interest on delinquent rent of . . . . $______________
The **Total Amount** due may be paid in one of the following manners:
a. By personal delivery to ______________________________ (Name)
______________________________ (Address)
______________________________ (Phone)
Payment of the Total Amount due will be accepted at the above address during the hours of _________ to ________ on the following days: ____________________.
b. By deposit into account number ______________________________
at ______________________________ (Financial Institution)
______________________________ (Address)
c. By the electronic funds transfer previsouly established between Landlord and Tenant.
d. ______________________________

OR

3.2 Deliver possession of the premises to Landlord or ______________________________.

4. If you fail to pay the Total Amount due or to deliver possession of the premises within three (3) days, legal proceedings will be initiated against you to regain possession of the premises and to recover the amounts owed, treble damages, costs and attorney fees.
5. The Landlord hereby elects to declare a forfeiture of your Right to Possession if you fail to pay the Total Amount demanded above.
5.1 Landlord reserves the right to pursue collection of any future loss of rent allowed by Civil Code §1951.2.
6. State law permits former Tenants to reclaim abandoned personal property left at the former address of the Tenant, subject to certain conditions. You may or may not be able to reclaim property without incurring additional costs, depending on the cost of storing the property and the length of time before it is reclaimed. In general, these costs will be lower the sooner you contact your former Landlord after being notified that property belonging to you was left behind after you moved out.

Date: _______________, 20_______
Landlord/Agent: ____________________ CalBRE# ____________________

Signature: ______________________________
Address: ______________________________
Phone: ____________________ Cell: ____________________

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The tenant may tender payment of the delinquent rent in the same manner the tenant made past rental payments — by personal or business check, money order, cashier's check, credit card, cash or electronic transfer.[4]

4 **Strom** v. **Union Oil Co.** (1948) 88 CA2d 78

Rent paid by check and timely received by the landlord becomes delinquent when the check is returned due to insufficient funds and replacement funds are not received within the established grace period. With rent now delinquent, the landlord may serve a three-day notice to pay or quit.

delinquency
A tenant or borrower's failure to pay the agreed amounts on or before the due date or expiration of any grace period.

To cure a **delinquency**, the tenant's delinquent rent payment needs to actually be paid to the landlord. For instance, when a check for delinquent rent is returned because of insufficient funds, the delinquent rent demanded in a three-day notice has not been paid. Unless the tenant actually pays the delinquent rent prior to expiration of the notice, the tenant's right of possession will be terminated under the declaration of forfeiture provision. At that point, the landlord may file an unlawful detainer (UD) action if the tenant remains in possession.

One-year delinquent rent limitation for UD

A three-day notice may only demand rents which became due during the one year prior to the date of service. If a three-day notice demands delinquent rents which have been due for more than one year on service of the notice, the notice is defective and will not terminate the right of possession.

More rent has been demanded than will be awarded by a court in a UD action. Thus, any UD action based on a notice demanding rent for delinquencies more than a year old at the time the notice is served will fail.[1]

Before serving a three-day notice

Before a landlord or property manager serves a tenant with a three-day notice to pay rent or quit, the following questions need to be answered:

- Is the rent delinquent?;
- What amounts are due and unpaid?;
- When can delinquent rent be estimated in the three-day notice?;
- What is a reasonable estimate of unknown but delinquent rent?;
- When does the three-day notice expire?;
- When does the tenant's right of possession terminate?;
- Is the rental or lease agreement cancelled?; and
- How are subtenants evicted?

When is the rent delinquent?

Rent needs to be *delinquent* before a three-day notice to pay or quit may be served.

Rent becomes delinquent:

- the business day following the **due date**, unless a grace period is established in the rental or lease agreement; or
- the business day following the last calendar day of the *grace period* established in the rental or lease agreement.

1 **Bevill** v. **Zoura** (1994) 27 CA4th 694

If no grace period exists, when the last day scheduled for payment of rent falls on a legal holiday, the payment is not delinquent if it is tendered before or on the next business day. For purposes of paying rent, legal holidays include:

- Saturdays;
- Sundays; and
- state and federal holidays.[2]

due date
The date provided in the rental or lease agreement on which rental payments are due. [See **RPI** Form 550 §4.1 and 552 §4.1]

A **grace period** is set in the rental or lease agreement. It is the time period following the due date during which rent may be paid without incurring a late charge. While rent may be past due and unpaid, it is not delinquent until the grace period expires.

grace period
The time period following the due date for a payment during which payment received by the lender or landlord is not delinquent and a late charge is not due. [See **RPI** Form 550 §4.3 and 552 §4.7]

When the last day of a grace period for payment of past due rent falls on a legal holiday, the tenant's rent payment is not delinquent if it is received by the landlord on the next business day.[3]

Similarly, when the final day of the three-day notice falls on a holiday such as a Saturday, Sunday or other legal holiday, the three-day notice expires on the next business day.[4]

Accurate residential rent demands

To be valid, the three-day notice to pay rent or quit served on a residential tenant is to state the exact amount of money due and unpaid. Conversely, a commercial landlord may estimate the amount of money due and unpaid, when the exact amount cannot be accurately ascertained.

A residential tenant is not required to pay more than the amount due and unpaid to retain their possessory rights under a rental or lease agreement.

However, if the amount stated in a three-day notice served on a residential tenant exceeds the amounts actually due and unpaid at the time of the UD trial, the notice is invalid and an UD action based on it will fail.[5]

For both residential and commercial tenants, if the amount stated in the three-day notice is less than the actual amount due and unpaid, the tenant may pay the amount stated and avoid eviction. To collect any amounts omitted in a three-day notice, the landlord serves another three-day notice to pay the balance or quit.

Estimated commercial rent

A three-day notice served on a commercial tenant may include an estimate of the amounts due if:

- the notice states the amount due is an estimate; and
- the amount estimated is reasonable.[6]

---

2 CCP §§10; 12a
3 CCP §13; Calif. Government Code §6706
4 **Lamanna** v. **Vognar** (1993) 17 CA4th Supp. 4; CCP §12a
5 **Jayasinghe** v. **Lee** (1993) 13 CA4th Supp. 33
6 CCP §1161.1(a)

Failure to indicate that an estimated amount due is an estimate renders the three-day notice invalid.

An estimate of rent owed in a three-day notice is considered reasonable if:

- the actual amount owed is truly in question; and
- the delinquent amount demanded is neither 20% more or less than the amount determined due at the UD hearing.[1]

An estimate which contains amounts not yet due, such as unbilled common area maintenance expenses (CAMs), is not considered reasonable. Future amounts due are not delinquent, and may not be included in an estimate of delinquent amounts due and unpaid.[2]

1 CCP §1161.1(e)

2 **WDT- Winchester** v. **Nilsson** (1994) 27 CA4th 516

*Editor's note – Additional eviction protections may apply under the Tenant Protection Act of 2019 and the Tenant, Homeowner, and Small Landlord Relief and Stabilization Act of 2020. For more on this recent legislation, see the **first tuesday journal** at journal.firsttuesday.us.*

Chapter 79 Summary

A property manager may serve a tenant, residential or commercial, with a three-day notice to pay rent or quit when the tenant defaults on their rental or lease agreement. The tenant defaults when they fail to pay rent or perform other significant obligations called for in the rental or lease agreement

After a landlord serves a tenant with a three-day notice to pay rent or quit, the tenant needs to cure the breach in three business days to avoid forfeiture and eventual eviction in an unlawful detainer (UD) action.

Chapter 79 Key Terms

Quiz 15 Covering Chapters 79-85 is located on page 620.

Chapter 80

Three-day notices to quit

Learning Objectives

After reading this chapter, you'll be able to:

- differentiate between a curable breach a tenant can resolve and an incurable breach a tenant cannot correct; and
- identify the proper three-day notice to serve on a tenant for a nonmonetary material breach of a rental or lease agreement.

Key Terms

nonmonetary breach
nonwaiver provision
nuisance
retaliatory eviction
statutory breach
waste

For additional information on this topic, see Chapter 26 of Real Estate Property Management.

Types of three-day notices for various breaches

A tenant breaches a provision in their rental or lease agreement and is served a **three-day notice to quit** by the landlord. If the three-day notice is not the correct type, an unlawful detainer of a premises by the tenant cannot be established and the tenant evicted.

Depending on the nature and extent of the tenant's breach, the landlord will serve a:

- three-day *notice to pay rent or quit* [See **RPI** Form 575 in Chapter 79];
- three-day *notice to perform or quit* [See Form 576 accompanying this chapter]; or
- three-day *notice to quit*. [See Form 577 accompanying this chapter]

When a tenant's breach is the failure to pay rent or other money obligation which is due, the tenant is served with a three-day *notice to pay rent or quit*. This type of breach is known as a **monetary breach** which is curable by paying money.

monetary breach
A tenant's failure to timely pay rent or other money obligation due.

When the provision breached is not for rent or other money obligation and the breach can still be quickly corrected by the tenant, the tenant is served with a three-day *notice to perform or quit*. This type of breach is known as a **nonmonetary breach**. [See Form 576]

nonmonetary breach
A tenant's breach of any obligation other than an obligation to pay money.

When a tenant is in default for a failure to pay rent as well as a curable nonmonetary breach, a three-day notice to perform or quit is used. The demand to pay rent is listed as an additional (monetary) breach to be cured under the notice to perform or quit.

Notice to perform or quit

The three-day notice to perform or quit requires the tenant to either:

- *perform* under the breached lease provision; or
- *vacate* the premises.[1]

The tenant's breach of a provision in a rental or lease agreement needs to be a significant breach, called a *material breach*, to justify serving a three-day notice. A minor or trivial breach by the tenant will not support a three-day notice.[2]

For a tenant to avoid a forfeiture of their right of possession, they need to be given an opportunity to reinstate the rental or lease agreement if the breach can be cured in three days.

The three-day notice to perform or quit will specify the provision breached and the action required to cure the breach. When the tenant cures the breach before the three-day notice expires, the breach of the rental or lease agreement is eliminated and possession continues as though no breach occurred.

If a tenant fails to cure the breach or vacate as required after the service of a three-day notice to perform or quit containing a **declaration of forfeiture** provision, the landlord may initiate an unlawful detainer (UD) action to have the tenant removed. Since the declaration of forfeiture provision exists in the three-day notice, the tenant is barred from reinstating their possession after the three-day notice expires.[3]

A landlord is required to allow a tenant to cure a material breach, monetary or nonmonetary, within three days after notice when the tenant is capable of performing under the breached lease provision within three days.[4]

1 Calif. Code of Civil Procedures §1161(3)
2 **Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818
3 CCP §1161(3)
4 CCP §1161(3)

Form 576

Three-Day Notice to Perform or Quit

THREE-DAY NOTICE TO PERFORM OR QUIT

NOTE: This form is used by a property manager or landlord when a tenant fails to perform a nonmonetary activity called for in a rental or lease agreement which can be performed or rectified within three days, to notify the tenant they are to perform the activity within three days or vacate and deliver up possession.

DATE: ______________, 20______, at ______________________________, California.
To Tenant: ______________________________
Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or expired lease agreement
   1.1 dated ______________, at ______________________________, California,
   1.2 entered into by ______________________________, as the Tenant,
   1.3 and ______________________________, as the Landlord,
   1.4 regarding real estate referred to as ______________________________.

NOTICE:

2. You are in breach of the terms of your rental or lease agreement as follows: ______________________________.
3. Within three (3) days after service of this notice, you are required to either:
   3.1 Perform or rectify the breach by ______________________________.

OR

   3.2 Deliver possession of the premises to Landlord or ______________________________.
4. If you fail to cure the breach or to deliver possession within three (3) days, legal proceedings may be initiated to regain possession of the premises and to recover the rent owed, treble damages, costs and attorney fees.
5. Landlord hereby elects to declare a forfeiture of your lease if you fail to cure the breach noted above.
   5.1 Landlord reserves the right to pursue collection of any future rental losses allowed by Calif. Civil Code §1951.2.
6. Notice: State law permits former Tenants to reclaim abandoned personal property left at the former address of the Tenant, subject to certain conditions. You may or may not be able to reclaim property without incurring additional costs, depending on the cost of storing the property and the length of time before it is reclaimed. In general, these costs will be lower the sooner you contact your former Landlord after being notified that property belonging to you was left behind after you moved out.

Date: ______________, 20________
Landlord/Agent: ______________ CalBRE #:____________

Signature: ______________________________
Address: ______________________________
____
Phone: ______________ Cell: ______________
Fax: ______________________________
Email: ______________________________

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Notice to quit; no alternatives

A three-day *notice to quit* requiring the tenant to vacate without alternative is served when the tenant's breach is:

- impossible to cure in three days;[5] or
- a *statutory breach*.[6]

5 **Matthew** v. **Digges** (1920) 45 CA 561
6 CCP §1161(4)

Incurable breaches and statutory breaches automatically forfeit the tenant's right of possession. These breaches either cannot be remedied within the notice period, or are incurable by statute.[1]

statutory breach
A breach of the lease agreement which automatically forfeits the tenant's right of possession.

Statutory breaches, being incurable, include:

- an unauthorized subletting or assignment of the premises;
- maintaining a *nuisance* on the premises; or
- *unlawful use* of the premises.[2]

The three-day notice to quit does not need to indicate the provision breached or the activity of the tenant constituting the breach. Nor does it need to include a lease forfeiture declaration by the landlord. Since these breaches cannot be cured by the tenant, the right of possession can only be reinstated if the landlord chooses to waive the forfeiture.

However, when a forfeiture of the lease has already occurred, a UD court requires service of a three-day notice before a landlord may recover possession.

Quit! The breach cannot be undone

Consider a tenant who leases agricultural property. The lease agreement states the tenant's use of the property is limited to grazing sheep. However, the tenant plants crops on the property.

Based on the tenant's unauthorized use of the premises, the landlord serves a three-day notice to quit on the tenant.

The tenant's use of the property to raise crops, instead of the single agreed-to use as a pasture, is *an incurable nonmonetary breach* of the lease agreement. The tenant cannot reverse the effects of raising the crops on the soil since the activity has already occurred.[3]

Breach of statutory prohibitions

A tenant may be evicted for maintaining a *nuisance* or *unlawful use* of the premises, even if these activities are not prohibited by the lease agreement.[4]

nuisance
An action which is injurious to health, offensive to the senses, or obstructs the use and enjoyment of surrounding property. [See **RPI** Form 550 §6.7 and 552 §7.3]

A **nuisance** includes anything which:

- is injurious to health, such as contamination of the property's soil;
- is offensive to the senses, such as excessive noise levels or obnoxious fumes; or
- obstructs the use and enjoyment of surrounding property.[5]

A tenant's *unlawful* use of the premises under the statute includes violations of local laws or ordinances affecting the property, such as noncompliance with zoning ordinances restricting the use of the premises. The leasehold is

1 CCP §1161(3)
2 CCP §1161(4)
3 **Harris** v. **Bissell** (1921) 54 CA 307
4 CCP §1161(4)
5 Calif. Civil Code §3479

Form 577

Three-Day Notice to Quit

THREE-DAY NOTICE TO QUIT
Residential and Commercial

NOTE: This form is used by a property manager or landlord when a tenant under a rental or lease agreement has committed an incurable breach or failed to perform obligations which cannot be performed or rectified within three days, to notify the tenant they are to vacate and deliver possession within three days.

DATE: _____________, 20_____, at ____, California.
To Tenant: ____
Items left blank or unchecked are not applicable.
FACTS:

1. You are a Tenant under a rental or expired lease agreement
   1.1 dated _________________, at ____, California,
   1.2 entered into by ____, as the Tenant,
   1.3 and ____, as the Landlord,
   1.4 regarding real estate referred to as ____
   ____.

NOTICE:

2. You are in breach of the terms of your rental or lease agreement as follows: _______________________________
____
____
____
____
____
____.
3. Within three (3) days after service of this notice, you are required to vacate and deliver possession of the premises to Landlord or ____.
4. If you fail to vacate and deliver possession of the premises within three (3) days, legal proceedings may be initiated to regain possession of the premises and to recover the rent owed, treble damages, costs, and attorney fees.
5. Landlord hereby elects to declare a forfeiture of your lease.
   5.1 Landlord reserves the right to pursue collection of any future rental losses allowed by Calif. Civil Code §1951.2.
6. **Notice:** State law permits former Tenants to reclaim abandoned personal property left at the former address of the Tenant, subject to certain conditions. You may or may not be able to reclaim property without incurring additional costs, depending on the cost of storing the property and the length of time before it is reclaimed. In general, these costs will be lower the sooner you contact your former Landlord after being notified that property belonging to you was left behind after you moved out.

Date: _____________, 20_______
Landlord/Agent: __________________ CalBRE #:____________

Signature: ____
Address: ____
____
Phone: __________________ Cell: ____________________
Fax: ____
Email: ____

FORM 577 01-13

forfeited automatically due to the statutory violation. The three-day notice is required only as a requisite to a UD action when the tenant remain in possession.[6]

However, before the unlawful use justifies service of a notice to quit, the use needs to:

- threaten the physical safety of the property;
- stigmatize the premises; or

6 Haig v. Hogan (1947) 82 CA2d 876

Form 580

Proof of Service

PROOF OF SERVICE
For Service of Notice to Real Estate Tenants

NOTE: This form is used by a property manager or landlord when serving a tenant a notice to pay, perform, vacate or quit or a notice of change in rental terms, to document the date and time the notice was served and the manner of service for use in any eviction proceeding.

1. I am over 18 years of age.

2. On ________________, 20______, at ____, California,
I served the following checked items:
☐ Three-Day Notice to Pay Rent or Quit [See **RPI** Forms 575 and 575-1]
☐ Three-Day Notice to Perform or Quit [See **RPI** Form 576]
☐ Three-Day Notice to Quit [See **RPI** Forms 577 and 578]
☐ 30-Day Notice to Vacate [See **RPI** Forms 569, 571 and 573]
☐ 60-Day Notice to Vacate [See **RPI** Form 569-1]
☐ 30-Day Notice of Change in Rental Terms [See **RPI** Form 570]
☐ 60-Day Notice of Change in Rental Terms [See **RPI** Form 574]
☐ ____

3. Regarding tenancy of property referred to as ____
____.

4. On Tenant(s) (name) ____
____.

5. Manner of service (check the appropriate box):
5.1 ☐ By personally delivering a copy to each named Tenant;
a. ☐ at Tenant's residence;
b. ☐ at Tenant's place of business.
5.2 ☐ By delivering a copy to a person of suitable age and discretion;
a. ☐ at the Tenant's residence; or
b. ☐ at Tenant's place of business, as the named Tenant was absent from each location;
and
mailing by first-class postage prepaid a copy to each named Tenant at his residence.
5.3 ☐ By posting a copy for each named Tenant in a conspicuous place on the property described in the notice as no person of suitable age or discretion was found at the Tenant's residence or place of business;
and
mailing by first-class postage prepaid a copy to each named Tenant at the address of the leased property.

I declare under penalty or perjury that foregoing is true and correct.

Date: ______________, 20________
Name: ____

Signature: ____

FORM 580 01-13

- impair the landlord's continued receipt of rent.

Waste forfeits the lease

Waste to the leased premises by a tenant is a breach that cannot be cured. *Waste* terminates the tenant's right of possession. The tenant needs to vacate if the landlord serves a three-day notice to quit.

However, waste is grounds for eviction only when the value of the leased premises is substantially or permanently impaired due to the tenant's conduct.

Waste occurs when a tenant:

- intentionally damages or destroys the leased premises; or
- neglects the premises and impairs its value by failing to care for and maintain it as agreed.

waste
The intentional destruction or neglect of property which diminishes its value. [See **RPI** Form 550 §6.8 and 552 §7.4]

Service of notice

Statutory requirements are to be strictly followed when preparing and serving a three-day notice.

If the three-day notice is incorrectly or inaccurately prepared, or improperly served on the tenant, the notice is invalid. To later evict the tenant, a new three-day notice needs to be correctly and accurately prepared, and properly served on the tenant.[1]

A *proof of service* form needs to be filled out and signed by the person serving the three-day notice. Without a proof of service, a UD action cannot be maintained. [See Form 580 accompanying this chapter]

A landlord may concurrently serve both a three-day notice to pay (perform) or quit and a 30-day notice to vacate or change terms. However, the notices are to be served separately. If attached or otherwise combined, other than in time, they may be reasonably confused as one. The confusion would properly defeat any UD action based on the three-day notice.

Also, each notice is to be accompanied by its own separate *proof of service* to clarify their independent existence. [See Form 580]

Retaliatory eviction

A **retaliatory eviction** occurs when a residential landlord attempts to evict a tenant for:

- exercising their right to file a complaint with an appropriate agency regarding the habitability of the premises;
- orally complaining to the landlord about the *habitability* of the premises;
- filing documents to initiate a judicial or arbitration proceeding regarding the habitability of the premises;
- organizing or participating in a tenant association or an association for tenant's rights; or
- lawfully exercising any rights, such as the refusal to authorize credit reports or personal investigation after vacating the premises.[2]

retaliatory eviction
A tenant whose tenancy is sought to be terminated for lawfully exercising any rights.

Recall that a notice to vacate need not include a reason for the termination of occupancy. It is therefore up to the tenant to determine whether the landlord's conduct may justify the claim of a retaliatory eviction.

A landlord convicted of a retaliatory eviction is liable for punitive damages up to $2,000 for each act of retaliation.[3]

1 **Lamey** v. **Masciotra** (1969) 273 CA2d 709
2 CC §1942.5
3 CC §1942.5

Editor's note – Additional eviction protections may apply under the Tenant Protection Act of 2019 and the Tenant, Homeowner, and Small Landlord Relief and Stabilization Act of 2020. For more on this recent legislation, see the ***first tuesday journal*** *at journal.firsttuesday.us.*

Chapter 80 Summary

A breach which can be remedied by action from the tenant during the notice period is known as a curable breach. A breach which cannot be remedied by action from the tenant during the notice period is known as an incurable breach.

Depending on the nature and extent of the tenant's breach, one of the following types of three-day notices may be served:

- a three-day notice to pay rent or quit;
- a three-day notice to perform or quit; or
- a three-day notice to quit.

When a tenant's breach is the failure to pay rent or other money obligation which is due, the tenant is served with a three-day notice to pay rent or quit. This type of breach is known as a monetary breach and is curable by paying money.

When the lease provision breached is not for rent or other money obligation and the breach can be quickly corrected, the tenant is served with a three-day notice to perform or quit. This type of breach is known as a nonmonetary breach and is not curable by paying money.

A three-day notice to quit is used when the tenant's material breach is:

- an incurable breach; or
- a statutory breach.

Incurable breaches and statutory breaches automatically forfeit the tenant's right of possession.

Chapter 80 Key Terms

monetary breach .... **pg. 532**
nonmonetary breach .... **pg. 532**
nuisance .... **pg. 534**
retaliatory eviction .... **pg. 537**
statutory breach .... **pg. 534**
waste .... **pg. 537**

Quiz 15 Covering Chapters 79-85 is located on page 620.

Chapter 81

Notices to vacate

Learning Objectives

After reading this chapter, you will be able to:

- determine a landlord's and tenant's correct use of a notice to vacate to terminate month-to-month tenancies; and
- differentiate the circumstances under which a landlord uses a 30-, 60- or 90-day notice to vacate.

Key Terms

bona fide lease agreement **Section 8 housing**
owner-by-foreclosure

For a deeper analysis of this subject matter, see Chapter 29 from Real Estate Property Management.

Landlord's intent to evict

A residential or commercial landlord terminates a month-to-month tenancy by serving the tenant with a *notice to vacate*. A **30-day notice to vacate** is used, except when notifying a residential tenant who has occupied the property for one year or more, in which case the landlord uses a **60-day notice to vacate**.[1]

However, if the tenant has *materially breached* the rental agreement, a landlord may use the appropriate **three-day notice to quit** to terminate the tenancy. [See **RPI** Form 579; see Chapter 80]

A *notice to vacate* form (as distinguished from a notice to quit) used by a landlord contains:

- the name of the tenant;
- the address of the premises;
- a reference to the rental agreement or expired lease;

1 Calif. Civil Code §1946.1

- a statement that the unit is to be vacant within the applicable number of days (30 or 60) after service of the notice;
- the dollar amount of pro rata rent to be paid when rent is next due;
- a statement regarding the security deposit and its disposition;
- a statement informing the tenant of their right to request a joint pre-expiration inspection of the premises; and
- a statement notifying residential tenants of their right to reclaim abandoned personal property.

Notices to vacate do not need to include declarations of forfeiture. The tenancy terminates automatically on expiration of the notice period. Due to its contents, the landlord's notice to vacate eliminates any confusion as to the amount of pro rata rent to be paid and when the rent is due. [See **RPI** Form 571 §4]

Tenant's intent to vacate

A residential or commercial tenant who intends to vacate under a month-to-month rental arrangement serves the landlord with at least a 30-day notice to terminate the occupancy and vacate. The notice may be in the form of a letter personally delivered to the landlord or their agent, or sent by certified or registered mail.[1] [See **RPI** Form 572]

Some landlords are willing to accept *oral notice* of the tenant's intent to vacate without reducing the notice to a writing signed by the tenant.

A tenant's 30-day notice to vacate acknowledges:

- the tenancy is terminated on expiration of 30 days after service of the notice on the landlord or property manager;
- the tenant's intent to pay pro rata rent on the next rent due date;
- the amount of the security deposit;
- the tenant's right to request a joint pre-expiration inspection;
- the tenant's right to receive an itemized statement of maintenance and cleaning deficiencies for any potential deductions from the security deposit;
- a security deposit statement and refund based on any deductions for cleaning and repairs on a final review of the premises by the landlord or property manager; and
- the landlord's right to show the premises to a prospective tenant on 24 hours' notice. [See **RPI** Form 572]

Holdover tenancy

If a tenant serves a 30-day notice to vacate but fails to vacate after expiration of the notice, they become a *holdover tenant*. Thus, they are unlawfully in possession of the property. The landlord may immediately file an unlawful detainer (UD) action to evict the tenant on the running of the 30 days after service.

1 CC §1946

Service of the notice to vacate

A notice to vacate may be served at any time during the month.[2]

However, a commercial landlord and tenant may memorialize in the rental agreement that the 30-day notice to vacate cannot be served later than seven days before the end of the rental term (e.g., the end of the month, in a month-to-month tenancy).

To be effective, the notice to vacate from a commercial tenant or landlord needs to be served:

- in the same manner as a three-day notice (in person, by substitution or post and mail); or
- by certified or registered mail, a method of service not available for three-day notices to quit.[3] [See Chapter 80]

Conversely, a residential landlord serves a notice to vacate by personally delivering the notice to the tenant. The residential landlord may also concurrently:

- leave a copy of the notice either at the residence or the tenant's place of business with a person of appropriate age;
- post the notice in a conspicuous place on the property; and
- mail the notice by certified or registered mail.[4]

The maximum period within which the tenant is to vacate begins to run the day after the date of service, which is day one of the 30- or 60-day period.[5]

If the day for expiration of the notice is a Saturday, Sunday or a federal holiday, the tenant is not required to vacate until the next business day.[6]

A properly completed notice to vacate form gives a specific date, on or after the minimum time period following service, for termination of the occupancy. The day is not left to chance and, as a practical matter, not set as a weekend or holiday.

Periodic tenancies extended/ terminated

Unlike the extension of a lease term, the 30-day rental period under a **month-to-month rental agreement** is automatically extended for the same period and on the same conditions. [See **RPI** Form 569 and 572]

The right to automatic extensions is terminated by a notice to vacate from either party to the other. However, if the property is residential and the tenant has resided on it for one year or more, the landlord is required to give the tenant at least a 60-day notice to vacate.[7] [See **RPI** Form 569-1]

---

2 CC §1946
3 CC §1946
4 Calif. Code of Civil Procedures §§ 1161a, 1162
5 CC §10
6 CCP §12a
7 CC §1946.1

If the notice to vacate expires and the tenant has not vacated, the landlord may file a UD action to evict the month-to-month tenant without further notice.[1]

Rent control limitations on eviction

When a residential rental property is located in a *rent control* community, the landlord has less discretion to evict tenants with a notice to vacate.

Typically, the termination of a tenancy and evictions are allowed in *rent control* communities when:

- the tenant fails to pay rent or otherwise materially breaches the lease agreement;
- the tenant creates a nuisance;
- the tenant refuses to renew a lease;
- the tenant uses the residence for an illegal purpose; or
- the landlord or a relative will occupy the unit.

A landlord and their property manager of a property subject to rent control need to make themselves aware of the local restrictions imposed on the eviction of tenants.

Good reason to evict exception

Section 8 housing
A government housing program for low income households which provides qualifying tenants with rent subsidies and minimum habitability standards.

A landlord is not required to state their reasons in a notice to vacate, or even have good cause for evicting a month-to-month tenant.[2]

Exceptions exist. If a tenant's unit is subject to rent control, or a tenant's rent is subsidized by the Department of Housing and Urban Development's (HUD) **Section 8 housing** program, the landlord needs to set forth good cause as the reason for the termination. The good cause is documented in the 30-day notice to vacate. Thus, the tenant is given notice so they can prepare their defense to avoid eviction.[3]

However, a landlord may not evict a tenant:

- in retaliation for the tenant making official complaints about the property or against the landlord;
- based on discriminatory reasons, such as the tenant's ethnicity or marital status; or
- due to the landlord's failure to maintain the property in a habitable condition.

Residential foreclosure and possession

The owner of a residential income property is in default on a loan secured by a trust deed encumbering the property. While the owner is in negotiations with the lender to modify the loan's payment schedule, the owner enters into a two-year lease agreement with a tenant.

1 CCP §1161(5)
2 CC §1946
3 **Mitchell** v. **Poole** (1988) 203 CA3d Supp. 1

Shortly after the tenant takes possession, negotiations with the lender break down. The lender records a *notice of default (NOD)* and forecloses on the property. The property is sold at a trustee's sale nearly one year later. The high bidder takes title to the property as the new **owner-by-foreclosure**.

owner-by-foreclosure
The winning bidder at a trustee's sale who takes title to the property sold by a trustee's deed.

An owner-by-foreclosure who purchases a residential property at a trustee's sale for investment purposes may only terminate an existing residential tenancy by serving the tenant with at least a **90-day notice to vacate**. This rule is set to expire December 31, 2019.[4] [See **RPI** Form 573 and 573-1]

However, an owner-by-foreclosure cannot use a 90-day notice to vacate to terminate an occupancy and avoid:

- a **bona fide lease agreement** entered into prior to the foreclosing lender recorded the NOD which grants the tenant the right of possession for a period running beyond the 90-day notice period.
- an existing Section 8 or state housing assistance payment contract which subsidizes the tenant's rent; or
- state or local rent control codes or ordinances that provide the residential tenant with a greater time period for occupancy or other tenant benefits such as relocation money.[5]

bona fide lease agreement
A lease agreement with a fair market rent held by a residential tenant when ownership of the property is transferred by a foreclosure sale. [See **RPI** Form 550 and 552]

A *bona fide lease agreement* is one entered into by a tenant and the prior owner which meets all of the following criteria:

- the lease agreement is an arm's length lease agreement, meaning the tenant is not a parent, spouse or child of the prior owner; and
- the lease agreement calls for payment of a fair market rent at the time entered into.[6]

4 CCP §§1161a,1161b
5 CCP §1161b
6 Pub L 111-22 §702 (a)(1)(2)(B)

Chapter 81 Summary

A residential or commercial landlord terminates a month-to-month tenancy by preparing and serving the tenant with at least a 30-day notice to vacate. If the tenant has resided in a residential property for one year or more, the landlord is required to give the tenant at least a 60-day notice to vacate However, if the tenant has materially breached the rental agreement, a landlord may use a three-day notice to quit to terminate the tenancy.

A residential or commercial tenant who intends to vacate and avoid further liability under a month-to-month rental agreement gives at least 30 days' advance notice to the landlord.

An owner-by-foreclosure of a residential property is required to serve a bona fide tenant occupying the property at the time of the foreclosure sale with at least 90 days' notice before the tenant's right of possession is terminated.

Chapter 81 Key Terms

Quiz 15 Covering Chapters 79-85 is located on page 620.

Chapter 82

Implied warranty of habitability

Learning Objectives

After reading this chapter, you will be able to:

- identify the circumstances in which the implied warranty of habitability is breached; and
- the actions a tenant may take when the landlord breaches the implied warranty of habitability.

Key Terms

habitability defense **implied warranty of habitability**

habitable condition

For an additional discussion of this topic, see Chapter 37 of Real Estate Property Management.

Safe, sanitary and fit for use

The residential tenant under a lease agreement acquires a leasehold interest to occupy the leased premises for a specific period of time. The tenant expects the premises and *appurtenances* (e.g., common areas, parking and storage) available to them to be safe, sanitary and fit for use. It is to be habitable at all times.

All residential rental and lease agreements carry an **implied warranty of habitability** regardless of the provisions in the lease agreements. However, commercial leases do not contain an implied warranty of habitability.

implied warranty of habitability
An unwritten provision, included by statute, in all residential lease agreements requiring the landlord to provide safe and sanitary conditions in the rental unit.

The *implied warranty* requires the residential landlord to care for the premises by maintaining it in a **habitable condition**. A *habitable condition* is the minimum acceptable level of safety and sanitation permitted by law.[1]

1 **Hinson** v. **Delis** (1972) 26 CA3d 62; Calif. Code of Civil Procedure §1174.2

habitable condition
The minimum acceptable level of safety, utility and sanitation permitted in a residential rental.

Residential property which is not in a habitable condition cannot be rented or leased "as-is." A property cannot be rented "as-is" even if defective property conditions have been fully disclosed and consented to by the tenant.

The public policy establishing the warranty of habitability was legislated due to landlord abuses during periods of scarcity in low-cost housing. This economic situation left residential tenants in lesser socioeconomic neighborhoods without the bargaining power possessed by more affluent and mobile tenants.

Landlord's breach of the warranty

Landlords breach the implied warranty of habitability when they fail to comply with building and housing code standards that materially affect health and safety.[1]

A habitable place to live is a dwelling free of major defects which would interfere with the tenant's ability to use the premises as a residence. This definition does not include mere inconveniences.

A residential dwelling is uninhabitable if any features of the dwelling are:

- not properly maintained; or
- do not substantially comply with building and housing codes

To be habitable, a residential property needs to have:

- effective waterproofing and weather protection of roof and exterior walls, including unbroken windows and doors;
- plumbing and gas facilities;
- a hot and cold running water system with appropriate fixtures connected to a sewage disposal system;
- heating facilities;
- electrical lighting; and
- floors, stairways and railings.[2]

In applying these guidelines, a *leaky faucet* would not render a residential unit uninhabitable. However, *lack of running water* is a significant defect that materially interferes with the tenant's ability to use the property as shelter.

Clean and sanitary

At the time the rental or lease agreement is entered into, the building grounds and appurtenances are to be clean and sanitary. This includes:

- the communal pool;
- laundry facilities;
- storage areas; and
- parking structures.

---

1 CCP §1174.2(c)

2 Calif. Civil Code §1941.1

To meet habitability guidelines, the building grounds and appurtenances are to be free from all accumulations of debris, filth, rodents and vermin.[3]

Further, the landlord is required to provide an adequate number of clean garbage receptacles.[4]

A residential tenant in an apartment complex is not expected to make repairs to major components of the complex. Major components include a central heating system, an electrical or plumbing system or the roof.

If a residential landlord fails to make necessary repairs, and the cost of the repair is less than one month's rent, the tenant may order out and pay for the needed repairs. The tenant may then deduct the cost from the rent, called the **repair-and-deduct remedy**.[5]

However, the *repair-and-deduct remedy* is not often feasible in apartment dwellings since areas where repairs need to be made are in the possession and control of the landlord.

The residential tenant then resorts to other remedies, such as:

- vacating the premises, called a **constructive eviction**;
- stop paying rent and prove the landlord breached the *implied warranty of habitability* in the ensuing unlawful detainer (UD) action; or
- raise and prove the defense of *retaliatory eviction* in any UD action.

Pre-leasing maintenance program

Before renting a residential unit in a building intended for human habitation, the landlord is to:

- install and maintain an operable dead bolt lock on each main entry door of a unit, unless the door is a horizontal sliding door;
- install and maintain operable security or locking devices for windows which are designed to be opened, unless the window is a louvered window, casement window, or more than 12 feet vertically or six feet horizontally from the ground, roof or other platform; and
- install locking mechanisms on the exterior doors leading to common areas with access to dwelling units in an apartment complex.

A tenant is responsible for promptly notifying the landlord of an inoperable dead bolt lock, window security or locking device in the unit. The landlord will only be liable for injuries caused by their failure to correct the defect once on notice. The landlord has a reasonable period of time after being notified or becoming aware of the defect to correct it before becoming liable for future injuries.[6]

If a residential landlord fails to comply with required security measures, the tenant may:

- repair and deduct the cost from rent;

3 CC §1941.1(f)
4 CC §1941.1(g)
5 CC §1942
6 CC §1941.3(b)

- vacate the premises;
- recover money losses incurred due to the condition of an uninhabitable building;
- recover losses caused by any landlord retaliation;
- file an action for breach of contract; or
- seek injunctive relief to stop the landlord from maintaining an uninhabitable building.[1]

A landlord may not allow a tenant to take possession of a property known to be unsafe or unsanitary. Before renting out such a unit, the landlord is to ensure the premises is fully repaired.

Repair before renting

The warranty of habitability is breached when the need for repairs is:

- known by the landlord, either through notice from the tenant or by the physical state of the property at the time it is rented; and
- the landlord fails to immediately correct the defective conditions.

Landlords have a duty to inspect and maintain their property and improve or correct known substandard conditions before renting it. Landlords are not granted a reasonable time to repair uninhabitable conditions if they are known to the landlord to exist before renting out the property to a tenant.[2]

However, during the time a tenant has possession of the property, the tenant is to make the landlord aware of any unsafe or unsanitary conditions that develop before the landlord can be held responsible for repairing them.

Landlord's warranty of habitability defense

In a UD action, a tenant who successfully raises the *habitability defense* will be allowed to:

- retain possession of the premises;
- pay a reduced amount of rent based on the uninhabitable condition of the property; and
- recover attorney fees and costs of litigation.[3]

To remain in possession, the tenant is to pay the rent amount awarded to the landlord, offset by the tenant's attorney fees, within:

- five days of the entry of judgment; or
- ten days, if the UD judgment is served on the tenant by mail.[4]

If the tenant fails to pay the rental amounts set by the court in a timely manner, the landlord is awarded possession of the premises.[5]

1 CC §1941.3(c)
2 CC §1714
3 CCP §1174.2(a)(1)
4 CCP §1174.2(a)
5 CCP §1174.2(b)

The UD judgment may or may not require the landlord to make all repairs necessary to return the premises to a safe and sanitary condition. When a landlord is ordered to correct the uninhabitable conditions by returning the premises to a safe and sanitary condition:

- the tenant remaining in possession pays the reasonable monthly rental value of the premises in its uninhabitable condition until the repairs are completed; and
- the court retains control to oversee compliance by the landlord.[6]

The tenant who raises the **habitability defense** instead of paying the rent takes the risk of being evicted. The landlord's failure to make repairs may not rise to the level of a substantial breach of the warranty of habitability. If the repairs are minor and are judged to create only an inconvenience or annoyance for the tenant, the landlord has not substantially breached the warranty of habitability, and:

- the landlord is awarded the right of possession; and
- the tenant is liable for rent accrued through the date of judgment.[7]

habitability defense
A residential tenant's pursuit of a legal remedy due to a landlord's failure to maintain habitable conditions on the rented premises.

6 CCP §1174.2(a)
7 CCP §1174.2(b)

Chapter 82 Summary

A residential landlord's failure to maintain the premises in a habitable condition constitutes a breach of the implied warranty of habitability. All residential rental and lease agreements are subject to this implied warranty regardless of the provisions in the lease agreement. Commercial leases do not contain an implied warranty of habitability.

The implied warranty requires the residential landlord to care for the premises by maintaining it in a habitable condition. On noticing a condition that breaches the implied warranty of habitability, the tenant has a duty to notify the landlord and give them a reasonable amount of time to make the repairs before taking other action.

Chapter 82 Key Terms

Quiz 15 Covering Chapters 79-85 is located on page 620.

Notes:

Security to prevent crimes

Chapter 83

Learning Objectives

After reading this chapter, you will be able to:

- identify the landlord's responsibilities to reduce the risk of crime through prevention; and
- understand the landlord's responsibilities to prevent reasonably foreseeable crime or warn tenants of known criminal activity.

Key Term

reasonably foreseeable

For a further study of this discussion, see Chapter 39 of Real Estate Property Management.

Protective measures and warnings

Assaults on tenants have occurred in the common areas of an apartment complex. The landlord receives a composite drawing of the criminal and a description of the criminal's activities by the local police.

The landlord does not undertake any security steps to reduce the risk of similar criminal activities.

The landlord later rents a unit to a new tenant. The landlord does not disclose the recent criminal assaults. Further, the landlord represents the complex as safe and patrolled by security.

Later, the tenant is assaulted by the same perpetrator inside the tenant's apartment unit. The tenant seeks to recover their money losses caused by the assault from the landlord. The tenant claims the landlord failed to disclose the prior assaults and misrepresented the safety of the apartment complex.

The landlord claims they are not liable for the tenant's injuries since the assault occurred within the tenant's apartment unit, whereas the prior attacks occurred in the common areas.

May the tenant recover money losses from the landlord?

Yes! The landlord is liable for the tenant's injuries. The landlord knew of criminal activity on the premises and owed a *duty to care* to the tenant. Thus, the landlord failed to protect the tenant by either:

reasonably foreseeable
The possibility a crime or danger may occur due to a previous crime on the premises. A landlord has a duty to take reasonable measures to prevent harm to persons on the property or warning tenants of the prior criminal activity.

- providing security measures in the common areas; or
- warning the tenant of the prior assaults.[1]

Based on the prior criminal incidents, the likelihood of similar future assaults on tenants is **reasonably foreseeable**. When criminal activity is *reasonably foreseeable*, the landlord has a duty to take reasonable measures to prevent harm to persons on the property from future similar criminal activities. Due to the landlord's failure to put security measures in place, the landlord needs to compensate the injured tenant by paying for their losses, called **damages**.

High degree of foreseeability

The landlord's duty to provide protection is determined in part by balancing the foreseeability of harm against the burden imposed on the landlord to remove or prevent the harm. A *high degree of foreseeability* is necessary to impose a duty on a landlord to hire security guards.

Unless prior incidents of similar crimes are brought to the landlord's attention, the high degree of foreseeability required to impose a duty on the landlord to take steps to prevent or eliminate future injury does not exist.

However, prior similar incidents are not the only determining factor. The foreseeability of an injury is also determined by the *circumstances* surrounding the injury and its occurrence, such as the nature, condition and location of the premises.[2]

No liability if not foreseeable

The extent of the security measures a landlord is required to provide is dictated by the degree of foreseeability of any future harm to others.[3]

If the nature, condition and location of the leased premises do not indicate a person entering or using the property is at a foreseeable risk, the landlord is not liable for an injury. The landlord is similarly not liable even if security measures would have prevented the injury from occurring.

Consider an apartment complex where previous criminal activity has not occurred. However, the community where the complex is located is known as a high-crime area.

1 **O'Hara** v. **Western Seven Trees Corporation Intercoast Management** (1977) 75 CA3d 798
2 Ann M., *supra*
3 Ann M., *supra*

The light bulb installed at the entrance to a tenant's apartment burns out. The tenant asks the landlord to replace the light bulb. The lighting in the common area is functional.

Before the landlord replaces the bulb, the tenant is assaulted in their unit, suffering injuries. The tenant claims the landlord is liable for their injuries since the landlord has a duty to provide adequate lighting as a security measure.

The landlord claims they are not liable since the light bulb outside the tenant's unit is for the tenant's convenience. It is not intended as a protective security measure .

Here, the landlord is not liable. Prior criminal activity had not occurred on the premises that would put the landlord on notice of foreseeable risks. Thus, the landlord has no duty to take security precautions against criminal activity. Further, lighting alone is not considered an adequate security measure for deterring crime.[4]

Further, the landlord does not have a duty to protect a tenant from criminal activity when they are not on the leased premises.[5]

4 **7735 Hollywood Boulevard Venture** v. **Superior Court** (1981) 116 CA3d 901
5 **Rosenbaum** v. **Security Bank Corporation** (1996) 43 CA4th 1084

Chapter 83 Summary

When criminal activity is reasonably foreseeable due to known prior criminal activity, the landlord has a duty to take reasonable measures to prevent harm to persons on the property from future similar criminal activities.

A landlord is to properly maintain existing security features on the leased premises. However, the landlord does not have a duty to take control over an adjoining property and remove or prevent injury from dangerous conditions existing on the adjoining property.

Chapter 83 Key Term

Quiz 15 Covering Chapters 79-85 is located on page 620.

Notes:

Chapter 84

Construction concepts

Learning Objectives

After reading this chapter, you will be able to:

- understand the regulations controlling the construction of residential and commercial properties in California;
- be conversant in basic construction and architectural concepts; and
- discuss how to market energy efficient property.

Key Terms

building inspectors	**radon gas**
contractor	**rafters**

Building regulations

Construction of residential and commercial buildings is regulated by the state of California through **building codes**.

The **State Housing Law** outlines the construction requirements and standards for all buildings in California. The Housing Law dictates the construction and occupancy of dwellings, including:

- single family residences (SFRs);
- apartments;
- hotels; and
- motels.

The **Department of Housing and Community Development (HCD)** *(www.hcd.ca.gov)* is responsible for adopting administrative regulations to carry out the provisions of the Housing Law. The HCD establishes building standards and codes, called the **California Building Standards Code**.[1]

1 24 Code of Federal Regulations §3280 et seq.

Local governments can amend building codes to meet the particular needs of its community. Local amendments are typically made based on local climactic, geological or topographical conditions. Though amended, local building codes need to comply with state regulations.

building inspectors
Individuals employed by municipalities to ensure properties comply with local building codes, ordinances, zoning regulations and contract specifications.

Building codes are enforced by **building inspectors** at the local level. Prior to beginning construction, a *building permit* is obtained from the local building department. Once complete, a building needs to pass inspection and receive a **certificate of occupancy** before allowing occupancy. The *California Department of Public Health* may stop the construction of a property if its water supply, sewage or drainage system is impaired.

Standards for the construction of mobilehomes are governed by the **Department of Housing and Urban Development (HUD)** in Title 24 of the Code of Federal Regulations.[1]

Role of a contractor

A **contractor** is anyone who constructs, alters, repairs, improves or demolishes any building, road, project, development or improvement.[2]

contractor
Anyone who constructs, alters, repairs, improves or demolishes any building, road, project, development or improvement.

A *contractor* is to be licensed by the California Department of Consumer Affairs Contractors State Licensing Board *(www.cslb.ca.gov)*. They also need to post a bond or cash deposit. Contracting without a license is a misdemeanor, unless exempt from licensing requirements.[3]

Exemptions from the contractor's licensing law include:

- any work performed, including labor and materials, for less than $500;[4]
- any work performed by the owner of the property;[5]
- any work performed by a public utility;[6]
- oil and gas operations;[7] and
- work performed for agricultural purposes.

There are three types of contractor licenses:

- **general engineering**;
- **general building**; or
- **specialty**.

A *general engineering* contractor specializes in engineering, such as irrigation and drainage, flood control, streets and roads and bridges.[8]

A *general building* contractor specializes in the construction of any structure designed for occupation by people, animals or personal property.[9]

1 24 CFR §3280 et seq.
2 Business and Professions Code §7026
3 Bus & P C §7028(a)
4 Bus & P C §7048
5 Bus & P C §7044
6 Bus & P C §7042
7 Bus & P C §7043
8 Bus & P C §7056
9 Bus & P C §7057

A *specialty* contractor focuses on one particular trade or craft, such as servicing fire extinguisher systems, laying carpet or linoleum, or preparing roadway construction zones.[10]

Contractors may hold all three types of licenses concurrently.[11]

A contractor's license may be suspended or revoked if the contractor:

- violates safety or building regulations;[12]
- breaches the construction contract in a material respect;[13]
- fails to follow the plans or specifications;[14]
- abandons an incomplete project;[15] or
- diverts funds received for the completion for a specific project or fails to substantially account for the use of the funds.[16]

Roofing components

rafters
Wood beams on which sheathing is placed. Together, these form the shape of a roof.

Rafters form the shape of a roof. Sheathing, made of plywood or a wood product called *oriented strand board (OSB)*, is placed on top of the *rafters*, which serves as a base for the **finishing material**. The *finishing material*, such as composition roofing, shingles, wood shakes, slate or tile, is layered over the rafters and sheathing, forming the roof. Where the rafters rise to meet the *ridge board* at the apex of the roof is known as the *ridge*.

Sheet metal called *flashing* is placed around the openings in the roof for vents and chimneys. It is also placed along the edges of the roof. A flat roof, most commonly used on commercial properties, is covered with a protective layer, such as felt, and coated with tar and gravel. This is commonly known as a *traditional built-up hot-mop roof*.

An alternative used method of finishing a roof is called *torch-down roofing*. Rolls of protective layering made of rubberized asphalt are unrolled over the surface of a roof then heated with a blowtorch. The heat melts the under layer of asphalt, binding it to the surface of the roof.

The portion of the roof that extends over the exterior wall of the house is called an eave. A gutter runs along the **eave** to catch and direct rain runoff through the *downspout*.

The following are types of roofs found on homes:

- single dormers;
- shed dormer or dustpan;
- gambrel;
- gable;
- mansard;

10 Bus & P C §7058
11 Bus & P C §7059
12 Bus & P C §7110
13 Bus & P C §7109
14 Bus & P C §7109
15 Bus & P C §7107
16 Bus & P C §7108

Architectural styles

There are numerous architectural styles found in California. The different architectural styles include:

- *colonial, also called Cape Cod, traditionally featuring wood siding and shutters with a steep wood-shingled roof;*
- *Dutch colonial, traditionally featuring a gambrel roof and dormer windows;*
- *Victorian, traditionally multiple stories and featuring ornate wood external decorations and high ceilings;*
- *town house, traditionally located in more densely packed urban areas. Town houses share a common wall with the neighboring property;*
- *English Tudor, traditionally featuring timber framing and a steep, gable roof;*
- *French provincial, traditionally multiple stories and featuring a hip roof with brick exterior;*
- *Spanish, traditionally one story with a light colored stucco exterior and featuring an orange or tan tile roof;*
- *ranch, traditionally one story with a wood or masonry exterior and an attached garage; and*
- *contemporary, traditionally constructed recently and featuring an open floor plan and minimal ornamentation.*

- hip;
- pyramid; or
- flat. [See Figure 1]

Construction basics

The placement of a house upon the lot is referred to as its **orientation**. *Orientation* is the key determinant of a property's sun exposure. The advantages and disadvantages of a particular orientation will vary depending on geography.

The **floor plan** of a house refers to how its internal space is arranged and allocated. An advantageous *floor plan* allows easy mobility and circulation through the improvements, as well as convenient access to living areas, shared rooms and restrooms.

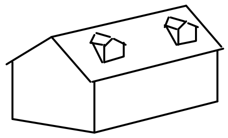
Some homes are built upon a **foundation**. The *foundation walls*, anchored by footings, are supports typically made of formed concrete, concrete block or masonry on which woodframe houses rest. In some older homes, the foundation walls are made of river rock or stone.

Unreinforced masonry walls used for structural purposes are earthquake hazards. *Unreinforced masonry* walls need to be disclosed by the seller by providing the buyer with a copy of the *The Homeowner's Guide to Earthquake Safety* for pre-1975 residential or commercial buildings.[1] [See **RPI** Forms 315-1 and 316-2; see Figure 2, excerpt from **RPI** Form 316-1]

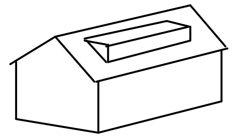
1 Government Code §8875.6

Figure 1

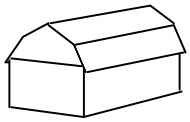
Images of roof styles



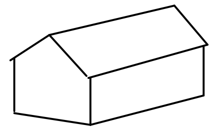
Single Dormers



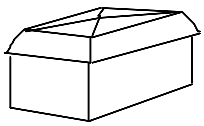
Shed Dormer, or Dustpan



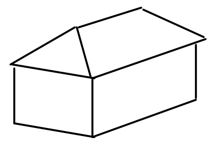
Gambrel



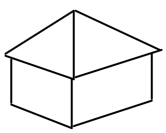
Gable



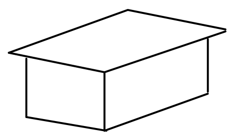
Mansard



Hip



Pyramid



Flat

Images courtesy of the Department of Real Estate (DRE) and featured in the DRE's Reference Book: Information Relating to Real Estate Practice, Licensing and Examinations.

After the construction site is excavated, the concrete foundation walls are poured into wood forms. Once the concrete has dried, also referred to as *cured,* the wood forms are removed and *dirt backfill* is packed against the walls. Placed directly on top of the foundation wall is the *mud sill*. Wood beams on which the floor of the house rests are called *girders* and *joists*.

A **crawl space** is sometimes left under a home to provide protection against termites and pests and provide a space for ventilation.

Radon gas is a naturally occurring gas resulting from the erosion of uranium in soil. *Radon gas* is harmless in well ventilated areas but can accumulate in confined areas, such as **crawl spaces** and **basements**, posing a health risk to occupants. [See Figure 2, excerpt from **RPI** Form 316-1]

radon gas
A naturally occurring gas which accumulates in confined areas at ground level and poses a health risk to occupants.

Other properties are built on a *concrete slab* and anchored by footings. Properties built on a slab are not elevated upon foundation walls, nor do they have a crawl space.

Figure 2

Excerpt from Form 316-1

Residential Environmental Hazards Disclosure Booklet for Buyers


firsttuesday
the California real estate educator

ENERGY EFFICIENT

Hazards Disclosure Booklets

Residential Environmental Hazards: A Guide for Homeowners, Homebuyers, Landlords and Tenants

Protect Your Family From Lead in Your Home

The Homeowner's Guide to Earthquake Safety

What is Your Home Energy Rating?

Protect Your Family From Lead in Your Home

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.

The **Protect Your Family From Lead in Your Home** booklet discusses how lead in the home can be identified and reviews what homeowners can personally do to protect themselves from lead poisoning, such as routine cleaning and frequently washing their hands. Also reviewed is how to permanently remove lead-based hazards by hiring a certified lead contractor.

50 Hazards Disclosure Booklets: *Protect Your Family From Lead in Your Home* | **first tuesday** 2019

Homeowner's Guide to Earthquake Safety

The **Homeowner's Guide to Earthquake Safety** analyzes the most frequently occurring structural weaknesses which may leave a home susceptible to damage on the occurrence of an earthquake — an inevitability in a state scarred by active fault lines.

The guide also contains practical information concerning how earthquake-related weaknesses in a home can be safely corrected.

71 Hazards Disclosure Booklets: *Homeowner's Guide to Earthquake Safety* | **first tuesday** 2019

ENERGY EFFICIENT

What is Your Home Energy Rating?

The **What is Your Home Energy Rating?** publication educates buyers and sellers of the statewide home energy rating system.

Further, it provides tips for limiting energy usage, making wise improvements to the property to lower energy bills, and reducing a home's negative physical impact on the environment.

127 Hazards Disclosure Booklets: *What is your home energy rating?* | **first tuesday** 2019

Once the foundation walls or slab have been laid, the **frame** of the house is erected. The *frame* is the skeleton of the house to which interior and exterior walls are attached. Vertical supports within the frame are called **studs**.

The standard spacing for **studs** is *16″ on center* (measured from the center of each stud) for load-bearing walls. Some non-load-bearing interior walls, also known as *partition walls*, allow a spacing of 24″ on center. *Fire stops* are horizontal pieces of material placed between the studs to block air drafts.

The **exterior walls** consist of sheathing, which may come in the form of structural plywood or OSB. Outside of the sheathing, the **siding** is placed. *Siding* can be wood, brick, stone, masonry, aluminum, stucco, cement board or other materials.

Home energy information

The California Energy Commission designed and implemented the **California Home Energy Rating System (HERS) program** to include a uniform **rating scheme** for the systematic delivery of home energy ratings to homeowners. The rating is assigned by a certified *Rater*.

The HERS Rating Index covers:

- space heating/cooling;
- service hot water;
- lighting in conditioned space;
- exterior lighting mounted on buildings or unconditioned garage;
- electric/gas appliances; and
- other interior electric and gas uses specified in the HERS Technical Manual.

The Rater then uses all of these factors to give the home a *California Whole-House Home Energy Rating (energy rating)*.

The **energy rating** is a numerical representation taken from the *Time Dependent Valued (TDV)* energy scale. The TDV numerical rating represents the level of energy consumed, produced and delivered to the home. The TDV is calculated by the Rater using an hourly energy consumption simulation approved by the Energy Commission.

As part of the Rater's assessment, the Rater provides **energy efficient improvement** recommendations for the home they inspect. The Rater will list the cost-effective improvements he believes will upgrade the energy-efficiency of the home. A low TDV energy score can be used by a seller and their agent to market the property to budget conscious buyers.

Chapter 84 Summary

Construction of California residential and commercial buildings is regulated through building codes. The Department of Housing and Community Development (HCD) is responsible for carrying out the provisions of the California Building Standards Code. Building codes are enforced by building inspectors.

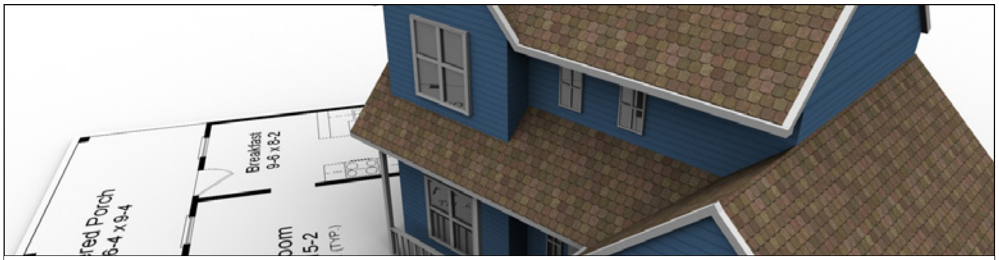
A contractor is anyone who constructs, repairs or demolishes a building or development project. There are three types of contractor licenses: general engineering, general building, or specialty.

The placement of a house upon the lot is referred to as its orientation. The floor plan of a house refers to how its internal space is arranged and allocated.

The California Home Energy Rating System (HERS) program codified a uniform rating scheme for the systematic delivery of home energy ratings to homeowners. The rating represents the level of energy consumed, produced and delivered to the home.

Chapter 84 Key Terms

Quiz 15 Covering Chapters 79-85 is located on page 620.



Chapter 85

Blue prints for construction

Learning Objectives

After reading this chapter, you will be able to:

- understand the function of public controls to guide the uniform growth of a municipality; and
- identify the government actions necessary to promote growth in the construction and real estate industries.

Key Terms

general plan
granny flat
public controls

Controlled growth

New construction is built in conformance with **public controls**.

Without *public controls*, growth becomes erratic. Inconsistent growth creates the potential for societal problems, such as:

- poor access to public areas;
- inadequate streets and parking;
- inconsistent architectural design and utility;
- poor air quality; and
- insufficient public services, such as police and fire protection.

public controls
State laws, zoning regulations, building codes and local plans designed to protect property values and control growth.

Further, governmental controls ensure property values are protected and not undermined by unchecked growth or deterioration.

Public controls are enacted through:

- state codes and regulations;
- zoning ordinances;

- local general and master plans; and
- building codes.

general plan
Development policies for acceptable land uses within a jurisdiction.

Every city and county has a **planning commission**, which is advised by the local agency planning department. The planning commission is tasked with reviewing and approving a **general plan** governing the growth of their municipality.[1]

A *general plan* sets forth acceptable land uses within a jurisdiction, including a statement of development policies on:

- land use;
- circulation patterns;
- housing;
- conservation;
- open space;
- noise; and
- safety.[2]

Implementation of the general plan

The planning commission maintains the general plan by making recommendations on:

- zoning proposals;
- subdivision regulation;
- use permits;
- variances; and
- other development permits related to general plan goals and policies.

Subdivision ordinances are the primary method of implementing the general plan. Local agencies may not approve a *tentative map* for a project when the planning commission finds the subdivision is inconsistent with the adopted general plan or any specific plan.[3]

A city or county may also control the physical aspects of a subdivision. A subdivider prepares a map of a proposed *common interest development (CID)* for approval by the local planning commission prior to commencing construction.[4]

The **Subdivision Map Act** establishes the conditions for approval of a subdivision map. The Act also provides the planning commission the authority to regulate the design and physical improvements installed in a CID.[5]

1 Calif. Government Code §65000 et seq.
2 Gov C §65302
3 Gov C §66473.5
4 Gov C §66410 et seq.
5 Gov C §66411

Further, the **Subdivided Lands Act** authorizes the Real Estate Commissioner to administer the *Subdivided Lands Law*. The Subdivided Lands Law protects buyers from misrepresentation or fraud in the initial sale of a subdivided property of 160 acres or less.[6]

A subdivision, which includes land, CIDs and timeshare projects, cannot be sold in California until the Commissioner issues a public report to be made available to buyers. The *public report* references critical information about a project and disclosures.[7]

The need for government action

As the demand for any type of improved property increases, prices initially begin to move upward faster than the rate of consumer inflation. To keep prices from ballooning, local governments need to permit the *higher* and *better use* of existing subdivided parcels. With proper zoning, construction can take place to meet demand without delay. Delayed housing starts drive prices upward artificially on existing housing when the population is growing.

To accomplish these goals efficiently, cities need to implement zoning that allows greater height for buildings and higher urban density. Smarter zoning keeps down the need for new infrastructure to connect newly developed properties on peripheral unsubdivided lands.

Successful zoning ordinances keep demand for government services at a consistent level. Zoning that facilitates economical projects allows builders to demolish obsolete and inefficient inter-city structures. These obsolete structures are replaced with high density housing on existing blocks and parcels within city centers. Thus, the need to extend infrastructure — roads and utilities — is avoided.

Local governments' first responsibility for housing is to revisit current limits on height, density and onsite parking. These limitations need to be modified with an eye toward the best use of inner city parcels, many of which are occupied by old, obsolete single family residences (SFRs).

Intelligent zoning will allow builders to meet the needs of future homeowners and renters. These new occupants will look for jobs in the city's core financial, governmental, educational, medical and other high-end service trades, the growth industries in California's future.

The state legislature has already established a pattern of increasing density. It has accomplished this by adding low-income units to the permitted use, including authorization to construct **granny flats**, also called casitas, for SFRs everywhere.[8]

granny flat
A separate, self-contained additional dwelling on a property zoned to accommodate only one unit.

Centralized growth

City councils can induce building activity by reducing permit costs for the construction of high-density multi-family units on center-city parcels.

6 Calif. Business and Professions Code §11000 et seq.
7 Bus & P C §11018
8 Gov. C §65852.2

Construction on central parcels is ultimately less costly for the city (and builders) as infrastructure, such as roads, sewers and utilities, are not required to be added.

Such policies encourage builders not to jump outward from the urban center into remote unsubdivided lands. Instead, they are an intelligent way to make cities more favorably centralized. They also have the added advantage of delivering apartments and condos for urban-dwellers convenient to where the higher skilled jobs are located.

Local governments are motivated by needs other than those of homebuyers or the construction industry. Among their other concerns, governments need to always maintain funding from the **tax base**. One way of ensuring funds is to encourage advantageous and higher valued construction during times of anticipated increases in housing demand, and let the assessment rolls grow.

Such incentives are welcomed by builders. However, the zoning of the past has created suburban sprawl, unimaginative designs and minimal onsite and offsite amenities. These suburban conditions are favorable to no one.

Chapter 85 Summary

All new construction conforms with public controls designed to regulate growth and protect property values. Public controls come in the form of state laws, zoning regulations, local and general master plans, and building codes. Further, every city and county has a planning commission and department tasked with developing and maintaining the general plan governing the growth of a municipality.

Thus, a region's construction environment is a product of local zoning regulations. To ensure an efficient use of land, local governments need to loosen urban density and building height restrictions.

Chapter 85 Key Terms

Quiz 15 Covering Chapters 79-85 is located on page 620.

Chapter 86

Real estate mathematics

Learning Objectives

After reading this chapter, you will be able to:

- understand the fundamental real estate math concepts a real estate agent may be tested on during the state licensing exam and exposed to during their first four years of practice; and
- calculate common real estate math problems, including fee percentages, area calculation, loan and interest payments and general computations for real estate investments.

Key Terms

amortization table
area
capitalization rate (cap rate)
financial calculator
net operating income (NOI)

The mathematical tools you need

As a requisite for entry into the real estate profession, a thorough understanding of the formulas commonly used in the real estate industry is necessary.

Once the basic formulas and logic behind them are mastered, most math issues in mortgages, income property, property management and investment are solved with a basic, **nonprogrammable calculator**. Further, a *nonprogrammable calculator* is provided during the agent and broker Department of Real Estate (DRE) licensing examination. The examinee is well advised to use the calculator supplied to ensure their accuracy on the exam.

Once an individual is licensed, a **financial calculator** is a wise investment in the real estate industry. Frequently used formulas are pre-programmed into the *financial calculator,* such as amortization schedules, making it an invaluable asset.

financial calculator
An electronic calculator preprogrammed to perform advanced financial functions needed in real estate transactions.

Basic units of measurements in real estate

Before delving into problems involving land descriptions and areas, here is a review of basic units of land measurement:

Township = 36 square miles broken up into 36 sections;

Section = 640 acres and 1 square mile;

Half section = 320 acres, a quarter section = 160 acres, and a quarter of a quarter = 40 acres;

Acre = 43,560 sq. ft;

Mile = 5,280 ft;

Square mile = 27,878,400 sq. ft (5,280 ft x 5,280 ft) or 640 acres (27,878,400 sq. ft / 43,560 sq ft);

Square acre = approximately 209 ft x 209 ft;

1 yard = 3 ft;

1 square yard = 9 sq. ft (3 ft x 3 ft);

1 mile = 320 rods; 5,280 ft; and

1 rod = 16.5 ft or 5.5 yards (16.5 ft x 3 ft).

Math basics

A grasp of mathematical basics is helpful when dealing with:

- percentages;
- fractions;
- area;
- loans;
- investments/cost analysis;
- capitalization (cap) rates; and
- all other mathematical concepts common to real estate transactions.

Percentages

A **percentage** needs to be converted to a decimal before any mathematical computations can be completed. This is a conversion financial calculators are preprogrammed to make.

When converting percentages to decimals, the basic rule to follow is to move the decimal point two spaces to the left.

Examples:

50% = 0.5

3% = 0.03

115% = 1.15

Alternatively, to convert a decimal to a percentage, move the decimal point two spaces to the right.

Examples:

1.43 = 143%

0.03 = 3%

0.5 = 50%

Fractions converted

As the use of a calculator is allowed while taking the DRE state licensing exam, it is beneficial to convert all fractions to decimals and then use the calculator to complete the computations.

To understand **fractions**, it is helpful to understand their basic mechanics. A *fraction* is composed of a **numerator** and a **denominator**. The number on the top of the fraction is the *numerator* and the number on the bottom is the *denominator*.

When converting a fraction into a decimal, divide the numerator (the number on top) by the denominator (the number on the bottom).

Examples:

4/5 = 0.8

1/2 = 0.5

3/4 = 0.75

3/100 = 0.03

667/100 = 6.67

Basic formulas for area

The formula for an **area** of a rectangle is most often used in *land measurement*. The area of a rectangle equals length multiplied by width, the result being the number of square feet within the parcel.

A = L x W

area
The amount of space within the boundaries of a parcel of real estate.

Problem 1

A rectangular lot is 1,230 ft by 2,340 ft. What is the area of the lot in acres? (Round acres to the nearest whole acre.)

1. Area = 1,230′ x 2,340′ (2,878,200 sq. ft).
2. Conversion of square feet to acres. (One acre equals 43,560 sq. ft.) 2,878,200 / 43,560 = **66 acres.**

   Solution: 66 acres.

Problem 2

A rectangular lot is comprised of 10 acres. If the length of the lot is 500 feet, what is its width?

1. 10 acres = 10 x 43,560 sq. ft (435,600 sq. ft).
2. 435,600 sq. ft / 500 ft = **871.2 ft.**

   Solution: 871.2 ft.

Problem 3

A rectangular lot is comprised of a quarter of a quarter (1/16) of a section of a township. The width of the lot is 800 feet. What is the length of the lot in yards?

3. A quarter of a quarter of a section is equal to 40 acres. (One section of a township equals 640 acres and 1/16 of a section (1/4 x 1/4) is 40 acres.)
4. 40 acres = 40 x 43,560 sq. ft (1,742,400 sq. ft).
5. 1,742,400 sq. ft / 800 ft = 2,178 ft.
6. 2,178 ft / 3 = **726 yards.**

   Solution: 726 yards.

Problem 4

A rectangular lot measures 1,652 ft by 2,430 ft. The cost per acre for the lot is $120. How much would the lot cost to purchase? (Round to the nearest whole acre.)

1. The lot area = 1,652 ft x 2,430 ft. (4,014,360 sq. ft).
2. 4,014,360 sq. ft = 92 acres (4,014,360 / 43,560).
3. 92 acres x $120 = **$11,040.**

   Solution: $11,040.

Area of a triangle

Another critical formula is the area of a **triangle**. This formula is used when determining the area of a *triangular* shaped lot.

The area of a triangle equals its base multiplied by its height divided by two.

A = (B x H) / 2

Problem 1

A triangular lot features a 200 ft base and a height of 150 ft. How many square feet are contained in the triangular lot?

1. The lot area = (200 ft x 150 ft) / 2.
2. 30,000 ft / 2 = **15,000 sq. ft.**

   Solution: 15,000 sq. ft.

Percentage formula

The *percentage formula* is a basic calculation used in real estate mathematics. It is typically used to determine the amount of a **broker's fee** on a transaction.

As compensation for services, a broker is entitled to a *broker's fee* typically stated as a percentage of the:

- sales price;
- loan amount; or
- total rents.

The percentage formula is easily converted to suit a variety of situations. Usually, two of the three variables will be known, leaving the third to be determined.

Understanding the basic formula makes solving problems a question of mechanics.

The percentage formula is as follows:

- **Fee = Percent (%) x Principal**

  Percent (%) = the rate charged.

  Principal (P) = the dollar amount of the price, loan or rents.

Given the basic formula and two of the three variables, solutions are determined as follows:

- To determine the fee, multiply the principal by the rate. **P x %**
- To determine the rate, divide the fee by the principal. **Fee / P**
- To determine the principal, divide the fee by the rate. **Fee / %**

Problem 1

A broker earns a 3% fee on the sale of a $100,000 home. How much will the broker earn?

Consider what we know:

% = 3%

P = $100,000

Using the percentage formula: Fee = % x P

1. Fee = 3% x $100,000
2. Fee = 0.03 x $100,000
3. Fee = $3,000

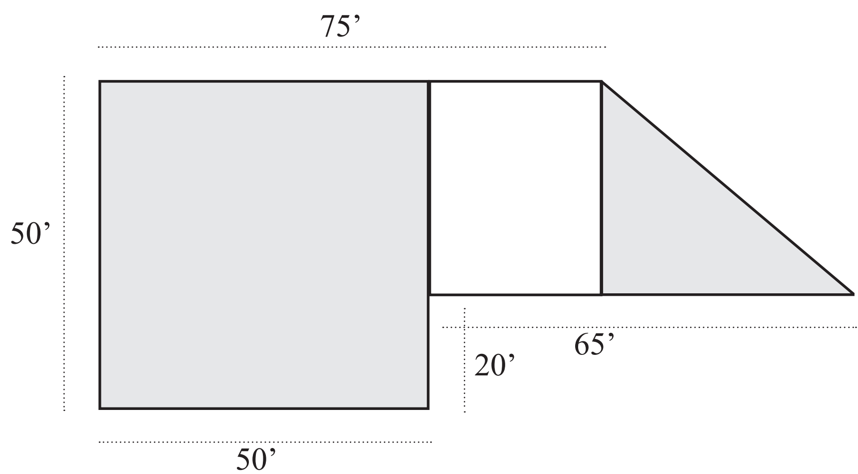
Thus, the broker earns a fee of **$3,000**.

Solution: $3,000

Figure 1

Area of an irregular lot

An irregular lot is neither an even square, rectangle or triangle. Instead, it is mathematically broken up into smaller known shapes. Thus, its area is determined by a combination of the above formulas and adding of the results



First, divide the irregular shaped lot into even squares, rectangles and triangles. Compute the area of each shape individually then add them to equal the total area of the lot.

The square portion is 50 ft x 50 ft.

The lot area of the square = (50 ft x 50 ft); thus, 2,500 sq ft.

The rectangular portion is 30 ft x 25 ft.

Editor's note – Length = 50 ft (the length of the square) less 20 ft. Thus, 30 ft.

Width = 75 ft (the width of the square and rectangle combined) less 50 ft (the length of the square). Thus, 25 ft.

The lot area of the rectangle = (30 ft x 25 ft); thus, 750 sq ft.

The triangular portion is (40 ft x 30 ft) / 2.

Editor's note – Width = 65 ft (the width of the rectangle plus the bottom outer edge of the triangle) less 25 (the width of the rectangle). Thus, 40 ft.

The lot area of the triangle = 1,200 ft / 2; thus, 600 sq ft.

Lastly, combine the lot area of each shape.

2,500 ft (the square) + 750 ft (the rectangle) + 600 ft (the triangle) = 3,850 sq ft.

Solution: 3,850 sq ft.

Problem 2

An agent shares in the broker's fee based on 40% of the 3% fee the broker is paid on a transaction. The home sells for $245,000.

Editor's note — Alternatively, the purchase price is analogous to the total loan amount in a mortgage loan brokerage situation, or the total amount of all rents due during the initial term of a lease agreement in a leasing agent situation.

How much will the agent earn?

Start with what we know to determine the broker's fee:

% = 3%

P = $245,000

Using the percentage formula:

1. Fee = 3% x $245,000
2. Fee = 0.03 x $245,000
3. Fee = $7,350

Thus, the broker will earn **$7,350**. The sales person will then receive 40% of $7,350.

Using the percentage formula:

1. Fee = 40% x $7,350
2. Fee = 0.4 x $7,350
3. Fee = $2,940

The agent receives **$2,940** on the close of the transaction.

Solution: $2,940

Problem 3

A real estate transaction involves both a seller's broker and a buyer's broker. The brokers agree to split a 6% fee paid by the seller 50-50.

You are the buyer's broker's agent and will receive 70% of the fee your broker receives.

If the home sells for $149,500, how much will you receive?

First, compute the total fee to be received by both brokers.

1. Total fee = 6% x $149,500
2. Total fee = 0.06 x $149,500
3. Total fee = $8,970

Thus, the total brokerage fee is **$8,970**.

Second, calculate the seller's broker's fee:

1. Seller's broker's fee = 50% x $8,970
2. Seller's broker's fee = 0.5 x $8,970

3. Seller's broker's fee = \$4,485

\$4,485 is the amount the seller's broker will receive on the close of the transaction.

Finally, calculate your share of the fee on in the deal:

1. Your fee = 70% x \$4,485
2. Your fee = 0.7 x \$4,485
3. Your fee = \$3,139.50

You will receive **\$3,139.50** from your broker on the completion of the sale.

Solution: \$3, 139.50

Problem 4

A broker lists an office building for sale. The listing agreement calls for a graduated fee payment computation. The broker agrees to accept a fee of 5% on the first \$150,000 and a smaller percent on the remaining sales price.

The broker sells the office building for \$240,000 and earns a total fee of \$11,100.

What is the percent of the sales price the broker has agreed they are to be paid on amounts over \$150,000?

The broker earns 5% on the first \$150,000 and an unknown percentage on the remaining \$90,000 (\$240,000 sales price - \$150,000). The total fee received is \$11,100.

Using the percentage formula (Fee = % x P), determine the fee on the first \$150,000.

1. \$11,100 = (5% x \$150,000) + (?% x \$90,000)
2. \$11,100 = (0.05 x \$150,000) + (?% x \$90,000)
3. \$11,100 = \$7,500 + (?% x \$90,000)

Next, determine the percentage the fee amount is of the remainder of the price.

1. \$11,100 - \$7,500 = ?% x \$90,0000
2. \$3,600 = ?% x \$90,000
3. \$3,600 / \$90,000 = 0.04

Convert the amount to a percent by moving the decimal two spaces to the right. Therefore, the fee is **4%** on the amount over \$150,000.

Solution: 4%

Loan problems

The percentage formula can also be used in **loan calculation** problems.

Cost of using the lender's money = *Cost*

Interest rate = *Percent*

Principal amount of the loan = *Principal*

When calculating problems involving simple interest, the interest rate is the rate of interest over one year.

Interest can be further broken down into months by dividing the annual interest rate by 12, and into days by dividing the interest rate by 360 (months are uniformly considered to be 30 days to avoid awkward numbers).

Financial calculators and **amortization tables** make interest calculations easier. An *amortization table* is a schedule of monthly loan payments which show the amount of principal and the amount of interest which comprises each constant payment until it is paid in full by the end of the term.

amortization table
A tabular schedule detailing the apportionment of principal and interest on each periodic payment due on an amortizing loan.

Early in the amortization schedule, a majority of the monthly payment is applied to interest. However, towards the end of the schedule, most of the monthly payment is applied towards the diminishing *principal balance*.

In loan problems, **time** is an important factor and is part of the percentage formula. Thus, the percentage formula is modified slightly for loan problems as follows:

Cost of borrowing money (C) = Interest Rate (%) x Time (T) x Principal (P)

C = % x T x P

When dealing with interest rates for different periods, remember the following:

- for *annual interest,* the interest rate is the percent given;
- for *monthly interest*, the interest rate is equal to the interest rate given divided by 12 (for the 12 months in the year); and
- for *daily interest*, the interest rate is equal to the interest rate given divided by 360.

Problem 1

A borrower owes $15,000 on a **straight note** payable at the end of the quarter. The borrower pays $225 in total interest costs with the timely payoff of the principal. What is the interest rate on the loan?

Editor's note – A quarter is equal to 3 months.

Using the modified percentage formula and the information given above:

1. $225 = (?%/12 months) x 3 months x $15,000
2. $225 = ?%/4 (one quarter) x $15,000
3. $225 x 4/$15,000 = ?%
4. .06 = ?%

Thus, the interest rate on the loan is **6%**.

Solution: 6%

Problem 2

If an investor earns $360 on a straight note with an interest rate of 8% payable in 60 days, what is the principal amount of the loan?

C = % x T x P

1. $360 = 8% x 60 days x P
2. $360 = .08 x (60 days/360) x P
3. $360/0.08 x 360/60 = P
4. 4,500 x 6 = P
5. $27,000 = P

The principal amount of the loan is **$27,000**.

Solution: $27,000

Problem 3

Consider a $200,000 interest-only straight note with monthly interest payments with a 6% annual interest rate due in 15 years. What is the amount of the final/balloon payment due on the end of the loan term?

Editor's note — Some loan problems don't require the computation of time, and thus this variable is omitted from the equation.

C = % x P

C = 6% x 200,000

The final/balloon payment equals the total loan balance, plus the last monthly interest payment. Start by determining the total annual interest charged for the loan.

1. C = 6% x $200,000
2. C = .06 x $200,000
3. C = $12,000

Next, determine the monthly interest and add this amount to the loan balance.

4. $12,000/12 months = $1,000
5. $1,000 + $200,000 = $201,000.

The final/balloon payment is **$201,000**.

Solution: $201,000

Investment and cost problems

Calculations in income property transactions determine the profit from a sale or the amount an investor will pay for the net operating income (NOI) produced by the property.

Problem 1

A seller wants an 8% return (profit) on a $125,000 investment they have in an unencumbered property they own.

What is the minimum net selling price the seller needs to receive to realize the 8% return?

First, consider that at $125,000, the seller has a 100% return of their investment. Thus, the seller needs to realize a 108% total return to receive an 8% profit on their investment.

Using the percentage formula and the information given:

1. Net price = 108% x $125,000
2. Net price = 1.08 x $125,000
3. Net price = $135,000

For an 8% profit on the original investment, the seller needs to net **$135,000** on the sale.

Solution: $135,000

Problem 2

A lender purchases a straight note at an 18% discount. The note has a remaining principal balance of $60,000 and a 10% interest rate.

What is the lender's **annual yield** on its investment in the straight note?

First, compute the amount the lender paid to purchase the principal remaining due on the note:

1. $60,000 x 18% = the amount of the discount.
2. $60,000 x 0.18 = **$10,800**

The principal amount of the note minus the amount of the discount equals the investment the lender has in the note:

3. $60,000 - $10,800 = **$49,200**

Next, determine the dollar amount of the annual interest accruing on the $60,000 principal remaining due on the note.

4. Annual interest = 10% x $60,000
5. Annual interest = 0.10 x $60,000
6. Annual interest = $6,000

Lastly, divide the dollar amount of the annual interest ($6,000) accruing on the note's principal by the amount invested in the note, i.e., the purchase price ($49,200):

7. $6,000 / $49,200 = 0.1219
8. 0.1219 = ?%

Thus, the lender realized a **12.19%** rate of return on the investment in the straight note.

Solution: 12.19%

Problem 3

A subdivider purchases three lots for $150,000. The three lots are subdivided into nine parcels. The parcels are all sold for $25,000 each.

What is the subdivider's return on their investment?

First, calculate the total amount received for the nine parcels:

1. (9 x $25,000) = $225,000

Next, subtract the owner's cost:

2. $225,000 - $150,000 = $75,000

Thus, $75,000 is the amount the subdivider profited on their investment.

Next, use the percentage formula to determine the percentage return on the subdivider's investment:

3. $75,000 = ?% x $150,000
4. $75,000/$150,000 = ?%
5. 0.50 = ?%

Thus, the percentage return on the subdivider's investment is **50%**.

Solution: 50%

Problem 4

An owner sells their property for $230,000. The owner takes a profit of 15% over the amount they originally invested in the property. How much has the owner invested in the property?

The way to conceptualize the problem is as follows: the owner will receive a 100% *return* of their investment in the property, plus an additional *return on* the investment of 15%. Thus, the owner's total return will equal 115%.

Use the percentage formula to determine how much the owner originally paid for the property:

1. $230,000 = 115% x P
2. $230,000 = 1.15 x P
3. $230,000/1.15 = P
4. $200,000 = P

Thus, the investor originally paid **$200,000** for the property.

Solution: $200,000

Problem 5

An investor purchased property listed at $100,000. The investor paid 15% less than the property's listed price. The investor then resold the property at the prior owner's listed price.

What is the investor's percentage return?

First, determine the price the investor paid for the property. If the investor received a 15% discount on the listed price, the investor paid 85% (100% - 15%) of $100,000, the listed price.

1. Price paid = 85% x $100,000
2. Price paid = 0.85 x $100,000
3. Price paid = $85,000

Since the investor sold the property for $100,000, the investor made a $15,000 profit on the sale.

Using the percentage formula:

4. $15,000 = ?% x $85,000
5. $15,000/$85,000 = ?%
6. 0.1765 = ?%

The investor received a **17.65%** return on the purchase and sale of the investment property.

Solution: 17.65%

Problem 6

A seller wishes to net a 14% profit over the original $240,000 purchase price of real estate.

What sales price does the property need to receive to yield a 14% return over the original price after the broker is paid a 6% fee out of the net proceeds? (Round answer to nearest whole number.)

Using the percentage formula, determine the amount of net proceeds the seller needs to receive to realize a gain of 14% over the original purchase price. The seller's net proceeds need to be 114% of their original investment.

1. Net proceeds = 114% x $240,000
2. Net proceeds = 1.14 x $240,000
3. Net proceeds = $273,600

The net proceeds from the sale of the property to yield a 14% return would be **$273,600**.

To determine the sales price after paying the 6% broker's fee, consider that $273,600 equals 94% (100% - 6%) of the total sales proceeds needed to net 14% after the 6% fee.

Using the percentage formula:

4. \$273,600 = 94% x P
5. \$273,600/0.94 = P
6. \$291,063.83 = P

Rounding to the nearest whole number, the price needed on a sale to yield 14% over the original purchase price after paying a 6% broker's fee is **\$291,064**.

Solution: \$291,064

Problem 7

A borrower took out a \$300,000 loan which contained a 3% prepayment penalty. The borrower paid two points to the lender to buy down the interest rate to 4.5%. The borrower sold the property and paid off the mortgage after seven years.

If the loan had an average balance of \$250,000 during the seven years the borrower owned the property and the balance of the loan was \$225,000 when it was prepaid, what was the lender's total gross profit on the loan?

Editor's note — Solve this problem by individually calculating the lender's profit on each component of the loan and totaling these amounts.

1. Total paid for points = \$300,000 x 2% = \$300,000 x 0.02 = \$6,000
2. Total prepayment penalty = \$225,000 x 3% = \$225,000 x. 0.03 = \$6,750
3. Total interest paid per year = \$250,000 x 4.5% = \$11,250
4. Total interest paid when loan was paid off = \$11,250 x 7 years = \$78,750
5. \$6,000 + \$6,750 + \$78,750 = \$91,500.

The lender's total gross profit on the loan is \$91,500.

Solution: \$91,500.

Capitalization rate

With income producing property, the value of the property is determined by *capitalizing* the **net operating income (NOI)** generated by the property (rental income minus operating expenses).

The rate of return an investor expects on their investment after rental operating expenses are subtracted from rental income is called the **capitalization rate (cap rate)**.

capitalization rate (cap rate)
The annual rate of return on investment produced by the operations of an income property or sought by an investor on the investment of capital. The cap rate is calculated by dividing the net operating income by the price asked or offered for income property.

Returning to the percentage formula:

Net operating income or loss = **NOI**

Capitalization rate = **%**

Purchase price = **P**

Problem 1

An apartment building produces an NOI of $24,000. A buyer seeks an annual rate of return of 12%.

net operating income (NOI) The net revenue generated by an income producing property as the return on capital, calculated as the sum of a property's gross operating income less the property's operating expenses. [See **RPI** Form 352 §4]

What price does the buyer pay for the property?

Using the percentage formula:

1. $24,000 = 12% x P
2. $24,000/0.12 = P
3. $200,000 = P

Thus, the buyer is to pay no more than **$200,000** to yield a 12% rate of return.

Solution: $200,000

Problem 2

Rent on each unit in a four-unit apartment building is $545 per month. The owner has been receiving a rate of return equal to an 8% c**ap rate** on their investment in the property.

If the rent for each unit drops to $500 per month, what is the owner's loss in value over the year?

First, determine the rental loss for all units over the year.

1. $545 - $500 = $45 loss per unit per month
2. $45 x 12 = $540 loss per year per unit
3. $540 x 4 = $2,160 loss for the entire complex

Using the percentage formula:

4. $2,160 = 8% x P
5. $2,160/0.08 = P
6. $27,000 = P

Thus, the owner suffers a **$27,000** loss in value over the year.

Solution: $27,000

Editor's note – This can also be calculated by subtracting the total annual rent at $500 per month from the total annual rent at $545 per month. Problem 3 below illustrates this alternative method of calculation using a different set of facts.

Problem 3

An owner owns a 5-unit apartment building. The owner uses a cap rate of 10% on their investment. The owner usually realizes an NOI of $650 per month per unit. However, due to an increase in rents, the owner now nets $700 per month per unit.

What is the corresponding increase in value for the apartment building?

First, compute the value of the apartment building when the net income was $650 per unit.

The total net income over the year for the apartment building is **$39,000** ($650 x 5 units x 12 months).

Using the percentage formula:

1. $39,000 = 10% x P
2. $39,000/0.1 = P
3. $390,000 = P

Next, compute the value of the apartment building at the new net income.

The new total net income over the year for the apartment building is **$42,000** ($700 x 5 units x 12 months).

Using the percentage formula:

4. $42,000 = 10% x P
5. $42,000/0.1 = P
6. $420,000 = P

Thus, the increase in value for the apartment building is **$30,000** ($420,000 - $390,000).

Solution: $30,000

Chapter 86 Summary

As a requisite for entry into the real estate profession, a thorough understanding of the formulas commonly used in the real estate industry is necessary.

The formula for an area of a rectangle is most often used in land measurement. The area of a rectangle equals length multiplied by width.

A = L x W

Another critical formula is the area of a triangle. This formula is used when determining the area of a triangular or irregular shaped lot. The area of a triangle equals its base multiplied by its height divided by two.

A = (B x H) / 2

The percentage formula is a basic formula typically used to determine the amount of a broker's fee on a transaction. The broker's fee equals the percentage multiplied by the principal amount.

F = % x P

The percentage formula is also used in loan calculation problems. However, in loan problems, time is an important factor and is added to the percentage formula. Thus, the cost of borrowing money equals the interest rate on the loan, multiplied by the term of the loan (time), multiplied by the principal amount.

C = % x T x P

Chapter 86 Key Terms

No quiz or exam questions are based on this chapter.

Notes:

Glossary

A

abandonment **285**
The termination of an easement when the easement holder's actions demonstrate a clear intent to permanently abandon all future use of the easement. [See **RPI** Form 581]

absolutely privileged publication **335**
Any statement made as part of a legislative, judicial or other official proceeding authorized by law, barring a slander of title action.

abstract of judgment **356**
A condensed written summary of the essential holdings of a court judgment.

abstract of title **338, 343**
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.

acceleration **436, 442**
A demand for immediate payment of all amounts remaining unpaid on a loan or extension of credit by a mortgage lender or carryback seller.

actual money losses **288**
Monetary losses recovered for injury to the real estate, lost use of the property, personal injury or injury to the occupant's personal property, also called damages.

ad valorem taxes **508**
Real estate taxes imposed on property based on its assessed value. [See RPI Form 552-2 §5.1]

addendum **497**
An attachment to a contract, rental or lease agreement for incorporating any provision agreed to but not included in the boilerplate provisions of the agreement. [See **RPI** Form 250]

adjustable rate mortgage (ARM) **404**
A variable interest rate note, often starting out with an introductory teaser rate, only to reset at a much higher rate in a few months or years based on a particular index. [See **RPI** Form 320-1]

adjusted gross income (AGI) **476**
The total of the taxpayer's reportable income and losses from all three income categories.

administrative agencies **22**
A government entity created by the state or federal legislature and local governing bodies to oversee specialized matters. Most have legislative, executive and judicial authority.

adverse possession **290, 303**
A method of acquiring title to real estate owned by another by openly maintaining exclusive possession of the property for a period of five years and paying all property taxes.

affiliated business arrangement (ABA) **36**
Referral of a client to a financially controlled business whose earnings are shared with the broker which requires a written disclosure. [See **RPI** Form 205 and 519]

affirmative covenant **262**
A recorded restriction limiting the use of a property to a specific purpose.

agency confirmation provision **26, 193**
A provision in all purchase agreements and counteroffers disclosing the agency of each broker in the transaction.

Agency Law Disclosure **25**
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]

agency relationship **159**
The scope of activities imposed on the broker by law as arising out of the representation authorized by the employment.

agent 21
One who is authorized to represent another, such as a broker and client or sales agent and their broker.

agreed-boundary doctrine 298
When owners of adjacent properties uncertain over the true boundary agree to establish the location of their common lot line and acquiesce to the boundary line for at least five years.

all-inclusive trust deed (AITD) 406
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

Alquist-Priolo Maps..122
Maps which identify earthquake fault areas available from the State Mining and Geology Board and the city or county planning department.

amortization tables 575
A tabular schedule detailing the apportionment of principal and interest on each periodic payment due on an amortizing loan.

Annual Property Operating Data (APOD).. 89, 153
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]

anti-deficiency...467
California legislation limiting a mortgage holder's ability to recover losses on a default when the mortgaged property's value is insufficient to satisfy the mortgage debt.

applicable federal rate (AFR 405
Rates set by the Internal Revenue Service for carryback sellers to impute and report income at the minimum interest when the note rate on the carryback debt is a lesser rate.

appraisal 199
An individual's opinion of a property's value on a specific date, documented in an appraisal report.

appraisal report 199
Documentation of an appraiser's findings, including the purpose and scope of the appraisal.

appurtenant easement 276
A type of easement which is incidental to the ownership and belongs to the property which benefits from its use.

appurtenant rights...233
Incidental property rights which are not located on a parcel of real estate nor reflected on its title, including the right of ingress and egress across adjoining properties.

area..569
The amount of space within the boundaries of a parcel of real estate.

"as-is" clause 86
An unenforceable provision stating the buyer accepts the property without a full disclosure of known conditions. Properties are sold "as-disclosed," never "as-is."

associate licensee 195
A sales agent employed by a broker.

assumption agreement 432
A promise given by a buyer to the seller or an existing mortgage holder to perform all the terms of the mortgage taken over by the buyer on the sale. [See **RPI** Form 431 and 432]

attorney fee provision 507
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]

B

balance sheet 367
An itemized, dollar-value presentation for setting an individual's net worth by subtracting debt obligations (liabilities) from asset values. [See **RPI** Form 209-3]

balloon payment 403, 413, 420
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment. [See **RPI** Form 418-3 and 419]

beneficiary 427
One entitled to the benefits of properties held in a trust or estate, with title vested in a trustee or executor.

beneficiary statement 430
A document issued by a mortgage holder on request noting future payment schedules, interest rates and balances on a mortgage assumed by an equity purchase (EP) investor. [See **RPI** Form 415]

best effort obligation 152
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 employment agreement 172
A written exclusive employment agreement obligating the broker to exercise due diligence to fulfill the client's real estate objectives in exchange for the promise to pay a fee under various circumstances.

blockbusting 54
The prohibited practice of a real estate licensee inducing a property owner to list their property for sale in response to a change taking place in the neighborhood demographics.

bona fide lease agreement 543
A lease agreement with a fair market rent held by a residential tenant when ownership of the property is transferred by a foreclosure sale. [See **RPI** Form 550 and 552]

bona fide purchaser (BFP) 457, 543
A buyer who purchases a property for valuable consideration in good faith without notice or knowledge of pre-existing encumbrances or conditions affecting their right to full ownership.

boundary dispute 271
When owners of neighboring property cannot agree on the location of the dividing property line.

brokered loan 413
A private lender loan made or arranged by a real estate broker.

building inspectors 556
Individuals employed by municipalities to ensure properties comply with local building codes, ordinances, zoning regulations and contract specifications.

bulk sale 15
The transfer of more than one-half the inventory of a business' materials or goods to a person other than the business' customers.

business opportunity 15
The assets for a business enterprise including its goodwill. The term includes the sale or lease of the business and goodwill of an existing business enterprise or opportunity.

buyer mortgage capacity 370
A buyer's ability to make mortgage payments based on their debt-to-income ratios (DTI).

buyer's agent 26
An agent representing the buyer. Also known as a selling agent. [See **RPI** Form 103]

C

California Home Energy Rating System (HERS) 144
California state system used to create a standard rating for energy efficiency and certify professional raters.

call provision 420
A provision in a note giving the mortgage holder the right to demand full payment at any time or after a specified time or event, also called an acceleration clause. [See **RPI** From 418-3]

capitalization rate (cap rate) 580
The annual rate of return on investment produced by the operations of an income property or sought by an investor on the investment of capital. The cap rate is calculated by dividing the net operating income by the price asked or offered for income property.

carcinogen **109**
A substance which causes cancer in human beings.

certificate of sale **463**
A certificate issued to the successful bidder on the completion of a judicial sale.

certified CID manager **482**
A non-required professional designation certifying an individual has met legislated educational requirements specific to managing common interest developments.

choice-of-law provision **508**
A clause which sets the state law applicable in the event of a dispute. [See RPI Form 552 §23.4]

civil law **220**
A Spanish legal system in which an elaborate system of statutes address permissible conduct of the people in advance of disputes.

Civil Rights Act **51**
A federal law which provides broad protections to numerous classes of individuals in the United States against discriminatory activities.

Civil Rights Department **66**
State agency designated with protecting Californians from housing, employment, and public accommodation discrimination.

common boundary improvement **265**
An improvement which acts as a demarcation of the property line.

common boundary trees **267**
Shrubbery or trees with trunks which stand partly on the land of two adjacent properties belonging to the adjacent owners.

common description **307**
Description of real estate by its street address. Also known as a common address.

common interest development (CID) **227**
Condominium projects, cooperatives or single family residences in a planned unit development. [See **RPI** Form 135]

common law **219**
An English legal system in which disputes are decided on a case-by-case basis before a judge applying codes and prior cases.

community property **325**
All property acquired by husband or wife during a marriage when not acquired as the separate property of either spouse.

comparison approach **204**
A method for comparing a given property with similar or comparable surrounding properties; also called market comparison.

conflict of interest **35**
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]

conservation easement **277**
A voluntary conveyance of the right to keep land in its natural or historical condition to a conservation organization or government agency.

constructive delivery **318**
Delivery of a deed occurring when the deed is understood by the grantor and grantee to be delivered by agreement, or when the deed is accepted by a third-party for the benefit of the grantee.

contingency fee **482**
An incentive bonus paid upon successfully completing or hitting certain benchmarks, or received as compensation on the occurrence of an event.

continuing nuisance **295**
An ongoing nuisance that can be entirely eliminated by those adversely affected by the activity or condition.

contractor 556
Anyone who constructs, alters, repairs, improves or demolishes any building, road, project, development or improvement.

conversion 47
The unlawful appropriation of another's property, as in the conversion of trust funds.

cost approach 204
An appraisal method used by an appraiser to arrive at a property's value based on the present cost of constructing the present improvements and acquisition of the land.

covenants, conditions and restrictions (CC&Rs) 261
Recorded restrictions against the title to real estate prohibiting or limiting specified uses of the property.

credit application 496
A document prepared by a prospective tenant which includes a provision authorizing the investigation and receipt of information on the applicant's creditworthiness. [See **RPI** Form 302]

credit reporting agency 76
A private agency which collects and reports information regarding an individual's credit history.

creditworthiness 370
An individual's ability to borrow money, determined by their present income, wealth and previous debt payment history.

D

date-down search 338
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.

debt-to-income (DTI) ratio 80, 369
Percentage of monthly gross income that goes towards paying debt.

Declaration of Default and Demand for Sale 453
A document delivered to the trustee under a power of sale provision by the mortgage holder instructing the trustee to initiate foreclosure on the secured real estate by recording a notice of default (NOD).

declaration of homestead 354
A document signed by a homeowner and filed with the county recorder's office to shield the owner-occupant's homestead equity from seizure by creditors. [See **RPI** Form 465]

deed-in-lieu of foreclosure 427
A deed to real property accepted by a lender from a defaulting borrower to avoid the necessity of foreclosure proceedings by the lender. [See **RPI** Form 406]

delinquency 528
A tenant or borrower's failure to pay the agreed amounts on or before the due date or expiration of any grace period.

Department of Real Estate (DRE) 2, 22
A government entity which oversees, regulates, administers and enforces California real estate law as practiced by licensees.

designated officer (DO) 13
The individual who is the licensed officer qualifying a corporation for a corporate broker license.

disabled person 57
Anyone who has a physical or mental impairment which significantly limits major life activities, has a record of disability, or is regarded as being disabled.

discriminatory practices 67
Unequal treatment given to members of a protected class of individuals.

documentary transfer tax 320
A tax imposed on a recorded document when real estate is transferred.

Dodd-Frank Wall Street Reform and Consumer Protection Act 417
A 2010 enactment of significant changes to U.S. financial regulation in response to the 2007 financial crisis.

dominant tenement 276
The property benefitting from an easement on a servient tenement.

double-end **198**
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 **38, 43, 195**
The agency relationship that results when a broker represents both the buyer and the seller in a real estate transaction. [See **RPI** Form 117]

due date **529**
The date provided in the rental or lease agreement on which rental payments are due. [See **RPI** Form 550 §4.1 and 552 §4.1]

due diligence **151**
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.

due-on clause **417, 430, 436**
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

dwelling **52, 82**
A building occupied or designed to be occupied as a residence by one or more families.

E

easement **275**
The right to use another's property for a specific purpose.

easement by necessity **281**
An easement providing access to a landlocked property.

easement in gross **276**
An easement which belongs to an individual and is not appurtenant to a property.

ejectment **289**
A civil action to recover possession or title to land from someone wrongfully in possession.

eminent domain **88, 221**
The right of the government to take private property for public use on payment to the owner of the property's fair market value.

employment relationship.......... **158**
The scope of activities the broker and the broker's agents are to undertake in the employment of a client.

encroachment **269**
An improvement on one parcel of real estate which extends onto real estate owned by another.

encumbrance **312, 342**
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 Efficient Mortgage (EEM) **380**
An FHA-insured purchase-assist or refinance mortgage which includes the additional amount to cover the costs of constructing energy improvements on the mortgaged property.

environmental hazards **105**
Noxious or annoying man-made conditions which are injurious to health or interfere with an individual's sensitivities.

Equal Credit Opportunity Act **73**
A 1974 federal enactment prohibiting lenders from discriminating against borrowers from a protected class.

equity purchase (EP) agreement **186**
The document used to negotiate the sale of an owner-occupied residence-in-foreclosure to an investor. [See **RPI** Form 156]

escrow **212**
The depository process employed to facilitate the gathering of instruments and funds for use to transfer real estate interests between two persons.

escrow instructions **212**
Directives an escrow officer undertakes, as given by buyer and seller, or lender and borrower to coordinate the closing on a purchase agreement or mortgage origination. [See **RPI** Form 401]

escrow officer **212**
An individual licensed and employed as an agent of an escrow company or other escrow service provider to perform escrow services.

estate **236**
The ownership interest a person may hold in real estate.

exception **344**
Any encumbrances affecting title and any observable on-site activities which are listed as risks assumed by the insured and not covered by a policy of title insurance under Schedule B.

excluded debts **391**
Extensions of credit by sellers of real estate creating a debt obligation in sales transactions which avoid usury laws.

exclusion **344**
Risks of loss not covered under a policy of title insurance, comprised of encumbrances arising after the transfer or known to or brought about by the insured.

exclusive agent **27**
An agent who is acting exclusively on behalf of only one party in a transaction.

exclusive right-to-buy listing agreement **170**
A written employment agreement by a broker and a prospective buyer of real estate employing and entitling the broker to a fee when property is purchased during the listing period. [See **RPI** Form 103]

exclusive right-to-sell listing **161**
An agreement employing a broker to act as agent for the seller of real property in which the seller promises to pay the broker a fee if the property is sold during the period of the employment, whether by the broker, through another broker or by the efforts of the owner. [See **RPI** Form 102]

exempt debt **391**
Private party transactions exempt from usury laws involving the origination of a mortgage secured by real estate and made or arranged by a real estate broker.

expungement **336**
A court order removing from title to real estate the effect of a recorded lis pendens regarding litigation asserting a claim to title or possession of the property.

extraordinary expense **137**
An emergency situation lifting the limits placed on the amount an HOA may charge for regular and special assessments.

F

fair market value (FMV) **200, 475**
The price a reasonable, unpressured buyer would pay for property on the open market.

fair value hearing **465**
The court proceeding at which a money judgment is awarded for any deficiency in the secured property's fair market value (FMV) at the time of the judicial foreclosure sale to fully satisfy all debt obligations owed the mortgage holder.

familial status **52**
A status which indicates a household includes individuals under the age of 18.

Federal Fair Housing Act (FFHA) **52, 81**
A collection of policies designed to prevent discrimination in the access to housing based on an occupant's inclusion in a protected class.

fee estate **236**
An indefinite, exclusive and absolute legal ownership interest in a parcel of real estate.

fee simple **302**
The absolute ownership of possessory rights in real estate for an indefinite duration.

fee splitting **181**
When fees made to a broker are split vertically with employed agents or split horizontally among other brokers.

fictitious business name **13**
The name under which a business or operation is conducted, also known as a d.b.a. ("doing business as…").

fiduciary duty **27, 94, 159, 177**
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.

final inspection 519
An inspection of the premises conducted by the landlord within 21 days after a residential tenant vacates the property. [See **RPI** Form 585]

financial calculator 567
An electronic calculator preprogrammed to perform advanced financial functions needed in real estate transactions.

finder..178
An unlicensed individual who locates, identifies and refers potential clients to brokers, agents or principals in exchange for the promise of a fee. [See **RPI** Form 115]

finder's fee...182
The fee paid to an individual who located, identified or referred a client to a broker, agent or principal. [See **RPI** Form 115]

fixed payment ratio 378
A debt-to-income ratio (DTI) used to determine eligibility for an FHA-insured mortgage limiting the buyer's total fixed payment on all debts to 43% of the buyer's gross income, also called the DTI back-end ratio.

fixed-term tenancy 238
A leasehold interest which lasts for the specific lease period set forth in a lease agreement. A fixed term tenancy automatically terminates at the end of the lease period. [See **RPI** Form 550 and 552]

fixture 231
Personal property permanently attached to real estate and conveyed with it.

foreclosure decree 461
A court judgment ordering the sale of secured property.

forfeiture 285
The termination of an easement when the easement holder exceeds their authorized use of the easement by placing an excessive burden on the property encumbered by the easement.

full credit bid 456
The maximum amount the foreclosing mortgage holder may bid at a trustee's sale without adding cash, equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses.

full listing offer 165
A buyer's or tenant's offer to buy or lease on terms substantially identical to the employment terms in the owner's listing agreement with the broker. [See **RPI** Form 556]

full-service gross lease 509
A commercial lease specifying that the landlord retains the responsibility for payment of all costs of care and maintenance, unless modified, including the tenant's utilities and janitorial services. [See **RPI** Form 552 and 552-1]

fully stepped-up cost basis 331
The tax basis of community property a surviving spouse receives on the death of a spouse is stepped up to the property's fair market value (FMV) on the date of death.

further-approval contingency 87
A provision in an agreement calling for the further approval of an event or activity by the seller, buyer or third party as a condition for further performance or the cancellation of the transaction by a person benefitting from the provision. [See **RPI** Form 185 §9 and 279 §2]

further-improvements provision 250
A commercial lease provision which allows a landlord to retain tenant improvements or require the restoration of the property to its original condition upon expiration of the lease. [See **RPI** Form 552 §11.3]

future advances 446
A trust deed provision authorizing a mortgage holder to advance funds for payment of conditions impairing the mortgage holder's security interest in the mortgaged property, such as delinquent property taxes, assessments, improvement bonds, mortgage insurance premiums or elimination of waste. [See **RPI** Form 450 §2.5]

G

general account 47
A broker or agent's personal or business account, not to be commingled with trust funds.

general duty 95
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]

general plan 564
Development policies for acceptable land uses within a jurisdiction.

good faith deposit 217
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]

goodwill 489
The intangible image or opinion held about a property which affects its earning power.

grace period 410, 529
The time period following the due date for a payment during which payment received by the lender or landlord is not delinquent and a late charge is not due. [See **RPI** Form 550 §4.3 and 552 §4.7]

graduated payment mortgage (GPM) 405
A mortgage providing for installment payments to be periodically increased by predetermined amounts to accelerate the payoff of principal.

granny flat 565
A separate, self-contained additional dwelling on a property zoned to accommodate only one unit.

grant 301
The transfer of an interest in title to real estate.

grant deed 306, 311
A document used to pass a fee simple interest in real estate from the grantor to another individual, unless a lesser interest is stated. [See **RPI** Form 404]

grantee 304
An individual acquiring an interest in title to real estate.

grantor 302
A individual capable of conveying an interest in real estate.

gross lease 508
A commercial lease specifying that the tenant pays for their utilities and janitorial fees, but unless modified is not responsible for any other care, maintenance or carrying costs of the property. [See **RPI** Form 552 and 552-1]

ground lease 239
A leasehold interest for which rent is based on the rental value of the land, whether the parcel is improved or unimproved.

guarantee 423
An assurance that events and conditions will occur as presented by the agent.

guaranteed sales listing 167
A variation of the exclusive right-to-sell listing in which the broker agrees to buy the property if the property does not sell during the listing period.

H

habitability defense 549
A residential tenant's pursuit of a legal remedy due to a landlord's failure to maintain habitable conditions on the rented premises.

habitable condition 546
The minimum acceptable level of safety, utility and sanitation permitted in a residential rental.

hazardous waste 110
Any products, materials or substances which are toxic, corrosive, ignitable or reactive.

heirs, assigns and successors clause 507
A clause in a lease agreement which binds those who later take the position of landlord or tenant to the existing agreement. [See **RPI** Form 552 §23.3]

holdover rent 245
Rent owed by a holdover tenant for the tenant's unlawful detainer of the rented premises as a tenant-at-sufferance. [See **RPI** Form 550 §3.3]

holdover tenant **245**
A tenant who retains possession of the rented premises after their right of possession has been terminated, called a tenant-at-sufferance.

home energy audit **143**
An audit conducted by a Home Energy Rater evaluating the energy efficiency of the home.

home equity mortgage **472**
A junior mortgage encumbering the value in a home remaining after deducting the principal on the senior mortgage from the market value of the home.

home inspection **103**
A non-invasive examination of the mechanical, electrical and plumbing systems of a dwelling, as well as the components of the structure, such as the roof, ceiling, walls, floors and foundations.

home inspection report (HIR) **141**
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 **102, 142**
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.

Home Mortgage Disclosure Act (HMDA) **77**
A regulatory scheme requiring lenders to publicly release loan data.

homeowners' association (HOA) **136**
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).

homestead **353**
The dollar amount of equity in a homeowner's principal dwelling the homeowner qualifies to shield as exempt from creditor seizure. [See **RPI** Form 465]

I

implicit discrimination **67**
Actions which are not openly discriminatory but yield discriminatory results.

implied covenant **312**
An implied warrant the grantor has not previously conveyed or encumbered their interest in the real estate.

implied easement **280**
An easement created by the conduct of parties without prior agreement.

implied warranty of habitability **545**
An unwritten provision, included by statute, in all residential lease agreements requiring the landlord to provide safe and sanitary conditions in the rental unit.

inaccessible areas **148**
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 **206**
One of three methods of the appraisal process applied to income producing property to develop the appraiser's opinion of value.

incurable breach **526**
Nonmonetary defaults in leases or mortgages that cannot be cured or undone. [See **RPI** Form 577]

ingress and egress **276**
Access to a property by its owner directly from publicly dedicated streets or by using their right to traverse a portion of another's land using an easement.

installment note **402**
A note calling for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a final balloon payment. [See **RPI** Form 420, 421 and 422]

itemized deduction **472**
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.

J

joint pre-expiration inspection **518**
An inspection conducted by a residential landlord or the property manager to advise a tenant of the repairs the tenant needs to perform to avoid deductions from their security deposit. [See **RPI** Form 567-1]

joint tenancy **325**
An ownership interest in property concurrently received by two or more individuals who share equally and have the right of survivorship.

judicial foreclosure **460**
The court-ordered sale by public auction of the mortgaged property. Also known as a sheriff's sale.

L

laches **273**
An unreasonable delay which bars pursuit of a claim.

late charge **409**
A fee imposed as an additional charge under a provision in a promissory note, lease or rental agreement when payments are not received by their due date or during a grace period.

lead-based paint **125**
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 **126**
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]

lease agreement **242**
The written document which sets the terms of a fixed-term tenancy. [See **RPI** Form 550 and 552 -- 552-4]

leasehold estate **238**
The right to possess a parcel of land, conveyed by a fee owner (landlord) to a tenant.

legal description **236, 307**
The description used to locate and set boundaries for a parcel of real estate.

lender-paid mortgage insurance (LPMI) **398**
Default mortgage insurance provided by private insurers in which the lender pays the mortgage insurance premium and recovers the cost through a higher interest rate.

levying officer **461**
A court-appointed receiver or sheriff who conducts a judicial foreclosure sale.

lien **226**
Interests in real estate which secure payment or performance of a debt or other monetary obligation.

life estate **237**
An interest in a parcel of real estate lasting the lifetime of the life tenant.

lis pendens **333, 461**
A notice recorded for the purpose of warning all persons that the title or right to possession of the described real property is in litigation.

listing agreement **157**
A written employment agreement used by brokers and agents when an owner, buyer, tenant or lender retains a broker to render real estate transactional services as the agent of the client. [See **RPI** Form 102 and 103]

litigation guarantee **460**
A title insurance policy which lists all parties with a recorded interest in a property and their addresses of record, ensuring that all persons with a recorded interest in a property are named and served in litigation.

loan-to-value ratio (LTV) 377, 398
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value. The degree of leverage.

lot line adjustment 300
When adjacent property owners move an existing property line.

M

marketing package 154
A property information package handed to prospective buyers containing disclosures compiled on the listed property by the seller's agent.

master lease 239
A leasehold interest granted to a master tenant with the right to sublease the property in exchange for rent paid to the fee owner.

material breach 526
A significant contractual breach that prevents the completion of the agreed upon activity.526

material defect 143
Information about a property which might affect the price and terms a prudent buyer is willing to pay for a property.

material fact 86, 132, 152
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.

mechanic's lien 253
A lien entitling a contractor or subcontractor to foreclose on a job site property to recover the amount due and unpaid for labor and materials they used.

merger 284
The termination of an easement when one owner acquires fee title to both the property benefitting from and the property burdened by an easement.

minor breach 526
Failure to pay late charges, interest penalties, bad check charges or security deposits.

misdemeanor 289
A lesser crime punishable by a fine and/or county jail sentence.

mobilehome 16
Property designed to be used as a dwelling, classified as either personal or real property depending on the method of attachment to a parcel of real estate. Also known as a manufactured home.

monetary breach 532
A tenant's failure to timely pay rent or other money obligation due.

money judgment 460
An award for money issued by a court resulting from a lawsuit for payment of a claim.

mortgage-backed bonds (MBB) ....
An asset-backed security representing a claim on the cash flows received on a mortgage loan.

mortgage commitment 394
A lender's commitment to make a mortgage, enforceable only when written, unconditional and signed by the lender for consideration.

mortgage insurance premium (MIP) 377
The cost for default insurance incurred by a borrower on an FHA-insured mortgage set as a percent of the mortgage amount paid up front and an annual rate on the principal balance paid with monthly principal and interest for the life of the mortgage.

mortgage interest deductions (MID) 472
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.

mortgage loan originator (MLO) 17
A Department of Real Estate (DRE) licensee who receives fees to arrange a consumer mortgage other than a carryback.

mortgage package 373
A collection of documents required to process a mortgage application and sent to a mortgage underwriting officer for review after receipt of the appraisal on the property offered as security.

mortgage payment ratio 378
A debt-to-income ratio (DTI) used to determine eligibility for an FHA-insured mortgage limiting the buyer's mortgage payment to 31% of the buyer's gross effective income.

Mortgage Shopping Worksheets 364
A worksheet designed for use by buyers when submitting applications for a consumer mortgage to compare mortgages offered by different lenders based on a list of all the variables commonly occurring as costs at the time of origination and over the life of the mortgage. [See **RPI** Form 312]

multiple listing service (MLS) 42
An association of real estate agents pooling and publishing the availability of their listing properties.

N

natural hazards 113
Risks to life and property which exist in nature due to a property's location.

Natural Hazard Disclosure Statement (NHD) 114, 153
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]

negative covenant 262
A recorded restriction prohibiting identified uses of a property.

net lease 509
A commercial lease which transfers to the tenant the obligation, unless modified, to pay all of the costs of ownership in addition to utilities and janitorial services. [See **RPI** Form 552-2 and 552-3]

net listing 166
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) 581
The net revenue generated by an income producing property as the return on capital, calculated as the sum of a property's gross operating income less the property's operating expenses. [See **RPI** Form 352 §4]

nominal money losses 288
Monetary recovery when no injury has occurred.

nonjudicial foreclosure 449, 460
When property is sold at a public auction by a trustee as authorized under the power-of-sale provision in a trust deed.

nonmonetary breach 532
A tenant's breach of any obligation other than an obligation to pay money.

nonrecourse 387, 430
A debt secured by real estate, the creditor's source of recovery on default limited solely to the value of their security interest in the secured property.

notice of change in rental terms 511
Written notice served on the tenant noting changes in the terms or conditions of a month-to-month rental agreement. [See **RPI** Form 570 and 574]

notice of default (NOD) 451
The notice filed to begin the nonjudicial foreclosure process. Generally, the NOD is filed following three or more months of delinquent mortgage payments.

notice of intent to vacate 513
A tenant's notice to the landlord signifying their intent to vacate the leased property. [See **RPI** Form 571 and 572]

notice of nonresponsibility 254
A notice used by an owner to declare they are not responsible for any claim arising out of the improvements their tenant is constructing on their property. [See **RPI** Form 597]

novation 433
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

nuisance 267, 271, 291, 534
An action which is injurious to health, offensive to the senses, or obstructs the use and enjoyment of surrounding property. [See **RPI** Form 550 §6.7 and 552 §7.3]

nuisance per se 292
Any activity specifically declared by statute to be a nuisance, such as construction of fences of excessive height or the illegal sale of controlled substances.

O

open listing 164
An employment entered into by a broker to render real estate services on a best-efforts basis under which a fee is due to the broker if they achieve the client's objective of the employment before the client or another broker separately first meet the objective, such as the sale or locating of a property.

option listing 167
A variation of the exclusive right-to-sell listing in which the seller grants the broker an option to buy the property at a predetermined price, if the property does not sell during the listing period. [See **RPI** Form 102 §10]

overlying right 256
The right of a real estate owner to take the ground water below the surface of their land.

owner-by-foreclosure 543
The winning bidder at a trustee's sale who takes title to the property sold by a trustee's deed.

owner's statement 48
An accounting on the status, expenditure and location of negotiable trust funds provided to the owner of those funds.

P

parcel 235
A three-dimensional portion of real estate identified by a legal description.

party wall 266
A common boundary improvement located on a property line between adjacent properties, such as a wall, fence or building co-owned by the adjacent property owners.

periodic tenancy 238
A leasehold interest which lasts for automatic successive rental periods of the same length of time, terminating upon notice from either party. [See **RPI** 551 and 552-5]

permanent nuisance 294
A nuisance which cannot be abated at a reasonable cost and by reasonable means.

permissive improvement 251
Improvements made to a leased property to meet the needs of the occupying tenant. [See **RPI** Form 552 §11]

personal property 226
Moveable property not classified as part of real estate, such as trade fixtures.

Pest Control Certification 147
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.

points 476
A fee charged by a lender as prepaid interest which in turn reduces the note rate on the mortgage, with a point equaling 1% of the amount of the mortgage.

police power 220
The basis for enacting local ordinances such as zoning, traffic, health and safety regulations and rent control.

portfolio category income 385
Unearned income from interest on investments in bonds, savings, income property, stocks and trust deed notes.

power-of-sale provision **442, 450**
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

pre-foreclosure workout **451**
Negotiations between a mortgage holder and defaulting property owner with the purpose of exploring options to avoid foreclosure.

prescriptive easement **281**
The right to use another's property established by the adverse use of the property for a period in excess of five years without a claim of ownership.

prescriptive rights **259**
The right to use water established by appropriating nonsurplus water openly and adversely for an uninterrupted period of five years without documentation of a legal right.

preliminary title report (prelim) **337, 343**
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.

prepayment penalty **415**
A provision in a note giving a lender the right to levy a charge against a borrower who pays off the outstanding principal balance on a loan prior to expiration of the prepayment provision. [See **RPI** Form 418-2]

principal **8, 22**
A person, an individual or an entity, acting as a buyer or seller, represented by a broker and their agents.

principal residence **472**
The residential property where the homeowner resides a majority of the year.

private mortgage insurance (PMI) **397**
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios higher than 80%.

pro forma operating budget **138**
A budget which discloses the amount of assessments collected by an HOA, its cash reserves and whether special assessments are anticipated to occur.

probate referee **465**
An appraiser appointed by the court in a judicial foreclosure action to advise the court on a property's fair market value (FMV) on the date of the judicial foreclosure sale.

profit a prendre **229, 237**
The right to remove minerals from another's real estate.

promissory note **402, 423**
A document given as evidence of a debt owed by one person to another. [See **RPI** Form 421 and 424]

proof-of-loss statement **351**
A statement submitted to the title insurance company by the insured referencing the encumbrance discovered after they were issued the policy, the amount of the loss and the basis for calculating the loss.

property profile **153, 486**
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

proration **216**
Provisions entitling the seller to a credit for the portion of prepaid sums which have not accrued on obligations a buyer assumes on the day escrow closes, or entitling the buyer to a credit for amounts assumed which accrued unpaid through the day prior to the close of escrow. [See **RPI** Form 401 §10]

prudent investor standard **485**
A property management standard reflecting the expectations of a well-informed investor for efficient and effective management of rental income and expenses.

public control **563**
State laws, zoning regulations, building codes and local plans designed to protect property values and control growth.

public nuisance 293
A nuisance affecting an entire segment of the public.

purchase agreement 186
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-money debt 468
A mortgage which funds the purchase or construction of a one-to-four unit owner-occupied residence, also called a nonrecourse debt.

purchase-money mortgage. 431
Nonrecourse mortgage financing provided by a lender as purchase-assist funding for the purchase of a one-to-four unit residential property the buyer is going to occupy, or a seller carryback note and trust deed as an extension of credit to a buyer of any type of real estate which is secured solely by the property sold. Anti-deficiency mortgage.

pure-net lease 509
A commercial lease in which a tenant assumes absolutely all the obligations of ownership. [See **RPI** Form 552-2 and 552-3]

Q

qualified interest. 476
Interest on a mortgage which has accrued and been paid and is an allowable interest deduction for ownership of a first and second home.

quiet title 357
A court action to remove a cloud and establish title to a property.

quitclaim deed 306, 315
A document used to convey whatever interest, if any, the grantor may hold in the real estate. [See **RPI** Form 405]

R

radon gas 559
A naturally occurring gas which accumulates in confined areas at ground level and poses a health risk to occupants.

rafters 557
Wood beams on which sheathing is placed. Together, these form the shape of a roof.

ratify 328
The later adoption or approval of an act performed on behalf of a person when the act was not previously authorized.

real estate 226
Land and anything permanently affixed or appurtenant to it.

real estate agent 2
A person who, for compensation or in expectation of compensation, is employed by a licensed broker to do one or more of the acts of a licensed broker

real estate fixture 253
Personal property attached to the real estate as an improvement, which becomes part of the conveyable real estate.

real estate owned (REO) property 170
Property acquired by a mortgage holder through foreclosure.

Real Estate Recovery Fund. 16
Funds available to individuals who have obtained a final-court judgment against a licensee and are unable to recover the judgment from the licensee. Also known as the Consumer Recovery Account.

Real Estate Settlement Procedures Act (RESPA) 179, 371, 380
Legislation prohibiting brokers from giving or accepting referral fees if the broker or their agent is already acting as a transaction agent in the sale of a one-to-four unit residential property which is being funded by a purchase-assist, federally-related consumer mortgage.

reasonable certainty 505
The degree of certainty expected from a reasonable person.

reasonably foreseeable 552
The possibility a crime or danger may occur due to a previous crime on the premises. A landlord has a duty to take reasonable measures to prevent harm to persons on the property or warning tenants of the prior criminal activity.

reconveyance 407, 427
A document executed by a trustee named in a trust deed to release the trust deed lien from title to real estate, used when the secured debt is fully paid. [See **RPI** Form 472]

recourse mortgage 431, 450, 460
A mortgage debt in which a lender may pursue collection from a property owner for a loss due to a deficiency in the value of the secured property to fully satisfy the debt if the lender forecloses judicially.

redemption 442
A property owner or junior lienholder's right to clear title to property of a mortgage lien prior to the completion of a trustee's sale or following a judicial foreclosure sale by paying all amounts due on the mortgage debt, including foreclosure charges.

redlining 70
Failure to provide financing or insurance in certain communities based on the demographics of that community.

reformation 315
A legal process to correct an omission or error in a grant deed by court action.

regular assessments 137
Recurring HOA assessments which fund the operating budget to pay for the cost of maintaining the common areas.

reinstatement 443
A property owner or junior lienholder's right to reinstate a mortgage and cure any default prior to five business days before the trustee's sale by paying delinquent amounts due on the note and trust deed, plus foreclosure charges.

remote grantee 314
A future owner of real estate who later takes title to a property, also known as a successor.

rental agreement 243
The written document which sets the terms and conditions of a periodic tenancy. [See **RPI** Form 551 and 552-5]

rental market 495
The market environment in which landlords seek tenants and tenants seek landlords for the occupancy of property. The rental market sets the amount of rent a property will command on any given day.

rescind 456
The cancellation of a contract which restores the parties to the same position they held before they entered into the contract.

restoration 115
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.

restricted real estate loans 391
All mortgages made by private party lenders which are neither made nor arranged by a real estate broker.

retaliatory eviction 537
A tenant whose tenancy is sought to be terminated for lawfully exercising any rights.

reversion 253
The conveyance of real estate fixtures from a tenant to landlord on expiration of a lease.

reversionary interest 502
A future interest a person retains on the grant of property which reverts to the person on the occurrence of an event.

right of survivorship 324
The right of surviving joint tenants or a spouse to succeed to the entire interest of the deceased co-owner.

riparian land 256
The right of a real estate owner to take the ground water below the surface of their land.

riparian right 230, 255
The right of a real estate owner to take surface water from a running water source contiguous to their land.

S

safety clause 175
A provision in an exclusive listing agreement earning the broker a fee during an agreed safety period after expiration of the employment for marketing efforts with identified buyers, tenants or property, if the client sells the listed property to an identified buyer or purchases or leases an identified property during the safety period. [See **RPI** Form 102 §3.1(d), 103 §4.1(c) and 110 §3.1(d)]

Schedule A 344
Identification of the property interest insured, the legal description of the insured property, the date and time coverage began, the premium paid for the policy and the total dollar amount to be paid for all claims settled.

Schedule B. 345
Exceptions from coverage, both standard and itemized, by the title insurance policy.

second home 474
An individual's alternative residence where they do not reside a majority of the year.

Section 8 housing 542
A government housing program for low income households which provides qualifying tenants with rent subsidies and minimum habitability standards.

security 319
Collateral for a debt in the form of a lien imposed on property.

security deposit 515
A source of funds to pay tenant obligations owed the landlord on the tenant's default in the rental or lease agreement. [See **RPI** Form 550 §2.1 and 552 §1.2]

seller financing 384
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 carryback financing.

seller's agent 26
An agent representing the seller. Also known as a listing agent. [See **RPI** Form 102]

seller's net sheet 155
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]

senior citizen housing 67
Housing intended for individuals 55 or 62 years of age or older.

separated report 146
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.

servient tenement 276
A property burdened by a license or easement.

set aside 328
To annul by court order a document transferring an interest in real estate.

short payoff 469
A sale in which the lender accepts the net proceeds at closing in full satisfaction of a greater amount of mortgage debt.

solar easement 277
An easement restricting an owner's ability to maintain improvements interfering with a neighbor's solar energy system.

special assessments 137
A lien against real estate by a public authority to pay the cost of public improvements such as street lights, sidewalks, street improvements. In a common interest subdivision, an additional charge levied by the association for unanticipated repairs.

specific performance action 335
Litigation to compel performance of an agreement.

start-up fee 491
A flat, one-time fee charged by a property manager for the time and effort taken to become sufficiently familiar with the operations of the property to commence management.

State Water Resources Control Board **258**
Government entity established to ensure the proper allocation and efficient use of state water resources.

statement of deficiencies **519**
A document a residential landlord presents to a vacating tenant specifying any repairs or cleaning to be completed by the tenant to avoid deductions from the security deposit. [See **RPI** Form 567-3]

Statute of Frauds **214**
California state law requiring specific types of contracts to be in writing and signed by the person to be charged with performance before they will be enforceable by a court, e.g., purchase agreements and lease agreements for a term of more than one year.

statute of limitations **300**
A period of time establishing the deadline for filing a lawsuit to resolve a dispute.

statutory breach **534**
A breach of the lease agreement which automatically forfeits the tenant's right of possession.

steering **54**
An unlawful housing practice that includes words or actions by a real estate sales licensee intended to influence the choice of a prospective buyer or tenant. A violation of federal fair housing provision that seek to eliminate discrimination in the sale or rental of housing.

straight note **402**
A note calling for the entire amount of its principal to be paid together with accrued interest in a single lump sum when the principal is due. [See **RPI** Form 423]

Structural Pest Control (SPC) report **145**
A report disclosing any active infestations, damage from infestations or conditions which may lead to infestations.

subaccount ledger **47**
An accounting document or file identifying the owner of trust funds and the amount held for the owner.

subagent........ **41**
An individual who has been delegated agency duties by the primary agent of the client, not the client themselves.

subject-to transaction **430**
A sale of mortgaged property calling for the buyer to take title subject to the mortgage, the principal balance being credited toward the purchase price paid. Compare with formal assumption. [See **RPI** Form 156 §5]

sublease **236**
A leasehold interest subject to the terms of a master lease.

surplus funds........ **457**
The price paid for property by the successful bidder at a trustee's sale in excess of the amount of debt and costs due under the foreclosed trust deed.

T

tenancy-at-sufferance **239**
A leasehold condition created when a tenant retains possession of the rented premises after the tenancy has terminated. [See **RPI** Form 550 §3.3]

tenancy-at-will **238**
A leasehold interest granted to a tenant, with no fixed duration or rent owed. A tenancy-at-will can be terminated at any time by an advance notice from either party.

tenant improvements **249**
Improvements made to a leased property to meet the needs of the occupying tenant. [See **RPI** Form 552 §11]

termination **115**
The cancellation of a transaction before escrow has closed or a lease has ended.

title conditions **96**
Encumbrances such as liens, conditions, covenants and restrictions and easements which affect title to property.

title insurance **342**
A form of indemnity insurance issued by a title insurance company which holds harmless the named insureds against monetary loss caused by an encumbrance not listed in Schedule B of the policy and not known by the insured when the policy was issued.

trade fixtures **232, 252**
A fixture used to render services or make products in the trade or business of a tenant.

transaction agent **359, 366**
The term lenders use to identify the buyer's agent in a sales transaction, its closing contingent on the buyer obtaining a mortgage to fund the purchase price.

Transfer Disclosure Statement (TDS **86, 94, 131**
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]

treble damages **392**
A usury penalty computed at three times the total interest paid by the borrower during the one year period immediately preceding their filing of an action on a non-exempt private lender mortgage.

trespass **271, 287**
Any wrongful and unauthorized entry onto real estate in the possession of another.

trespasser **242**
A person who occupies a property without the owner's transfer of the right to occupy.

triple net lease **509**
A commercial lease which passes the responsibility for all costs and maintenance of the property to the tenant. [See **RPI** Form 552-2 and 552-3]

trustee **424, 451**
One who holds title to real estate in trust for another.

trustee's sale guarantee **453**
A policy issued by a title insurance company to a trustee before or at the time the notice of default is recorded providing coverage for the trustee should they fail to serve notices on any party of record due to an omission in the guarantee.

trust account **484**
An account separate and apart and physically segregated from a broker's own funds, in which the broker is required by law to deposit all funds received for clients.

trust funds **45, 490**
Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.

U

Uniform Residential Loan Application **361,366**
A standardized mortgage application completed by the buyer with the assistance of the transaction agent and the mortgage lender's representative. [See **RPI** Form 202]

unilateral employment agreement **173**
An oral or written employment agreement obligating the broker to use their best-efforts to fulfill the client's real estate goals without imposing a due diligence duty on the broker until a match is located, commonly called an open listing.

unlawful detainer **242**
The unlawful possession of a property. [See **RPI** Form 575 -578]

Unruh Civil Rights Act **56**
A California law which prohibits discrimination by a business establishment based on sex, race, color, religion, ancestry, national origin, disability or medical condition. A real estate practice is a business establishment.

usury **389, 407**
A limit on the lender's interest rate yield on nonexempt real estate mortgages.

V

vesting **323**
A method of holding title to real estate, including tenancy in common, joint tenancy, community property and community property with the right of survivorship.

void deed **320**
A deed that is unenforceable and conveys no interest in real estate.

voidable deed **321**
A deed that is valid and enforceable until it is challenged due to a defect and declared invalid by a court order.

W

waiver agreement 439
An agreement in which a mortgage holder consents to the owner's present or future transfer of an interest in the mortgaged property as a waiver of the mortgage holder's due-on rights. Also known as an assumption agreement. [See **RPI** Form 431 and 432]

waste 537
The intentional destruction or neglect of property which diminishes its value. [See **RPI** Form 550 §6.8 and 552 §7.4]

waterbed addendum 497
An addendum to a rental or lease agreement setting the additional security deposit and insurance coverage the tenant will provide the landlord to keep a waterbed on the premises. [See **RPI** Form 564]

Real Estate Principles, Second Edition

Instructions: Quizzes are open book. All answers are multiple choice.
Quizzes are **optional** and may be taken as many times as you like.
Answer key is located on page 622.

Quiz 1 – Chapters 1-3

1. The California Legislature created the __________ to oversee, regulate, administer and enforce the real estate law.
   a. Department of Home Finance
   b. California Bureau of Veterans
   c. Department of Real Estate (DRE)
   d. Department of Agriculture and Property

2. The chief officer of the Department of Real Estate (DRE) is the:
   a. Real Estate Commissioner.
   b. President of the United States.
   c. Governor of California.
   d. Real Estate Solicitor.

3. To be eligible for a broker or agent license, the applicant needs to be honest and truthful, complete mandatory education and:
   a. provide proof of legal presence in the U.S.
   b. be at least 21 years of age.
   c. have previously worked as an unlicensed assistant.
   d. pass the qualifying exam.

4. All real estate brokers and agents need to complete at least __________ of continuing education (CE) every four years to renew a license issued by the Department of Real Estate (DRE).
   a. 15 hours
   b. 30 hours
   c. 45 hours
   d. 50 hours

5. The __________ is available to individuals who have obtained a judgment against a licensee and are unable to recover the judgment from the licensee for losses caused while acting as an agent.
   a. Real Estate Recovery Fund
   b. Broker Protection Fund
   c. Homeowner Relief Fund
   d. Borrower Education Fund

6. A residential mortgage primarily for personal, family or household use and secured by a deed of trust on a dwelling is known as a:
   a. consumer purpose mortgage.
   b. public project loan.
   c. adjustable rate mortgage (ARM).
   d. Zero Ability to Pay (ZAP) loan.

7. Agency in real estate related transactions includes relationships between brokers and their:
   a. principals.
   b. agents.
   c. Both a. and b.
   d. A real estate broker is never an agent.

8. A broker's representation of a client, such as a buyer or seller, is best undertaken:
   a. with an oral agreement only.
   b. through coercion.
   c. on a written employment agreement signed by both the client and the broker.
   d. through ratification after acts requiring a license have been performed.

9. The Agency Law Disclosure needs to be attached to which of the following documents and signed by all parties in targeted transactions?
   a. A counteroffer.
   b. A seller's listing agreement.
   c. A lease agreement for a term exceeding one year.
   d. All of the above.

10. Failure of the seller's agent to provide the seller with the Agency Law Disclosure prior to entering into the listing agreement may result in:
    a. payment of a $1,000 fine.
    b. the loss of their fee.
    c. jail time.
    d. the forfeiture of all funds in their trust account.

Quiz 2 – Chapters 4-7

1. A(n) __________ 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.
    a. affiliated business arrangement (ABA)
    b. subagency
    c. conflict of interest
    d. implied agency
2. A(n) ___________ is a broker who simultaneously represents the best interest of opposing parties in a transaction, e.g., both the buyer and the seller.
    a. dual agent
    b. secret agent
    c. subagent
    d. finder
3. When a dual agency is established in a one-to-four unit residential sales transaction, the broker may not:
    a. pass on confidential pricing information to the opposing parties.
    b. communicate to one of the parties without the express consent of the other.
    c. collect their fee when the sale closes.
    d. disclose materials facts about the property which might dissuade the buyer from submitting an offer to purchase the property.
4. Funds belonging to others which a broker and their agents handle when acting in a transaction are called:
    a. broker fees.
    b. trust funds.
    c. bonds.
    d. security deposits.
5. A broker is required to regularly account to an owner on the status, expenditure and location of negotiable trust funds, called a(n):
    a. balance sheet.
    b. deposit receipt.
    c. owner's statement.
    d. amortization schedule.
6. Regardless of race, all citizens of the United States have the right to rent residential and commercial real estate under the federal:
    a. Civil Rights Act.
    b. Freedom of Information Act.
    c. Unruh Civil Rights Act.
    d. Proposition 13.
7. __________ involves the restriction of a person seeking to buy or rent a dwelling in a community in a manner that perpetuates segregated housing patterns.
    a. Blockbusting
    b. Redeveloping
    c. Redlining
    d. Steering
8. A residential landlord may not induce or attempt to induce an individual to offer, or abstain from offering, a dwelling to prevent the entry of certain classes of people into the neighborhood, known as:
    a. blockbusting.
    b. condemnation.
    c. redlining.
    d. dual agency.
9. A(n) ____________ is housing intended for and solely occupied by persons 62 years of age or older, or intended and operated for occupancy by persons of 55 years of age or older.
    a. senior citizen housing project
    b. Section 8 housing project
    c. common interest development (CID)
    d. cooperative housing project

10. California's Unruh Civil Rights Act specifically prohibits discrimination by:
    a. educational institutions.
    b. government institutions.
    c. individuals.
    d. businesses.

Quiz 3 – Chapters 8-12

1. California anti-discrimination law is enforced by:
    a. the Department of Business Oversight (DBO).
    b. the Civil Rights Department (formerly the Department of Fair Employment and Housing.)
    c. the Department of Housing and Urban Development (HUD).
    d. Fannie Mae.
2. Until __________ was added to the anti-discrimination laws in 1992, it was legal to exclude minors under the age of 18 from housing accommodations.
    a. implicit discrimination
    b. familial status
    c. religious preference
    d. senior citizen housing
3. __________ practices are those which are not openly discriminatory, but result in discriminatory effects.
    a. Overtly discriminatory
    b. Harmlessly prejudiced
    c. Conflict of interest
    d. Implicit discriminatory
4. Failing to provide financing in certain communities is called:
    a. redlining.
    b. redevelopment.
    c. panic selling.
    d. subordination.
5. The __________ is a 1974 federal enactment prohibiting lenders from discriminating against borrowers from a protected class.
    a. Credit Reporting Act
    b. Truth-in-Lending Act
    c. Equal Credit Opportunity Act
    d. Dodd–Frank Wall Street Reform and Consumer Protection Act
6. A lender may lawfully consider __________ when determining the applicant's creditworthiness.
    a. a mortgage applicant's age
    b. the religious preference of the mortgage applicant
    c. whether the mortgage applicant intends to bear children
    d. whether an applicant's income is derived from alimony
7. Consumers may request a free copy of their credit report __________ to review it for errors.
    a. once every month
    b. once every quarter
    c. twice every year
    d. once every year
8. The __________ requires lenders to compile and submit their home loan origination data to their respective supervisory agencies.
    a. Equal Credit Opportunity Act
    b. Home Mortgage Disclosure Act (HMDA)
    c. Home Affordable Modification Plan (HAMP)
    d. Federal Fair Housing Act (FFHA)
9. The printing or publishing of an advertisement for the sale or rental of residential property that indicates a wrongful discriminatory preference is a violation of the:
    a. Unruh Civil Rights Act.
    b. Federal Fair Housing Act (FFHA).
    c. American with Disabilities Act (ADA).
    d. Equal Credit Opportunity Act.

10. The Department of Housing and Urban Development (HUD) issues guidelines that require real estate brokers selling or renting single family residences (SFRs) display a(n):
    a. code of ethics.
    b. copy of the broker's driver's license.
    c. inspirational poster.
    d. fair housing poster.

Quiz 4 – Chapters 13-17

1. A property defect which would likely affect the price a buyer would be willing to pay is referred to as:
    a. a material fact.
    b. a matter of opinion.
    c. circumstantial evidence.
    d. an "as is" condition.
2. The broker analyzes the suitability of an income property which is for sale by preparing a(n) ____________ and reviewing it with the buyer.
    a. Profit and Loss Statement
    b. Balance Sheet
    c. Annual Property Operating Data Sheet (APOD)
    d. Investment Circular
3. A seller's broker and their agents have a ___________, owed solely to the seller who has employed the broker, to diligently market the listed property for sale.
    a. non-fiduciary general duty
    b. fiduciary agency duty
    c. implied agency duty
    d. limited general duty
4. A seller of a one-to-four unit residential property needs to complete and deliver to a prospective buyer a statutory form called a(n):
    a. Transfer Disclosure Statement (TDS).
    b. Condition of Neighborhood Addendum.
    c. Agency Law Disclosure.
    d. Oil-Based Paint Disclosure (OBP).
5. Radon gas concentrations in enclosed, unventilated spaces located within a building where the underlying rock contains uranium is an example of a(n):
    a. environmental hazard located off a property.
    b. environmental hazard located on a property.
    c. natural hazard located off a property.
    d. seismic hazard located on a property.
6. Environmental hazards not itemized in the Transfer Disclosure Statement (TDS) include:
    a. hazardous construction materials and waste.
    b. window security bars and inoperable release mechanisms.
    c. environmental noise.
    d. whether the property is located in a special flood hazard area.
7. Natural hazards such as __________ come with the location of a parcel of real estate, not with the man-made aspects of the property.
    a. very high fire hazard severity zones
    b. high local crime rates
    c. security bars which interfere with an occupant's ability to exit a room
    d. asbestos-containing building materials
8. To unify and streamline the disclosure made by a seller and their agent about natural hazards affecting a property, the California legislature created a statutory form called the:
    a. Transfer Disclosure Statement (TDS).
    b. Natural Hazard Disclosure Statement (NHD).
    c. Conflict of Interest Disclosure.
    d. Mortgage Settlement Statement.

9. The Natural Hazard Disclosure Statement (NHD) handed to a prospective buyer does not disclose:
    a. whether the property is located in an area of potential flooding.
    b. whether the property is situated in a very high fire hazard severity zone.
    c. environmental hazards and physical deficiencies in the soil or property improvements.
    d. the fact the property was built in a seismic hazard zone.
10. The Natural Hazard Disclosure Statement (NHD) requires the seller's agent to disclose to a prospective buyer whether they have knowledge the property:
    a. has a roof greater than three years old.
    b. is located in a fault zone.
    c. is located in an area with a high crime rate.
    d. has an outdoor pool.

Quiz 5 – Chapters 18-23

1. The federal lead-based paint (LBP) disclosure is required on all __________ residential construction.
    a. pre-1978
    b. post-1978
    c. pre-1995
    d. post-1995
2. A(n) ___________ 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.
    a. natural hazard
    b. lead-based paint hazard
    c. oil-based paint hazard
    d. neighborhood security hazard
3. ______________ are exempt from federal lead-based paint (LBP) disclosure requirements.
    a. Residential properties built prior to 1968
    b. Single family residences built after 1970
    c. Foreclosure sales of residential property
    d. Resales of housing previously acquired by the lender at a foreclosure sale
4. A real estate agent has no affirmative duty to voluntarily disclose information to a potential buyer regarding a prior occupant whose death occurred on the real estate more than __________ years prior to the purchase offer.
    a. one
    b. two
    c. three
    d. An agent always need to disclose a death.
5. Ownership of a unit in a condominium project includes compulsory membership in:
    a. the local trade union.
    b. the homeowners' association (HOA).
    c. Facebook.
    d. the board of directors.
6. ___________ levied by a homeowners' association (HOA) fund the operating budget to pay for the cost of maintaining the common areas.
    a. Special assessments
    b. Regular assessments
    c. Mello Roos assessments
    d. Extraordinary assessments
7. Any individual who holds themselves out as being in the business of preparing a home inspection report on a one-to-four unit residential property is referred to as a(n):
    a. appraiser.
    b. home inspector.
    c. handyman.
    d. subcontractor.
8. A statement by a structural pest control (SPC) company indicating the property is free of infestation in the visible and accessible areas is referred to as a:
    a. Certificate of Completion.
    c. Pest Elimination Voucher.

b. Certificate of Occupancy.
d. Pest Control Certification.

9. Brokers owe a fiduciary duty to the client to use __________ in a continuous effort to meet the objective of the employment.
   a. due diligence
   b. minimal effort
   c. moderate caution
   d. general competence

10. All records of an agent's activities on behalf of a buyer or seller during the listing period are to be retained by the agent's broker for:
    a. one year.
    b. two years.
    c. three years.
    d. four years.

Quiz 6 – Chapters 24-30

1. A(n) __________ is a written employment contract between a client and a licensed real estate broker.
   a. job application
   b. listing agreement
   c. month-to-month rental agreement
   d. letter of intent (LOI)

2. Under a(n) __________, a client can enter into listings with as many brokers as they want without becoming obligated to pay more than one fee.
   a. exclusive agency listing
   b. exclusive right-to-sell listing
   c. open listing
   d. triple-net lease agreement

3. The function of a __________ is limited to soliciting, identifying, and referring potential real estate clients to brokers, agents, or principals in exchange for a fee.
   a. finder
   b. appraiser
   c. home inspector
   d. mortgage loan originator (MLO)

4. The primary document used to negotiate the transaction between a buyer and seller is a:
   a. listing agreement.
   b. counteroffer.
   c. purchase agreement.
   d. waiver.

5. The ________________, contained in all purchase agreements, states the existence or nonexistence of each broker's fiduciary agency with the various parties to the transaction.
   a. agency confirmation provision
   b. broker liability agreement
   c. hold harmless agreement
   d. attorney fee provision

6. An Agency Law Disclosure is provided each time any broker prepares a purchase agreement or:
   a. lease agreement for less than one year.
   b. counteroffer.
   c. makes any contact with a client.
   d. independent contractor agreement.

7. A(n) ___________ is an individual's opinion or estimate of a property's value on a specific date.
   a. termite inspection
   b. home inspection
   c. appraisal
   d. open house

8. The __________ of a property is the highest price on the date of valuation a willing seller and buyer would agree to, both having full knowledge of the property's various uses.
   a. fair market value
   b. depreciation schedule
   c. replacement cost
   d. conforming value

9. A process employing an independent agent to manage the closing of a real estate transaction through the exchange of documents and money between two parties is referred to as:

a. a title search.
b. escrow.
c. underwriting.
d. pre-approval.

10. The specific duties of the escrow officer in a particular transaction are documented in:
    a. the county records.
    b. the escrow officer's oath.
    c. the listing contract.
    d. escrow instructions.

Quiz 7 – Chapters 31-36

1. The right of the government to take private property for public use is referred to as:
    a. theft.
    b. put option.
    c. eminent domain.
    d. the power to tax.
2. __________ are interests in real estate which secure payment or performance of a debt or other monetary obligation, such as a trust deed lien or a local property tax lien.
    a. Liens
    b. Legal descriptions
    c. Title insurance policies
    d. Bundle of rights
3. The first component of real estate is land, which includes:
    a. soil.
    b. rocks.
    c. reasonable airspace above the earth.
    d. All of the above.
4. The right to use water is called a:
    a. riparian right.
    b. taking.
    c. fixture.
    d. endorsement.
5. Incidental rights to real estate which are not located on the real estate nor reflected on its title are called:
    a. trade fixtures.
    b. appurtenant rights.
    c. fructus industriales.
    d. freehold estates.
6. A(n) ________ lasts for a specific length of time as stated in a lease agreement entered into by a landlord and tenant.
    a. tenancy-at-will
    b. estate at will
    c. fixed-term tenancy
    d. life estate interest
7. On expiration of a lease, a tenant who remains in possession of a property without an agreement or acceptance of rent by the landlord for the extended occupancy becomes a:
    a. holdover tenant.
    b. equity purchaser.
    c. subtenant.
    d. successor tenant.
8. Improvements that become part of the real estate include walls, central air conditioning and:
    a. wash stations in a beauty salon.
    b. chairs.
    c. attached flooring.
    d. drapes and curtains.
9. On expiration of a lease, the passage of real estate fixtures from the tenant to landlord is a conveyance called:
    a. waste.
    b. tariff.
    c. sacrifice.
    d. reversion.
10. California established the __________ to act as a referee for all disputes over water rights.
    a. Department of Real Estate (DRE)
    b. Department of Motor Vehicles (DMV)
    c. Federal Water Conservation Authority (FWCA)
    d. State Water Resources Control Board

Quiz 8 – Chapters 37-43

1. A(n) ________ is a recorded restriction which requires a property to be used for a specific purpose.
   a. negative covenant
   b. Declaration of Covenants, Conditions and Restrictions (CC&Rs)
   c covenant which does not run with the land
   d. affirmative covenant

2. The location of a common property line that is represented by an improvement which acts as a demarcation of the property line is called a:
   a. spite fence.
   b. common boundary improvement.
   c. implied boundary.
   d. nuisance.

3. A(n) ________ is an improvement on real estate which extends onto real estate belonging to another person without their consent.
   a. nuisance
   b. trespass
   c. encroachment
   d. implied boundary

4. The property which benefits from an easement is referred to as the:
   a. dominant tenement.
   b. diminutive tenement.
   c. servient tenement.
   d. subsistence tenement.

5. A(n) ___________ belongs to an individual and is their personal right.
   a. easement in gross
   b. appurtenant easement
   c. easement running with the land
   d. encroachment

6. ________ easements restrict an owner's ability to maintain or construct improvements which interfere with a neighbor's solar energy system.
   a. Light
   b. Air
   c. View
   d. Solar

7. If a property is landlocked, the owner of the property will most likely be able to acquire a(n):
   a. easement by necessity.
   b. partial easement.
   c. easement by grant.
   d. solar easement.

8. An easement is terminated by ___________ if the easement holder places an excessive burden on the property encumbered by the easement.
   a. abandonment
   b. merger
   c. forfeiture
   d. prescription

9. A __________ is any wrongful and unauthorized entry onto real estate in the possession of another.
   a. trespass
   b. forcible detainer
   c. transient possession
   d. right of way

10. ____________ refers to a method of acquiring title to real estate owned by another by openly maintaining exclusive possession of the property for a period of five years and paying all property taxes.
    a. Eminent domain
    b. Inheritance
    c. Adverse possession
    d. Probate

Quiz 9 – Chapters 44-48

1. The illegal sale of a controlled substance is considered a(n):
   a. nuisance per se.
   b. trespass.
   c. unlawful detainer.
   d. encroachment.

2. A ________ is a nuisance which affects an entire segment of the population.
   a. private nuisance
   b. continuing nuisance per se
   c. public nuisance
   d. temporary nuisance

3. A(n) ____________ exists when the nuisance cannot be abated at a reasonable cost and by reasonable means.
   a. permanent nuisance
   b. easement by necessity
   c. continuing nuisance
   d. unlawful detainer

4. Under the ___________, owners of adjacent properties uncertain over the true boundary agree to establish the location of their common lot line and acquiesce to the boundary line for at least five years.
   a. agreed-boundary doctrine
   b. statute of limitations
   c. doctrine of estoppel
   d. balancing hardships doctrine

5. The individual conveying real estate is called the ________ and the individual acquiring title is called the ________.
   a. grantee; grantor
   b. grantor; beneficiary
   c. grantor; grantee
   d. trustee; beneficiary

6. At the time of signing the deed, a capable grantor needs to:
   a. possess their civil rights.
   b. be of sound mind.
   c. be an adult at least 18 years of age.
   d. All of the above.

7. A(n) __________ is used to pass a fee simple interest in real estate from the grantor to another individual, unless a lesser interest is stated in the deed.
   a. quitclaim deed
   b. grant deed
   c. warranty deed
   d. bill of sale

8. To simply convey any interest in real estate without an assurance the individual holds that interest conveyed, a(n) __________ deed is used.
   a. grant deed
   b. abstract of title
   c. quitclaim deed
   d. implied covenant

9. For delivery of a deed to occur, the grantor needs to _______ and the grantee needs to __________.
   a. place the deed in the mail; plan to accept the deed on certain conditions
   b. physically hand the deed to the grantee; record the deed with the county
   c. intend to convey title; accept the deed as immediately effective
   d. intend to convey partial title; record the deed with the county

10. A(n) ________ is valid and enforceable after delivery until it is challenged due to a defect and declared invalid by court order.
    a. voidable deed
    b. void deed
    c. void ab initio deed
    d. implied deed

Quiz 10 – Chapters 49-54

1. All property acquired jointly by a married couple during the marriage, no matter how vested, is presumed to be:
   a. community property.
   b. separate property.
   c. public property.
   d. joint property.

2. A(n) _______________ vesting is characterized by an ownership interest in property concurrently received by two or more individuals who share equally and have the right of survivorship.
   a. tenancy in common
   b. joint tenancy
   c. community property
   d. community property with right of survivorship

3. Lis pendens means:
   a. Notice of Pending Action.
   b. Notice of Prior Litigation.
   c. Notice of Nonresponsibility.
   d. Notice of Expungement.

4. To properly record a lis pendens, the lis pendens is required to identify the parties to the lawsuit and:
   a. provide reasonable compensation for the real estate.
   b. post a notice of the pending legal action on the property.
   c. give an adequate description of the real estate.
   d. be published in a newspaper in general circulation in the city where the property is located.

5. A(n) _________ is a written statement which presents an accurate, factual representation of title to the property being acquired, encumbered or leased.
   a. preliminary title report
   b. property profile
   c. abstract of title
   d. balance sheet

6. The ______________ insures against all encumbrances affecting title which can be discovered by a search of public records prior to issuance of the policy, but does not cover against unrecorded encumbrances.
   a. California Land Title Association (CLTA) standard policy
   b. American Land Title Association (ALTA) policy
   c. property profile
   d. homestead exemption

7. A(n) ________ is the dollar amount of the equity in a homeowner's dwelling that the homeowner qualifies to hold which has priority on title over most judgment liens and some government liens.
   a. overriding lien
   b. homestead
   c. interest deduction
   d. negative equity

8. The submission of a(n) _____________ to a private or institutional lender is the catalyst which sets the machinery of the mortgage industry in motion.
   a. Letter of Intent (LOI)
   b. appraisal report
   c. Option to Purchase
   d. mortgage application

9. A(n) ____________ is an estimate of the buyer's settlement charges and mortgage terms delivered to the buyer within three business days following the lender's receipt of the mortgage application.
   a. Good Faith Estimate (GFE)
   b. Loan Estimate
   c. HUD-1 or HUD-1A Closing Statement
   d. Uniform Residential Loan Application

10. The __________ program assists qualified veterans or their surviving spouses to buy a home with a zero down payment.
    a. California Housing Finance Agency (CalHFA)
    b. California Department of Veterans Affairs (CalVet)
    c. U.S. Department of Veterans Affairs (VA) mortgage guarantee
    d. Federal Housing Administration (FHA)-insured mortgage

Quiz 11 – Chapters 55-61

1. A buyer's ________ is their ability to make mortgage payments, as evaluated by their debt-to-income (DTI) ratio.
    a. balance sheet
    b. mortgage capacity
    c. loan-to-value ratio (LTV)
    d. yield spread premium (YSP)
2. The ________ insures mortgages with high loan-to-value ratios (LTV) that are made with less demanding cash down payment requirements than loans originated by conventional lenders.
    a. Truth-in-Lending Act
    b. Keep Your Home California program
    c. MGIC Investment Corp.
    d. Federal Housing Administration (FHA)
3. A __________ occurs when a seller carries back a note executed by the buyer to evidence a debt owed for the purchase of the seller's property.
    a. short sale
    b. mortgage cramdown
    c. seller financing arrangement
    d. loan assumption
4. The tax impact a carryback seller will receive on their carryback financing is ________ category income, regardless of whether the property sold was in another income category.
    a. portfolio
    b. passive
    c. earned
    d. deductible
5. The amount of interest a private, non-exempt lender can charge is regulated by statute and the California Constitution, collectively called:
    a. usury laws.
    b. Fair Housing Laws.
    c. private mortgage insurance (PMI).
    d. loan sharking.
6. The most common penalty suffered by a non-exempt private lender in violation of usury laws is:
    a. a five year jail sentence.
    b. the forfeiture of all interest paid on the loan.
    c. the forfeiture of all principal remaining due.
    d. a $100,000 fine.
7. Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios higher than 80% is referred to as:
    a. the loan-to-value ratio (LTV).
    b. homeowners' insurance.
    c. private mortgage insurance (PMI).
    d. American Land Title Association (ALTA) insurance.
8. A note calling for the entire amount of its principal to be paid together with accrued interest in a single lump sum when the principal is due is called a(n):
    a. straight note.
    b. installment note.
    c. interest-extra note.
    d. interest-included note.

9. ________ call for periodic adjustments to the interest rate and the amount of scheduled payments.
    a. All-inclusive trust deeds (AITDs)
    b. Adjustable rate mortgages (ARMs)
    c. Fixed-rate mortgages
    d. shared appreciation mortgages (SAMs)

10. A mortgage providing for installment payments to be periodically increased by predetermined amounts to accelerate the payoff of principal is known as a(n):
    a. shared appreciation mortgage (SAM).
    b. graduated payment mortgage (GPM).
    c. adjustable rate mortgage (ARM).
    d. all-inclusive trust deed (AITD).

Quiz 12 – Chapters 62-67

1. A(n) ___________ imposes an additional charge if a mortgage payment is not received by the lender when due or within a grace period.
    a. due-on clause
    b. final/balloon payment provision
    c. late charge provision
    d. acceleration clause

2. ____________ is the minimum grace period allowed for a private lender secured by an owner-occupied single family residence (SFR), even if the homeowner agrees to a shorter grace period, or no grace period is agreed to.
    a. Two days
    b. Five days
    c. Ten days
    d. One month

3. An owner of real estate who wants to pay off principal on a debt before it is due may be levied an additional charge by the lender, called a(n):
    a. grace period.
    b. balloon payment.
    c. prepayment penalty.
    d. late fee.

4. A(n) ________ is any final payment on a note which is an amount greater than twice the amount of any one of the six regularly scheduled preceding payments.
    a. late charge
    b. balloon payment
    c. usury limit
    d. prepayment penalty

5. Notice of a final/balloon payment needs to be given to the buyer or current owner ________ before its due date.
    a. 30 days
    b. 60 days
    c. 70 days
    d. 90 days

6. The ________ is the preferential method used to impose a lien on real estate.
    a. promissory note
    b. trust deed
    c. due-on clause
    d. Notice of Nonresponsibility

7. The __________, such as a lender or carryback seller, is the entity entitled to the performance of the promised activity referenced in the trust deed as the purpose for obtaining the security.
    a. trustee
    b. trustor
    c. beneficiary
    d. executor

8. When the lender enters into an agreement with both the buyer and seller for the buyer's assumption of the loan and a release of the seller's liability, this is known as a:
    a. substitution of security.
    b. novation.
    c. equitable subordination.
    d. subject-to transaction.

9. The occurrence of an event which triggers due-on enforcement automatically allows the lender to call the loan, also known as:
   a. waiver by consent.
   b. acceleration.
   c. recasting.
   d. subordination.

10. The due-on clause is triggered not only by a transfer using a standard grant deed, but by a lease with a term over:
    a. six months.
    b. one year.
    c. two years.
    d. three years.

Quiz 13 – Chapters 68-72

1. The __________ contained in a trust deed authorizes the trustee to initiate a non-judicial foreclosure sale of the property on a declaration of default and instructions to foreclose from the beneficiary.
   a. liquidated damages clause
   b. arbitration clause
   c. indemnification provision
   d. power-of-sale provision

2. Prior to completion of the trustee's sale, an owner may ________ by paying all sums due under the note and trust deed and reimbursing the lender's costs of foreclosure.
   a. redeem property in foreclosure
   b. subordinate the lender's interest
   c. initiate foreclosure
   d. hypothecate the note

3. Before recording a Notice of Default (NOD) on a trust deed securing a purchase-assist mortgage on a borrower's principal residence, a mortgage holder needs to:
   a. contact the county sheriff to notify them of the imminent sale.
   b. offer to modify the terms of the mortgage or temporarily suspend collection of mortgage payments.
   c. record and post a Notice of Trustee's Sale (NOTS).
   d. conduct a pre-foreclosure workout with the owner.

4. Within ________ after recording a Notice of Default (NOD), the trustee sends a copy of the NOD by registered or certified mail to holders of a recorded interest in the secured property.
   a. one week
   b. one month
   c. one year
   d. two years

5. At least ________the date selected by a trustee to hold a trustee's sale, the trustee sends two copies of the Notice of Trustee's Sale (NOTS) to each party the trustee previously sent a Notice of Default (NOD).
   a. 20 calendar days before
   b. 6 business days before
   c. three months before
   d. 30 calendar days before

6. A trustee's sale is considered final and complete:
   a. when a beneficiary makes a bid.
   b. when the trustee records a Notice of Default (NOD).
   c. on the trustee's acceptance of the last and highest bid.
   d. when the lender signs the certificate of sale.

7. A(n) _________ is the court-ordered sale by public auction of a secured property, lasting from eight months to multiple years before it is completed.
   a. judicial foreclosure
   b. nonjudicial foreclosure
   c. trustee's sale
   d. power-of-sale foreclosure

8. A(n) ________ is issued to the successful bidder on the completion of a judicial sale.
   a. certificate of sale
   b. Notice of Trustee's Sale (NOTS)
   c. fair value hearing certificate
   d. Advance Fee Disclosure

9. The ______________ is 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.
   a. alternative minimum tax (AMT)
   b. mortgage interest deduction (MID)
   c. mortgage cramdown
   d. short sale proceeds

10. A ______________ is an individual's home where the homeowner's immediate family resides a majority of the year, is close to the homeowner's place of employment and banks which handle the homeowner's accounts.
    a. recreational vehicle
    b. second home
    c. vacation property
    d. principal residence

Quiz 14 – Chapters 73-78

1. Tenant negotiations that can be performed by unlicensed agents who have been retained to manage an apartment building include:
   a. rental or lease negotiations.
   b. landlord-related solicitations.
   c. accepting rents and security deposits.
   d. entering into property management agreements with the landlord.

2. Apartment complexes with _________ need to have a resident manager.
   a. 12 or less units
   b. a community pool
   c. 16 or more units
   d. an on-site fitness facility

3. The intangible image or opinion held about a property which affects its earning power is known as:
   a. goodwill.
   b. business operations.
   c. opportunity costs.
   d. conflicts of interest.

4. A(n) __________ runs for an indefinite period of time since it automatically renews monthly, and on the same terms, until modified or terminated by notice.
   a. fixed-term lease
   b. month-to-month rental agreement
   c. tenancy-at-sufferance
   d. triple net lease

5. To avoid disputes over who is responsible for any damage to the premises, the residential landlord and tenant complete and sign a(n) __________ before the tenant is given possession.
   a. Notice of Nonresponsibility
   b. open listing
   c. right of first refusal
   d. condition of premises addendum

6. A lease agreement conveying a term of occupancy exceeding __________ needs to be written to be enforceable, a requirement of the statute of frauds.
   a. 90 days
   b. 120 days
   c. six months
   d. one year

7. A(n) _________ provision in a lease assures application of California law when a dispute arises between a tenant and landlord.
   a. choice-of-law
   b. hold harmless
   c. subtenancy
   d. attorney fee provision

8. A landlord under a month-to-month rental agreement can increase the rent or shift repair and maintenance obligations to the tenant by serving a(n):
   a. unlawful detainer (UD) action.
   b. 60-Day Notice to Pay Rent or Quit.
   c. 30-Day Notice of Change in Rental Terms.
   d. 30-Day Notice to Vacate.

9. A ________ provides a source of recovery for money losses incurred by the landlord due to a tenant default on monetary obligations agreed to in the rental or lease agreement.
   a. tenant screening fee
   b. security deposit
   c. Real Estate Recovery Fund
   d. savings account

10. If no repairs are made to a rented unit, the residential landlord needs to refund the security deposit, less reasonable deductions, within _____ days after a tenant vacates.
    a. 7
    b. 10
    c. 21
    d. 30

Quiz 15 – Chapters 79-85

1. A tenant who commits a(n) __________ is served with a Three-Day Notice to Quit.
   a. minor breach
   b. incurable breach
   c. monetary breach
   d. statutory breach

2. A(n) __________ is a set time period following the due date during which rent may be paid without incurring a late charge.
   a. grace period
   b. prepayment period
   c. pre-termination inspection period
   d. delinquent period

3. The Three-Day Notice to Perform or Quit requires the tenant to vacate the premises or:
   a. perform under the breached lease provision.
   b. correct the incurable breach.
   c. forfeit possession of the property and all furnishings.
   d. subordinate their interest in the property.

4. Waste occurs when a tenant:
   a. vacates and quits the premises.
   b. neglects the premises and impairs its value by failing to maintain it as agreed.
   c. subleases the premises to a subtenant without the landlord's consent.
   d. allows greater than five guests to stay in the premises overnight.

5. When a tenant has resided in a residential property for one year or more, the landlord terminates the tenancy by giving the tenant a:
   a. 30-day Notice to Vacate.
   b. 60-day Notice to Vacate.
   c. 90-day Notice to Vacate.
   d. 120-day Notice to Vacate.

6. An owner-by-foreclosure who purchases a residential property at a trustee's sale for investment purposes may only terminate an existing residential tenancy by serving the tenant with a:
   a. 30-day Notice to Vacate.
   b. 60-day Notice to Vacate.
   c. 90-day Notice to Vacate.
   d. 120-day Notice to Vacate.

7. A landlord breaches the __________ when they fail to comply with building and housing code standards that materially affect health and safety.
   a. implied warranty of habitability
   b. unspoken gentlemen's agreement
   c. implied agency duty of care
   d. statute of frauds

8. Construction of residential and commercial buildings is primarily regulated by the state of California through:
   a. conditions, covenants and restrictions (CC&Rs).
   b. building codes.
   c. the Department of Real Estate (DRE).
   d. the Department of Motor Vehicles (DMV).

9. The placement of a building upon the lot is referred to as its:
   a. preference.
   b. zoning classification.
   c. orientation.
   d. location.

10. The __________ establishes the conditions for approval of a subdivision map, and provides the planning commission the authority to regulate the design and physical improvements to be installed in a common interest development (CID).
   a. Subdivided Lands Act
   b. Subdivision Map Act
   c. local surveyor
   d. general contractor

Answer References

The following are the answers to the quizzes for *Real Estate Principles, Second Edition* and the page numbers where they are located.

Quiz 1

1.	**C**	1
2.	**A**	2
3.	**D**	3
4.	**C**	9
5.	**A**	16
6.	**A**	17
7.	**C**	22
8.	**C**	24
9.	**D**	30
10.	**B**	31

Quiz 2

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3.	**A**	43
4.	**B**	45
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6.	**A**	51
7.	**D**	54
8.	**A**	54
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Quiz 3

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3.	**D**	67
4.	**A**	70
5.	**C**	73
6.	**A**	75
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8.	**B**	77
9.	**B**	81
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Quiz 4

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4.	**A**	99
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7.	**A**	113
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9.	**C**	120
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Quiz 5

1.	**A**	126
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7.	**B**	142
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7.	**A**	245
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Quiz 8

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4.	**A**	276
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6.	**D**	277
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Quiz 9

1.	**A**	292
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3.	**A**	294
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5.	**C**	302
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1.	**A**	324
2.	**B**	325
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4.	**C**	335
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6.	**A**	345
7.	**B**	353
8.	**D**	359
9.	**B**	361
10.	**C**	362

Quiz 11

1.	**B**	370
2.	**D**	376
3.	**C**	384
4.	**A**	385
5.	**A**	389
6.	**B**	392
7.	**C**	397
8.	**A**	402
9.	**B**	404
10.	**B**	405

Quiz 12

1.	**C**	409
2.	**C**	412
3.	**C**	415
4.	**B**	419
5.	**D**	420
6.	**B**	424
7.	**C**	427
8.	**B**	432
9.	**B**	435
10.	**D**	436

Quiz 13

1.	**D**	441
2.	**A**	444
3.	**D**	451
4.	**B**	454
5.	**A**	455
6.	**C**	456
7.	**A**	460
8.	**A**	463
9.	**B**	472
10.	**D**	475

Quiz 14

1.	**C**	481
2.	**C**	481
3.	**A**	489
4.	**B**	493
5.	**D**	496
6.	**D**	502
7.	**A**	508
8.	**C**	511
9.	**B**	515
10.	**C**	519

Quiz 15

1.	**B**	526
2.	**A**	529
3.	**A**	532
4.	**B**	537
5.	**B**	539
6.	**C**	543
7.	**A**	545
8.	**B**	555
9.	**C**	558
10.	**B**	564