Real Estate Matters

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Chapter 1

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
material fact
preliminary title report (prelim)
title conditions
Transfer Disclosure Statement (TDS)

General duty to voluntarily disclose

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

fiduciary duty
The licensee's obligation as an agent to act with the utmost good faith and diligence for the benefit of the principal who employs them.

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

general duty
The duty a licensee owes to non-client individuals to act honestly and in good faith with upfront disclosures of known conditions which adversely affect a property's value.

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. Thus, the seller's agent is severely limited in their ability to engage in any conduct or means at hand to exploit the prospective buyer's lack of knowledge about the condition of the property by use of these disclosures.

The seller's agent may not:

- deliver 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 inquires about the property in a vigorous pursuit of the best financial advantage possible for the seller (or the seller's broker).

Gathering facts on adverse features

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 Figure 1, **RPI** Form 304];[1]
- assuring **seller compliance** with the **seller's duty** to deliver statements to prospective buyers as soon as possible, namely, the upfront disclosure in marketing documents of routine facts

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.

1 Calif. Civil Code §2079

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

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

material fact
Information which would likely affect the price and terms a buyer is willing to pay for a property.

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

title conditions
Encumbrances such as liens, conditions, covenants and restrictions (CC&Rs) and easements which affect title to property.

preliminary title report (prelim)
A report furnished by a title insurer constituting an offer to issue title insurance based on property vestings and itemized encumbrances presented in the report.

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

- the **suitability of the property** based on the facts disclosed to actually meet the buyer's objectives in the acquisition, be they financial, legal, possessory, etc.; and
- information or data on any **mixed use** of the property, such as acreage included in the purchase for use as subdividable lands, groves or other farming operations, or for use for tenant income or as a vacation rental.

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

Respond fully and fairly

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

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

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.

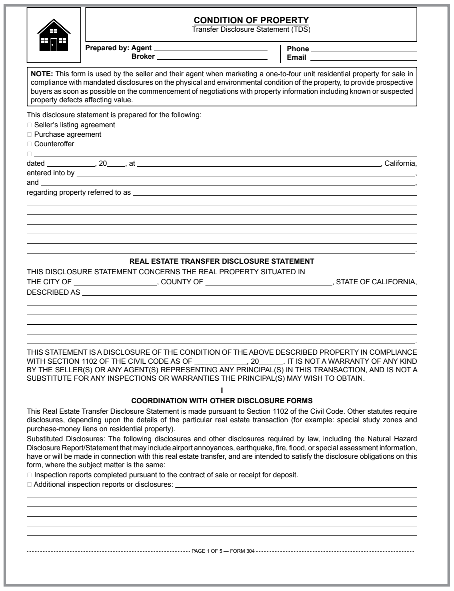
Further, the seller's agent needs to:

- 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.

Form 304

Condition of Property

Pages 1-3



CONDITION OF PROPERTY
Transfer Disclosure Statement (TDS)

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

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

This disclosure statement is prepared for the following:
☐ Seller's listing agreement
☐ Purchase agreement
☐ Counteroffer
☐ ______________
dated __________, 20____, at ______________, California,
entered into by ______________,
and ______________,
regarding property referred to as ______________.

REAL ESTATE TRANSFER DISCLOSURE STATEMENT

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

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

I

COORDINATION WITH OTHER DISCLOSURE FORMS

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

Substituted Disclosures: The following disclosures and other disclosures required by law, including the Natural Hazard Disclosure Report/Statement that may include airport annoyances, earthquake, fire, flood, or special assessment information, have or will be made in connection with this real estate transfer, and are intended to satisfy the disclosure obligations on this form, where the subject matter is the same:
☐ Inspection reports completed pursuant to the contract of sale or receipt for deposit.
☐ Additional inspection reports or disclosures: ______________

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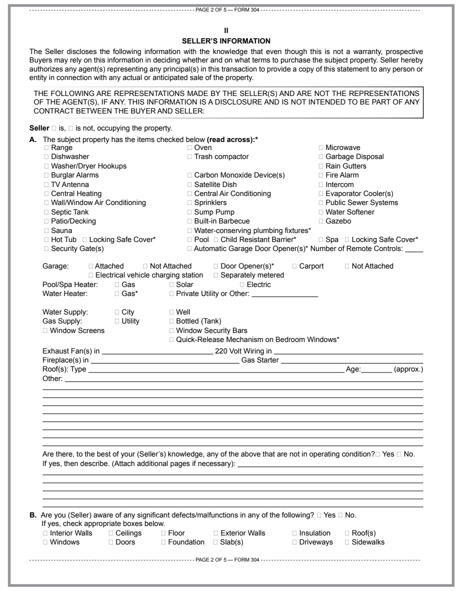

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II

SELLER'S INFORMATION

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

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

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

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

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

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

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

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

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

B. Are you (Seller) aware of any significant defects/malfunctions in any of the following? ☐ Yes ☐ No.
If yes, check appropriate boxes below.
☐ Interior Walls ☐ Ceilings ☐ Floor ☐ Exterior Walls ☐ Insulation ☐ Roof(s)
☐ Windows ☐ Doors ☐ Foundation ☐ Slab(s) ☐ Driveways ☐ Sidewalks

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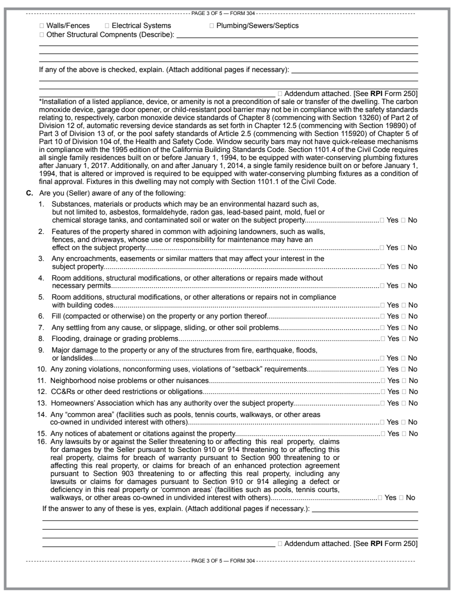

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☐ Walls/Fences ☐ Electrical Systems ☐ Plumbing/Sewers/Septics
☐ Other Structural Compnents (Describe): ______________

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

☐ Addendum attached. [See **RPI** Form 250]

*Installation of a listed appliance, device, or amenity is not a precondition of sale or transfer of the dwelling. The carbon monoxide device, garage door opener, or child-resistant pool barrier may not be in compliance with the safety standards relating to, respectively, carbon monoxide device standards of Chapter 8 (commencing with Section 13260) of Part 2 of Division 12 of, automatic reversing device standards as set forth in Chapter 12.5 (commencing with Section 19890) of Part 3 of Division 13 of, or the pool safety standards of Article 2.5 (commencing with Section 115920) of Chapter 5 of Part 10 of Division 104 of, the Health and Safety Code. Window security bars may not have quick-release mechanisms in compliance with the 1995 edition of the California Building Standards Code. Section 1101.4 of the Civil Code requires all single family residences built on or before January 1, 1994, to be equipped with water-conserving plumbing fixtures after January 1, 2017. Additionally, on and after January 1, 2014, a single family residence built on or before January 1, 1994, that is altered or improved is required to be equipped with water-conserving plumbing fixtures as a condition of final approval. Fixtures in this dwelling may not comply with Section 1101.1 of the Civil Code.

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

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

☐ Addendum attached. [See **RPI** Form 250]

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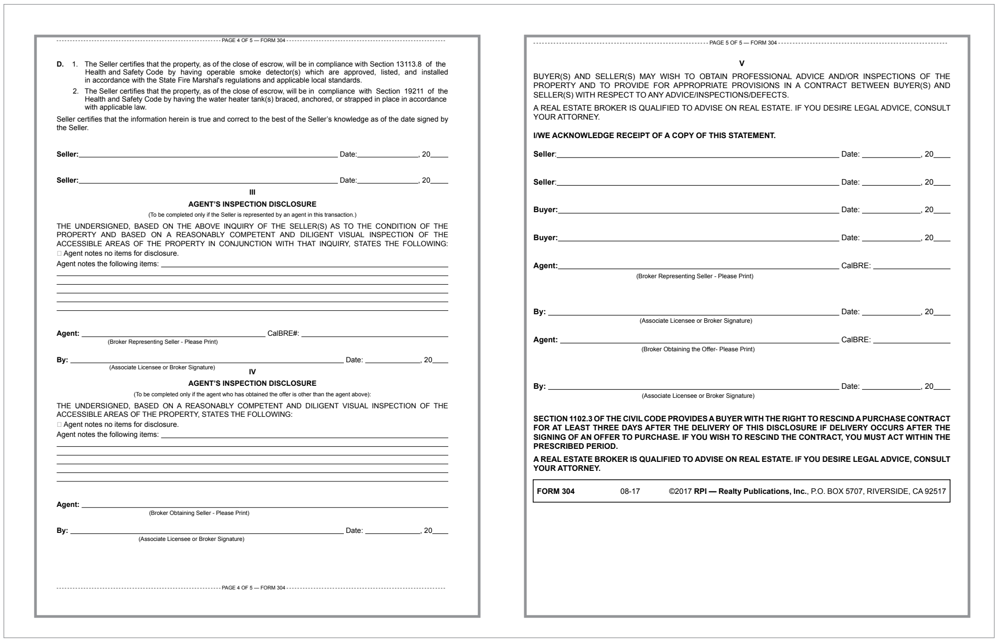
The buyer's inquiry is entitled to a response based on the seller's agent's working knowledge of the underlying facts or identification of the source of the information given. If the seller's agent lacks sufficient knowledge to comment, they are duty-bound to say so.

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.



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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)

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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	08-17	©2017 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Form 304

Condition of Property

Pages 4-5

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).[2]

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.[3]

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;

2 CC §§2079 et seq.

3 CC §2079.3

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

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 1 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 1 Key Terms

Chapter 2

Human resources: (be)low-level management by brokers

Learning Objectives

After reading this chapter, you will be able to:

- recognize the natural equilibrium of approximately 1.5 active agents for every active broker in a stable market;
- track agent and broker licensing and renewal trends though oscillations in the market cycle;
- anticipate the effect a return to core economic principles and real estate fundamentals will have on broker and agent licensing; and
- implement strategies to operate a successful brokerage office and keep claims from clients and others under control.

Key Terms

risk reduction program **turnover rate**
sticky pricing

The entry and exit of agents

In a stable market, a *natural equilibrium* develops between active real estate agents and brokers. This ratio has historically found balance at approximately 1.5 active agents for every active broker. [See Figure 1]

After a protracted period of inflated agent population, the ratio began its downward trajectory towards historic norms bottoming at 1.6 in mid-2014. However, due to rising home prices, the ratio increased to an average of 2.2 active agents for every active broker in 2020.

As real estate entered its boom phase of the market cycle in the mid-2000s, new agents arrived en masse with the optimistic belief that extra money was to be had working real estate. In 2006, following the peak of the boom, there were a total of 2.6 active agents for every active broker. The high number of agents accompanied an inflated market, with unsustainable prices and little sense fundamentally.

Keep in mind that the active licensee totals in Figure 1 understate the real depth of the problem, as many licensees remained technically "inactive." They presented themselves as licensees to **speculate** in property as principals or negotiate purchases for family members, all without being employed by a broker.

Agents speculate on the market

In October 2006, for instance, there were 261,683 active agents, but a total of 376,561 Californians held agent licenses. Compare this to the more stable period of January 2000, when there were 122,260 active agents and 196,524 total agent licensees. Rather than just providing brokerage services to other individuals, the superfluous agents—active and inactive — bought and flipped properties. They speculated in the market while operating as insiders pulling (or saving) a fee when they, their family members and their friends decided to buy the property they located.

Even now, as we anticipate a return to core economic principles (supply for sale vs. demand by actual user-occupants rather than speculators) and real estate fundamentals (price-to-rent and mortgage-to-income ratios) in the residential and commercial markets, Figure 1 shows the licensee population has surpassed the standard 1.5:1 agent-to-broker ratio. Expect discouraged agents to slowly drop out of the active population as sales volume continues to slump going into 2022. The number of brokers will begin to stabilize in the years following the recovery from the 2020 recession.

Licensing in the economic recovery

Will this ratio last after the trough in licensee population?

Not likely. The boost in home prices experienced in the end of 2012 through 2014 caused increased optimism among the agent population. The perception of a healthy real estate market due to price increases has lured more individuals seeking career opportunities to become real estate agents. Sales agent and broker licensing jumped in Q1 2013 and remained at their highest levels since the housing crisis fallout in 2008.

Insufficient **lender regulation** to protect public institutions and society from harm creates a mentality that will eventually lead to another destructive real estate boom. When this happens, possibly in the years following the next economic recession, agents will begin to rapidly multiply once again, and standards will diminish.

It will be up to **California's Department of Real Estate (DRE)** to protect society from adverse licensee conduct. To do so, they will need to tighten up the agent licensing exam to control a too-permissive passing rate. This move will limit new agents to the most qualified, dedicated and committed.

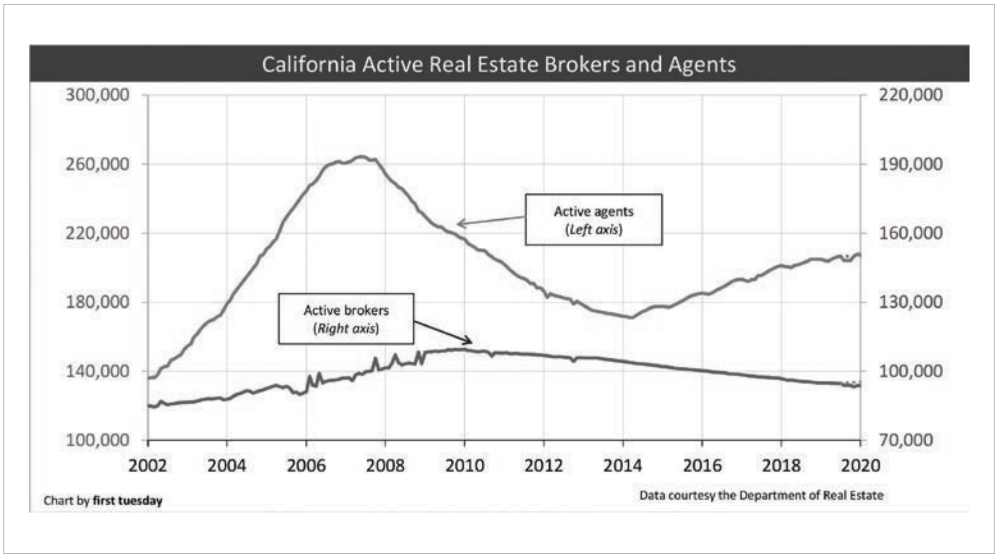


Figure 1

California Active Real Estate Brokers and Agents

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.

Whether the *DRE* will be politically able to do this in the face of opposition from big brokerage offices is doubtful. Large brokerage operations require a constant high number of agents-for-hire to blanket the market when momentum takes hold.

California demographics point to this return of "excitement" in the field of real estate following the recovery from the 2020 recession. The rate of buyer-occupant homeownership has dropped from 60% in 2005 to 56% in 2020. Thus, fewer brokers and agents will be needed to service the purchase and sale of homes.

As mortgage rates return to their steady long-term rising trend, downward pressure will be put on home prices. This will work well for brokers and agents representing investors interested in acquiring income property. But slipping housing prices are unlikely to attract more buyer-occupant homeowners unless growth in the job market returns to the pace in the mid-1990s of 350,000 to 400,000 annually in California.

Agent and broker population, past and future

In early 2008, 7% (1 in 14) of all single family residences (SFRs) in California stood vacant, owned by:

- speculators;
- buyers of second homes (which were acquired in large part due to speculative fervor); or
- lenders (in the case of real estate owned property (REOs)).

With the current batch of licensee entrants embracing more sustainable, long-term real estate strategies, the "quick-buck" real estate agents are continuing to exit the stage.

No longer do we see the sort of high competition between agents that helped push up prices from 2003-2005. The return of lending fundamentals, pushing higher down payments will set a slower pace in the real estate market than has been experienced at any time during the last decade. If it weren't for the cash-heavy speculator interference experienced in 2013, California property prices would have remained at their 2012 levels without a bounce well into 2015.

Purchasing trends between 2013 and 2014 reflected the intermittent influxes of excited purchasers who are experienced neither as investors nor homebuyers. These buyers who are speculators are most frequently nothing more than gamblers placing bets on houses without the patience or intent to do anything but wait for the market to increase the price so they can cash out on their "investment."

Industry behavior

turnover rate
The rate at which a broker loses and replaces agents.

Large SFR brokerage operations with branch offices have always depended on a constant flood of newly-licensed agents to fill their cubbies. This practice was enabled in the past by a high agent **turnover rate**, as freshly-minted agents burned through their family members and social contacts without developing a viable client base. [See Figure 2]

Brokers and office managers were able to mitigate the eventual loss of sales production from client-exhausted agents by aggressively soliciting new licensees to bring in as replacements.

These "list-and-run" type agents have disappeared from the ranks of new agents, as the total number of new agents has dropped dramatically. During the peak years of 2004-2007, 5,000 new agents were licensed monthly. Since October 2007, the number of new sales agents has remained steady with a slight general decline, from 1,100 monthly at that time to about 1,000 monthly through 2012. Then, licensing spiked in the first half of 2013 (due primarily to excitement caused by the price movement resulting from the speculator frenzy).

Economic reality

When viewed in the context of disappearing short-term agents, rather than vanishing homebuyers (the rate of homeownership statewide continues to trend down from its 2006 peak), it appears that **economic reality** is forcing employing brokers to:

- shutter their least productive branch offices;
- release the weakest office managers and under-performing agents;
- attempt to locate agents who generate business;
- upgrade office locations and cut rent expense by taking advantage of office vacancies and ever lower rent;

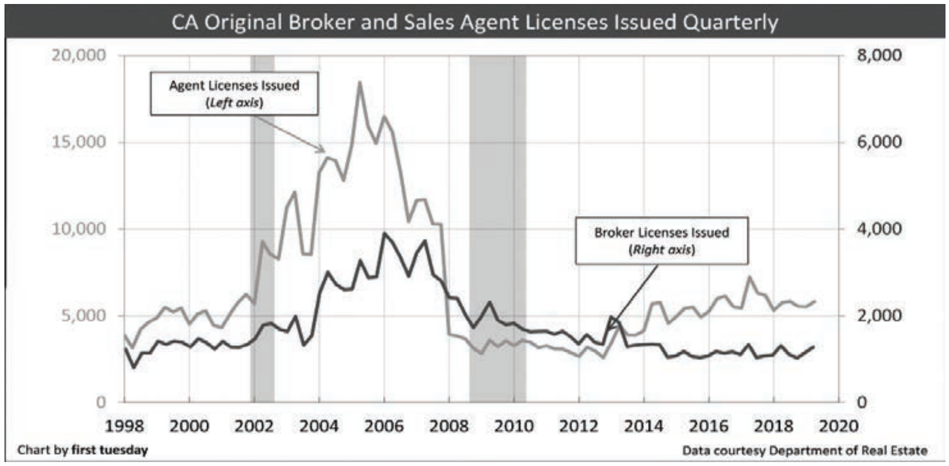


Figure 2

CA Original Broker and Sales Agent Licenses Issues Quarterly

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.

- develop new profit centers with office divisions for escrow, finance, homeowner/tenant insurance, property management, syndication and other brokerage services; and
- require agents to "get back on the street" and gather property information and smoke out the deals to generate leads and sales.

Even more troubling for large brokerage operations is the bickering arising over brokers' **fee-splitting arrangements** with their agents. Agents are now making roughly half as many sales, at prices nearing 2005 levels.

In the meantime, employing brokers take in fewer dollars and shoulder the costs of overhead, promotion, often servicing unmarketable listings at great cost. Gradually, the younger and more aggressive agents employed by large brokerage offices will look to become brokers or team up with brokers and other agents relocating into smaller operations. Others with a long-term client base will join *"rent-a-desk"* operations in order to reduce the fee percentage taken by the broker.

Survival and success

Agents jumping out on their own too often do not have the business acumen to set up and operate a broker office, even if it is their own one-man operation. They attempt to do so under the belief, right or wrong, that their current broker is getting too large a share of the fees.

Sellers who continue to demand unreasonable prices (the **sticky price** phenomenon), or who involve themselves in other conduct which keeps the property from selling within a 30- to 60-day marketing period, need to have their listings cancelled and returned. All this conduct suggests that fewer agents are needed by brokerage offices to effectively service the needs of the public.

sticky pricing
A seller's irrational reliance on past home pricing as a basis for setting current pricing.

Blasphemous talk? Not at all if an efficient brokerage operation is what it takes to get into the full recovery stage without going broke.

Brokers who advertise property that looks good from the curb, and who set listing prices appropriate to the property (prices which are likely to quickly generate offers at near the listed price) will get an offer within 30 days. Such conduct will provide for the survival and success of the rational seller, the broker and his agents. At times of speculative fervor, which are always short in duration, discussion of a stable office environment might seem like nonsense to those with a short-term outlook.

In a recovering market, time lost hurts everyone, a lesson inept policy makers – both state and federal – are beginning to learn from the totally ineffective and ongoing "extend-and-pretend" loan modification fiascos and 2009-2010 federal and state homebuyer subsidies.

Brokers who learned to cut overhead and eliminate operating inefficiencies while beefing up their staff of performing licensees prior to 2016 enjoyed the best position for 2021's up-tick in annual sales volume. Employing brokers operating successfully in 2022 will be defined by their ability to *plan ahead*. They will have to be visionaries if they are to get in on the action when the federal government and Wall Street return to easy lending standards in a time of newly lucrative home sales.

Looking ahead for smaller brokerages and others affected

In the near future, small brokerage offices with fewer than 16 agents will probably continue to recruit agents as they always have. Large brokerages typically use mail-blitzing campaigns and seminars to entice both seasoned MLS agents and newly licensed agents into their offices.

Conversely, smaller offices traditionally recruit from local *word-of-mouth* contacts. Brokers maintaining a single office with a staff of agents tend to have several different types of business clientele and need to focus on more than scope in the numbers game to drive the listing and marketing of SFR properties.

These smaller brokerage offices may well attract the more thoughtful entrants into real estate looking for the long-term advantages of being around others who work income property, land, and property management.

The boom during the mid-2000s saw five times as many individuals enrolled in **licensing courses** as compared to the late '90s. That licensing education revenue is all but gone for the schools, reduced to 15-20% of its peak 2007 four-year run.

If that is not bad enough for real estate educators, the **license renewal rates** among brokers and sales agents (especially those hit-and-run agents who arrived during the past six years) dropped to unprecedented levels by 2011. Today's flattening renewal rates are directly related to the flat-to-down home sales experienced since 2016, which has slowed the flow of agent fees.

A substantial increase in sales agents will occur with the forecasted boom in real estate sales volume and prices. This boom, most likely to occur in the years following 2022, will see the Great Confluence of first-time homebuyers and cash-flush retiring Baby Boomers.

Many let their licenses expire, then wait to see if the real estate market picks up during their **two-year grace period** for late renewal. Some of them cite 2020's surging home prices as a reason to renew when they otherwise would not have done so. However, California's jobs market is a better reflection of its housing market than sales volume. Therefore, licensees need to look to the jobs recovery for a housing recovery.

The broker takes charge

To operate a successful brokerage office, the broker needs to employ **viable agents**.

It is the quantity and quality of agents that produce the end result sought by brokers to be successful, i.e., *broker fees.* As in all service businesses, the linchpin for achieving success is the ability of management to orchestrate the efforts of qualified agents.

However, most brokers employing agents tend not to dedicate sufficient energy to the supervision of their agents. A level of seemingly deliberate neglect prevails in most single family residential brokerage offices, consistent with the proverbial "dumb agent rule."

Thus, agents are left to learn the trade by observation or some third-party training, and to hone their skills by *trial and error*. This is an empirical result based more on the agents' good instincts than on training, procedural policy and constant supervision by the broker — all required by law.

Brokers need to be more than distant observers limited to providing remote oversight for the agents. They or their administrative assistants and managers need to learn to supervise and police the business-related conduct of their agents.

Policing of business-related conduct

Supervisory conduct by brokers and managers includes:

- setting the production goals to be attained (listings and sales);
- an analysis of the agent's income and expenses;
- the setting of fees needed for the agent to become financially viable as a real estate agent;
- establishing the personal routines and activities which will likely make the agent productive, i.e., overseeing the agent's management of time spent working for the broker; and
- the insistence that compliance reports be prepared and delivered periodically to management. [See **RPI** Forms 520 through 523-1; see Figure 3, **RPI** Form 521]

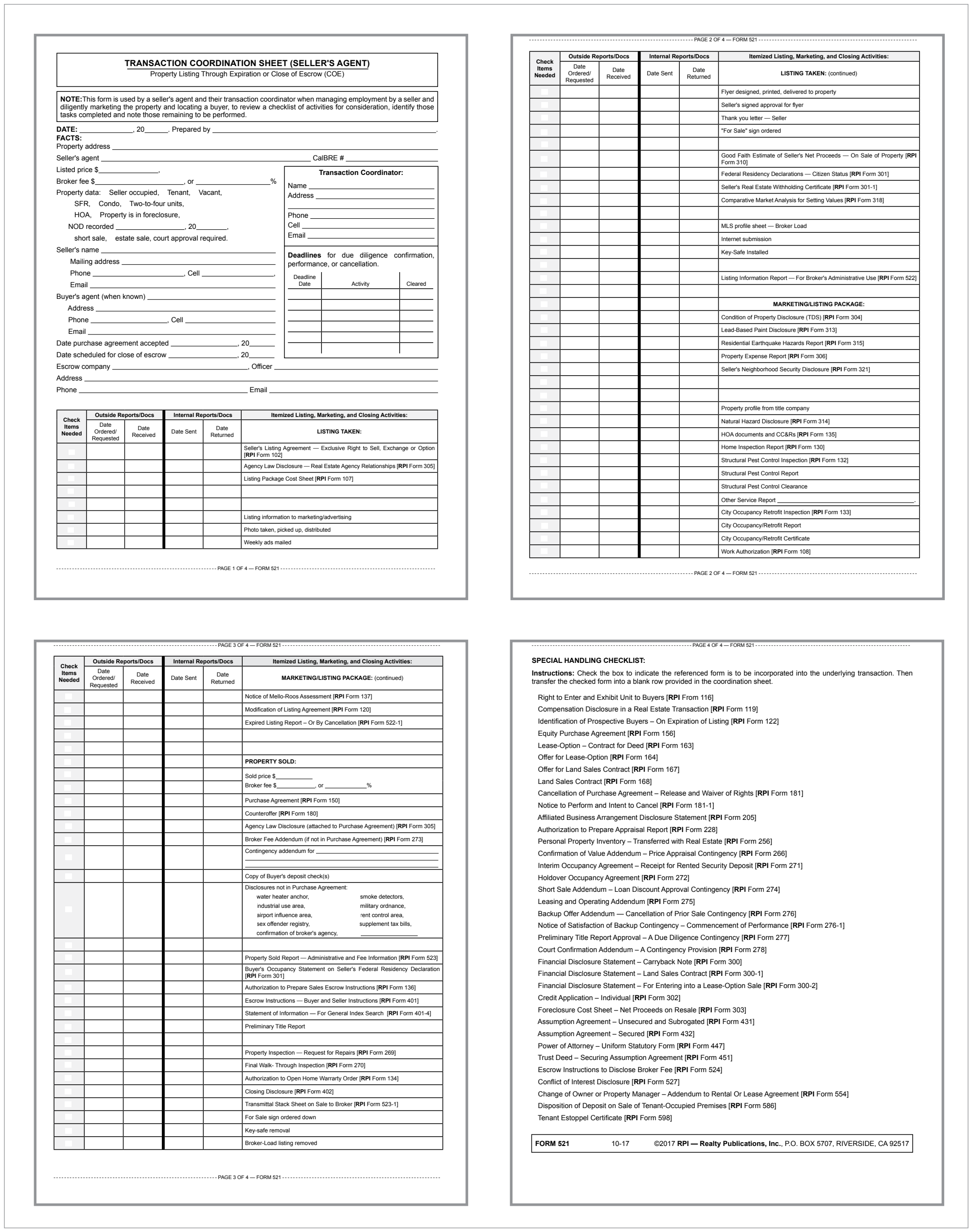
Further, the broker needs to be actively involved in the agent's fulfillment of the duties the broker owes to clients with whom the agent has contact.

Thus, the agent knows from the beginning just what level of production is expected by the broker as a requirement for remaining with the office. Also,

Figure 3

Form 521

Transaction Coordination Sheet (Seller's Agents)



TRANSACTION COORDINATION SHEET (SELLER'S AGENT)

Property Listing Through Expiration or Close of Escrow (COE)

NOTE: This form is used by a seller's agent and their transaction coordinator when managing employment by a seller and diligently marketing the property and locating a buyer, to review a checklist of activities for consideration, identify those tasks completed and note those remaining to be performed.

DATE: ____________, 20_____. Prepared by ______________________________.

FACTS:

Property address ______________________________

Seller's agent ______________________________ CalBRE # ____________

Listed price $______________,

Broker fee $______________, or ______________%

Property data: Seller occupied, Tenant, Vacant,
SFR, Condo, Two-to-four units,
HOA, Property is in foreclosure,
NOD recorded ______________, 20_______,
short sale, estate sale, court approval required.

Seller's name ______________________________

Mailing address ______________________________

Phone ______________, Cell ______________,

Email ______________________________

Buyer's agent (when known) ______________________________

Address ______________________________

Phone ______________, Cell ______________

Email ______________________________

Date purchase agreement accepted ______________, 20______

Date scheduled for close of escrow ______________, 20______

Escrow company ______________________, Officer ______________________

Address ______________________________

Phone ______________________ Email ______________________

Transaction Coordinator:

Name ______________________

Address ______________________

Phone ______________________

Cell ______________________

Email ______________________

Deadlines for due diligence confirmation, performance, or cancellation.

Deadline Date	Activity	Cleared

Check Items Needed	Outside Reports/Docs		Internal Reports/Docs		Itemized Listing, Marketing, and Closing Activities:
	Date Ordered/ Requested	Date Received	Date Sent	Date Returned	**LISTING TAKEN:**
					Seller's Listing Agreement — Exclusive Right to Sell, Exchange or Option [**RPI** Form 102]
					Agency Law Disclosure — Real Estate Agency Relationships [**RPI** Form 305]
					Listing Package Cost Sheet [**RPI** Form 107]
					Listing information to marketing/advertising
					Photo taken, picked up, distributed
					Weekly ads mailed

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Check Items Needed	Outside Reports/Docs		Internal Reports/Docs		Itemized Listing, Marketing, and Closing Activities:
	Date Ordered/ Requested	Date Received	Date Sent	Date Returned	**LISTING TAKEN:** (continued)
					Flyer designed, printed, delivered to property
					Seller's signed approval for flyer
					Thank you letter — Seller
					"For Sale" sign ordered
					Good Faith Estimate of Seller's Net Proceeds — On Sale of Property [**RPI** Form 310]
					Federal Residency Declarations — Citizen Status [**RPI** Form 301]
					Seller's Real Estate Withholding Certificate [**RPI** Form 301-1]
					Comparative Market Analysis for Setting Values [**RPI** Form 318]
					MLS profile sheet — Broker Load
					Internet submission
					Key-Safe Installed
					Listing Information Report — For Broker's Administrative Use [**RPI** Form 522]
					MARKETING/LISTING PACKAGE:
					Condition of Property Disclosure (TDS) [**RPI** Form 304]
					Lead-Based Paint Disclosure [**RPI** Form 313]
					Residential Earthquake Hazards Report [**RPI** Form 315]
					Property Expense Report [**RPI** Form 306]
					Seller's Neighborhood Security Disclosure [**RPI** Form 321]
					Property profile from title company
					Natural Hazard Disclosure [**RPI** Form 314]
					HOA documents and CC&Rs [**RPI** Form 135]
					Home Inspection Report [**RPI** Form 130]
					Structural Pest Control Inspection [**RPI** Form 132]
					Structural Pest Control Report
					Structural Pest Control Clearance
					Other Service Report ______________________.
					City Occupancy Retrofit Inspection [**RPI** Form 133]
					City Occupancy/Retrofit Report
					City Occupancy/Retrofit Certificate
					Work Authorization [**RPI** Form 108]

PAGE 2 OF 4 — FORM 521

PAGE 3 OF 4 — FORM 521

Check Items Needed	Outside Reports/Docs		Internal Reports/Docs		Itemized Listing, Marketing, and Closing Activities:
	Date Ordered/ Requested	Date Received	Date Sent	Date Returned	**MARKETING/LISTING PACKAGE:** (continued)
					Notice of Mello-Roos Assessment [**RPI** Form 137]
					Modification of Listing Agreement [**RPI** Form 120]
					Expired Listing Report – Or By Cancellation [**RPI** Form 522-1]
					PROPERTY SOLD:
					Sold price $__________
					Broker fee $__________, or __________%
					Purchase Agreement [**RPI** Form 150]
					Counteroffer [**RPI** Form 180]
					Agency Law Disclosure (attached to Purchase Agreement) [**RPI** Form 305]
					Broker Fee Addendum (if not in Purchase Agreement) [**RPI** Form 273]
					Contingency addendum for ______________________
					Copy of Buyer's deposit check(s)
					Disclosures not in Purchase Agreement: water heater anchor, smoke detectors, industrial use area, military ordnance, airport influence area, rent control area, sex offender registry, supplement tax bills, confirmation of broker's agency, ______________
					Property Sold Report — Administrative and Fee Information [**RPI** Form 523]
					Buyer's Occupancy Statement on Seller's Federal Residency Declaration [**RPI** Form 301]
					Authorization to Prepare Sales Escrow Instructions [**RPI** Form 136]
					Escrow Instructions — Buyer and Seller Instructions [**RPI** Form 401]
					Statement of Information — For General Index Search [**RPI** Form 401-4]
					Preliminary Title Report
					Property Inspection — Request for Repairs [**RPI** Form 269]
					Final Walk- Through Inspection [**RPI** Form 270]
					Authorization to Open Home Warrarty Order [**RPI** Form 134]
					Closing Disclosure [**RPI** Form 402]
					Transmittal Stack Sheet on Sale to Broker [**RPI** Form 523-1]
					For Sale sign ordered down
					Key-safe removal
					Broker-Load listing removed

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PAGE 4 OF 4 — FORM 521

SPECIAL HANDLING CHECKLIST:

Instructions: Check the box to indicate the referenced form is to be incorporated into the underlying transaction. Then transfer the checked form into a blank row provided in the coordination sheet.

Right to Enter and Exhibit Unit to Buyers [**RPI** From 116]
Compensation Disclosure in a Real Estate Transaction [**RPI** Form 119]
Identification of Prospective Buyers – On Expiration of Listing [**RPI** Form 122]
Equity Purchase Agreement [**RPI** Form 156]
Lease-Option – Contract for Deed [**RPI** Form 163]
Offer for Lease-Option [**RPI** Form 164]
Offer for Land Sales Contract [**RPI** Form 167]
Land Sales Contract [**RPI** Form 168]
Cancellation of Purchase Agreement – Release and Waiver of Rights [**RPI** Form 181]
Notice to Perform and Intent to Cancel [**RPI** Form 181-1]
Affiliated Business Arrangement Disclosure Statement [**RPI** Form 205]
Authorization to Prepare Appraisal Report [**RPI** Form 228]
Personal Property Inventory – Transferred with Real Estate [**RPI** Form 256]
Confirmation of Value Addendum – Price Appraisal Contingency [**RPI** Form 266]
Interim Occupancy Agreement – Receipt for Rented Security Deposit [**RPI** Form 271]
Holdover Occupancy Agreement [**RPI** Form 272]
Short Sale Addendum – Loan Discount Approval Contingency [**RPI** Form 274]
Leasing and Operating Addendum [**RPI** Form 275]
Backup Offer Addendum — Cancellation of Prior Sale Contingency [**RPI** Form 276]
Notice of Satisfaction of Backup Contingency – Commencement of Performance [**RPI** Form 276-1]
Preliminary Title Report Approval – A Due Diligence Contingency [**RPI** Form 277]
Court Confirmation Addendum – A Contingency Provision [**RPI** Form 278]
Financial Disclosure Statement – Carryback Note [**RPI** Form 300]
Financial Disclosure Statement – Land Sales Contract [**RPI** Form 300-1]
Financial Disclosure Statement – For Entering into a Lease-Option Sale [**RPI** Form 300-2]
Credit Application – Individual [**RPI** Form 302]
Foreclosure Cost Sheet – Net Proceeds on Resale [**RPI** Form 303]
Assumption Agreement – Unsecured and Subrogated [**RPI** Form 431]
Assumption Agreement – Secured [**RPI** Form 432]
Power of Attorney – Uniform Statutory Form [**RPI** Form 447]
Trust Deed – Securing Assumption Agreement [**RPI** Form 451]
Escrow Instructions to Disclose Broker Fee [**RPI** Form 524]
Conflict of Interest Disclosure [**RPI** Form 527]
Change of Owner or Property Manager – Addendum to Rental Or Lease Agreement [**RPI** Form 554]
Disposition of Deposit on Sale of Tenant-Occupied Premises [**RPI** Form 586]
Tenant Estoppel Certificate [**RPI** Form 598]

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the broker will be demonstrating their expectation that the sales agent is to maintain a competitive attitude about producing listings and buyers that do deals. Further, an environment will have been created with a greater probability of producing purchase agreements and closings, which spells success for all involved.

Tracking agent compliance with policy

Without an **administrative structure** to verify the broker's agents are conducting themselves as intended, the broker will be exposed to an unnecessary *risk of loss*. Thus, continued oversight and policing are put in place to limit unilateral changes, distortions and deviations from agent conduct acceptable to the broker.

Oversight requires:

- the commitment of financial and human resources to report unacceptable conduct;
- the holding of training meetings; and
- the maintenance of client files.

In a word: **continuing management**.

Further, all acts carried out by a broker or their agents present the possibility that a client or other party will be *injured financially*. This includes investigations, inspections, negotiations, the giving of advice, and the preparation of disclosures and contracts.

Controlling risk as a broker

It is the risk of causing these losses which the broker needs to control. Risks are best limited by choosing activities which can be conducted with more certainty of a favorable result when relied on by the client or other person in a real estate transaction. Thus, brokers need to maintain a **risk reduction program** to keep claims from clients and others under control.

risk reduction program
Office procedures implemented and actively overseen by a broker to mitigate risk and ensure the broker's agents are conducting themselves as intended.

The five steps necessary to establish a *risk reduction program* are as follows:

- All activities exposing the broker to liability are **identified** based on whether the activity runs the risk of causing the client or others to be injured financially.
- Each identified activity is **broken down** into its component parts, i.e., all of the acts and events that comprise the activity, which need to be properly performed to eliminate the risk of causing a loss to a client, others or the broker.
- An **evaluation** undertaken into what sorts of loss the client, others or the broker might experience if the broker or their agents undertake the identified activity, or a modified or alternative version of the activity.
- Brokerage activities are **chosen** and procedures and limitations **adopted** to control the parameters of the agent's conduct when performing those activities, based on whether they fall within the broker's comfort zone as providing the level of exposure to liability acceptable to the broker.
- Agent **compliance** with activities authorized and limited by the broker's policies and procedures are tracked, and ongoing remedial training and dispute resolution for claims made by clients and others are established.

Chapter 2 Summary

In a stable market, a natural equilibrium develops between active real estate agents and brokers; approximately 1.5 active agents for every active broker. After a protracted period of inflated agent population, the ratio began to rise again, currently an average of 2.2 agents for every active broker in 2020.

With the current batch of licensee entrants embracing more sustainable, long-term real estate strategies, the "quick-buck" real estate agents are continuing to exit the stage swiftly and in large numbers. With them goes the artificial support they gave to sales numbers.

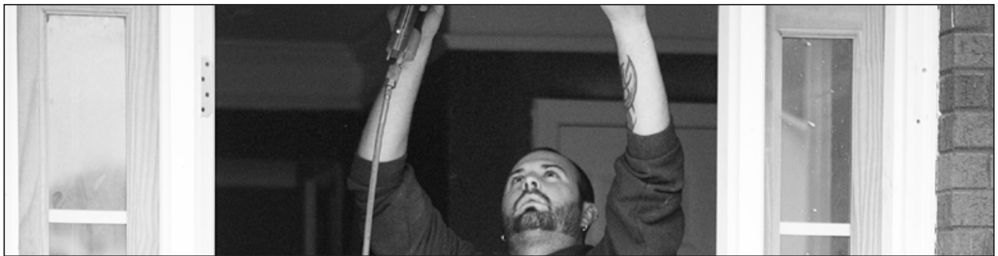
To operate a successful brokerage office, the broker needs to employ viable agents. However, most brokers employing agents tend not to dedicate sufficient energy to the supervision of their agents.

Brokers or their administrative assistants and managers need to police the business-related conduct of their agents by implementing and overseeing risk reduction programs tracking their agent's compliance with broker policy. Proper broker supervision keeps claims from clients and others under control.

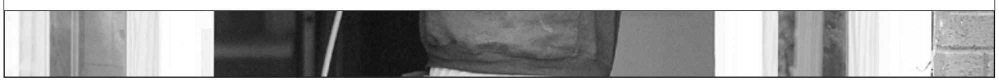
Chapter 2 Key Terms

risk reduction program .... **pg. 17**
sticky pricing .... **pg. 13**
turnover rate .... **pg. 12**

Chapter 3



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

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]

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

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."

The marketing role of the seller's agent

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

Further, for the seller's agent to retain control throughout the process of marketing, selling and closing escrow with a buyer, the seller's agent needs to request and use the HIR (on behalf of the seller) to assist in the preparation of the TDS. [See **RPI** Form 130]

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

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

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

A home inspector's qualifications

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

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

- general contractors;
- structural pest control operators;

1 Calif. Civil Code §2079
2 Calif. Business and Professions Code §7195(d)

- architects; and
- registered engineers.

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

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

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

Hiring a home inspector

Sellers and seller's agents are encouraged by legislative policy to obtain and rely on the content of 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.

If **care in the selection** of a home inspector is lacking, then reliance on the HIR by the seller and seller's agent preparing the TDS will not relieve the broker or the seller's agent of liability for the home inspectors incompetence or error.

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

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

3 Bus & P C §7068
4 Bus & P C §7196
5 Bus & P C §7196.1
6 CC §1102.4(a)

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

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

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

The home energy rater

Consider a first-time homebuyer who, acting on their own and without the advice of a buyer's agent, buys a fixer-upper for a starter home.

In the first month of residence, the uncapped air conditioning ducts, badly sealed window frames and insufficient ceiling insulation cause his 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.

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.

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

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

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

California Home Energy Rating System (HERS)
California state system used to create a standard rating for energy efficiency 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.[7]

Reliance by buyers on the report

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

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

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

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

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

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

The home inspection contract

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

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

7 Bus & P C §§ 7199.5, 7199.7

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

9 Bus & P C §7198

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

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

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

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.

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

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.

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.[12]

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

Non-invasive indicates no intrusion into the roof, walls, foundation or soil by dismantling or taking apart the structure which would disturb components or cause repairs to be made to remove the effects of the intrusion.[13]

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.[14]

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

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

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

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

The home inspector's conflicts of interest

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

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

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

Chapter 3 Summary

A seller, through their agent, requests the preparation of a home inspection report (HIR) to be used to prepare the mandatory seller's Transfer Disclosure Statement (TDS). Both will be handed to prospective buyers in a marketing package. The TDS and HIR inform prospective buyers about the precise physical condition of the improvements on the property before an offer to purchase is made.

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

- roof;
- ceiling;
- walls;
- floors; and
- foundations.

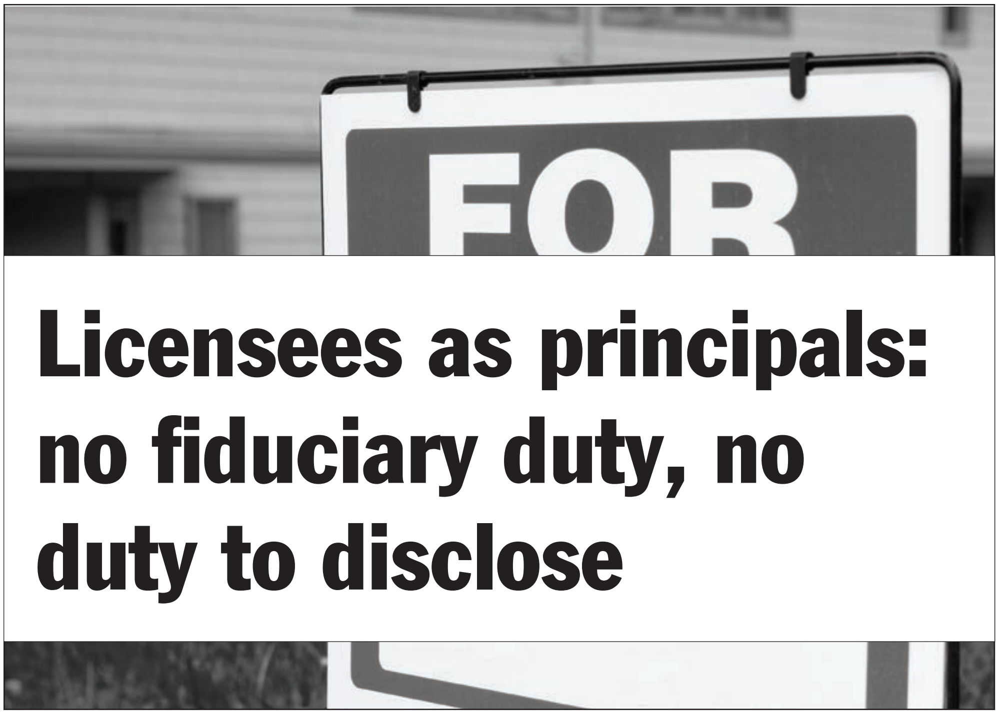
The home inspection describes any observed or suspected material defects, and makes recommendations for each condition. Defects are material if they adversely affect the price a reasonably prudent and informed buyer would pay for the property when entering into a purchase agreement.

Reliance on an HIR prepared by an inspector relieves the seller and the seller's broker from liability for errors in the TDS which are unknown to them to exist. Qualifications to look for in a home inspector include:

- educational training in home inspection;
- the length of time in the home inspection business or a closely related field;
- errors and omissions insurance coverage;
- professional and client references; and
- membership in a recognized association of professional home inspectors.

A buyer and their agent may also wish to assess the energy efficiency of the property and the costs of making energy efficiency upgrades. A home energy audit is performed by a Department of Energy-certified Home Energy Rater.

Chapter 3 Key Terms



Chapter 4

Licensees as principals: no fiduciary duty, no duty to disclose

Learning Objectives

After reading this chapter, you will be able to:

- determine when a licensee involved in a transaction as a transaction agent (TA) needs to disclose their further status as a direct or indirect principal involved in the same transaction;
- disclose the conflict of interest which exists when a licensee acts as an agent for a party in a sale, lease or loan transaction and also has a direct or indirect principal benefit in the transaction;
- understand how a licensee when acting solely as a principal may unintentionally activate statutory agency responsibilities by disclosing their licensed status to the other party.

Key Terms

agency relationship	**for sale by owner (FSBO)**
conflict of interest	**general agency duties**

No agency, no duty to disclose the license

A seller of real estate holds a real estate license issued by the California Department of Real Estate (DRE).

The seller markets property they own as **"for sale by owner" (FSBO)**. The seller is not represented by a real estate broker.

A buyer responds to the advertisement by contacting the seller directly, as the buyer is not represented by a buyer's agent.

for sale by owner (FSBO)
A property owner's method of marketing property for sale without the use of a DRE-licensed broker or agent to locate a buyer.

The seller makes all the necessary disclosures of data and information regarding the property's:

- physical condition;
- operating data;
- title condition; and
- the nature of its location.

The buyer and seller enter into a purchase agreement prepared by the seller. The buyer does not know and is not informed the seller is a real estate licensee. Further, the buyer does not inquire about any licensing status of the seller. Neither the purchase agreement nor escrow instructions contain a declaration disclosing the existence of a DRE license.

After escrow closes on the sale, the buyer believes they paid too much for the property, having been acquired at the peak of the real estate market cycle for pricing. Further, the buyer discovers the seller was a real estate licensee.

The buyer attempts to **rescind** the transaction, claiming the seller, while acting solely as a principal for their own account, breached their duty owed to the buyer as a member of the public to disclose their status as a licensee and protect the buyer's interests in the purchase.

Agent for another?

Two issues arise in the previous example. First, did the seller, selling property for their own account, at any time act as an *agent* for anyone in the transaction?

agency relationship
The scope of conduct imposed on a broker arising out of the representation undertaken by employment as a licensee.

No! The seller never undertook an **agency relationship** to act on behalf or advise the buyer or anyone else in the transaction. A licensee acts as an **agent** in a transaction only when they *represent another person*. Thus, a licensee is not and cannot be an agent for themselves — it is a legal impossibility.[1]

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.

When a licensee in a sale, lease or loan transaction acts as a *transaction agent (TA)* representing one party, and also in the same transaction are directly or indirectly considered a principal, they have a **conflict of interest** which will be disclosed. [See Figure 1, **RPI** Form 527]

Disclosure of participation as a principal is required since the licensee is acting both as:

- an agent for the *other principal* in the transaction; and
- a principal in some capacity for their own benefit.

However, in our opening example, the seller did not act in their capacity as a licensee. They did not undertake the duty to represent the buyer (or others) as a TA, with or without the expectation of compensation. Thus, they did not hold themselves out as a licensee acting under the authority of their license to gain a benefit in the transaction, much less act as the buyer's agent in the transaction.

1 Calif. Civil Code §2295

Duty to disclose license status?

The second issue: whether the seller, acting only as a principal, has a duty to disclose their status as a real estate licensee (or as holder of any other professional license) when they market and sell real estate they own to a buyer?

No! A principal's duty, when acting as a seller of property, is to disclose sufficient information about the property to place the buyer on notice of all **property conditions** which are not observable or known to the buyer and might affect the buyer's decisions. The status of the property, not the seller's status as a licensee, delimits the disclosures. The buyer is acquiring real estate from the seller, not expectations of benefiting from agency obligations or services of a licensee.

A *conflict of interest* does not arise when a real estate licensee sells property they own — unless they act or imply they are acting in the capacity of an agent in the transaction or on behalf of another.

Further, to advertise property for sale as an "owner/agent" is a contradiction, a legal absurdity. The term is confusing to a buyer about the nature of a real estate agent handling the transaction. No agency exists with anyone at the time of the advertising, none need be inferred before incurred, and the word "owner/agent" is never prudent to use.

A licensee-principal conflict requiring additional conflict of interest disclosures only arises when:

- the licensee represents the buyer or seller as an agent; and
- the licensee has or will have a direct or indirect interest in the property sold or bought. [See **RPI** Form 527]

Licensee conduct as a transaction agent

Real estate law focuses on defining **agency duties**, and the rights and limitations pertaining to the holding and use of a real estate license. In other words, real estate law only controls when one acts in the capacity of an agent.

Individuals acting as principals in real estate transactions are not subject to the rules governing licensees, unless they are also licensed and acting as an agent in the transaction.

A person acts as a real estate licensee when they:

- negotiate the sale or purchase of property on behalf of another person; and
- expect to be compensated in some way for their services.[2]

Consider a licensee who acts solely as the seller or buyer in a transaction. However, in handling negotiations, the licensee conducts themselves in a manner which leads the **other principal** to believe the licensee is also acting as their agent in the transaction.

2 Calif. Business and Professions Code §10131

A licensee's agency conduct, while not calling for the payment of a fee, includes an assurance to the buyer that the transaction will be handled properly since the seller or buyer is a real estate licensee.

By this conduct, the licensee is deemed the agent of the other party. Critically, they disclosed their licensee status and used the existence of the license to gain a psychological advantage — a benefit — over the other party in negotiations.[3]

No agency duty owed

All the confusion about whether or when to disclose one's licensed status originates from the existence of *agency activities* in a transaction, not principal activities. Holding a license does not create a conflict of interest; using that license to act as an agent or otherwise benefit does, and therefore the conflict needs to be disclosed.

Specifically, the misunderstanding stems from *conflict of interest disclosures* a licensee is to make when acting as an agent and is concurrently deemed to be involved as a principal in the same transaction.

It is the **agency activity** that mandates the further disclosure, not the licensee's participation as a principal (when coincidentally also a licensee).

Also, conflicts of a TA to be disclosed to the affected parties are situations in which a principal or service provider in a transaction is the TA's:

- relative or relative of a fellow employee;
- employee or fellow employee;
- affiliated business; or
- any person about whom the agent may have a positive or negative bias. [See **RPI** Form 527]

Payment of a fee to themselves

Consider also the conflict that arises when an ill-informed real estate licensee sells their own property and includes a **broker fee provision** in the purchase agreement calling for payment of a fee to themselves on the sale. When a licensee receives a brokerage fee on the sale of their own property (or on their purchase of property) for their own account, they subject themselves to real estate agency requirements – as well as adverse *tax consequences*.

When a licensee holds themselves out as a licensee by collecting a fee, they implicitly act as an agent in the transaction. Thus, they are obligated to fulfill a real estate broker's **general agency duties** owed to all parties.[4]

general agency duties
The duty of a licensee acting as an agent in a real estate transaction owed to all parties in the transaction to be honest and avoid deceitful conduct.

Another common conflict of interest arises when a licensee acting as an agent for a buyer or a seller has a **bias** towards another person (individual or entity) who is a principal, agent or provider in the transaction. Further, a

3 **In re Woosley** (9th Cir. BAP 1990) 117 BR 524
4 **Prichard** v. **Reitz** (1986) 178 CA3rd 465

broker employed to act on behalf of a principal in a transaction will disclose to all parties the nature and extent of any **direct or indirect interest** they or their agents hold or are acquiring in the property. [5]

Trade union lore

The most likely cause of these misconceptions arises from the rhetoric espoused by the **California Association of Realtors (CAR)** trade union and its members.

CAR's code of ethics outlines several restrictions requiring the inculcated faithful to disclose their status as "real estate professionals," "licensees" and, most of all, reference themselves as *realtors* (same-same to the public) when acting as principals in a real estate transaction.

According to common CAR trade union lore, it is a showing of good faith to disclose one's status as a REALTOR in order to inform the opposing parties in a real estate transaction of one's expertise, honesty and above-average knowledge of real estate sales transactions.

Editor's note — In truth, this disclosure only serves to further CAR's own trade union legacy. Clarification: it is the DRE which is charged with policing competency and standards set by the legislature, not CAR.

This unionized logic quickly degenerates into pure absurdity as it instigates (not mitigates) risk.

Are medical doctors to disclose their licensing status at every checkup they receive? Does every CPA need to disclose they are an accountant if they have another person prepare their tax return? What about the attorney buying property who, like all other trained individuals, will marshal all their expertise for their own best business advantage – within legal parameters, of course?

And what of those individuals who let their licenses lapse, but still have all the skills developed in the trade? Is a seller of property who dropped their broker license after 20 years of practice to confess to their buyer that the seller is an insider who knows a great deal about real estate?

Professionals whose services are real estate related, such as attorneys, loan officers, escrow officers, title officers, brokers/sales agents and CPAs, are not compelled to disclose their professional licensee status when acting solely as a principal in a real estate transaction.

Increased risk for liability

Aside from the absurdity of disclosing all your various licenses when acting as a principal, licensure disclosure when no agency is involved substantially increases one's **risk of liability** to other principals in the transaction.

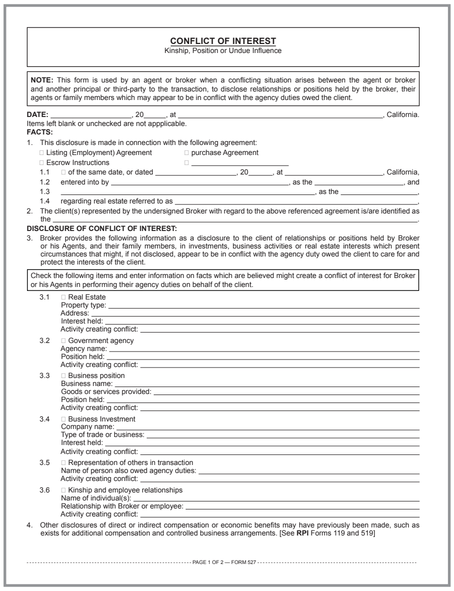
A licensee unintentionally activates statutory responsibilities in some situations by disclosing their licensee status.

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

Figure 1

Form 527

Conflict of Interest



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 principal 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: ____________

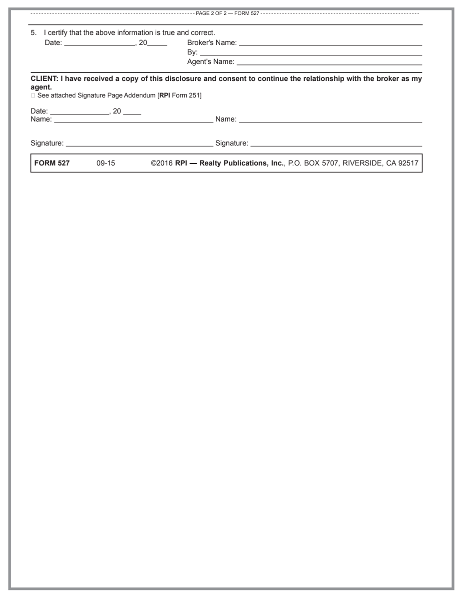
3.5 ☐ Representation of others in transaction
Name of person also owed agency duties: ____________
Activity creating conflict: ____________

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

For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to realtypublications.com/forms



PAGE 2 OF 2 — FORM 527

5. I certify that the above information is true and correct.
   Date: ____________, 20____ Broker's Name: ____________
   By: ____________
   Agent's Name: ____________

CLIENT: I have received a copy of this disclosure and consent to continue the relationship with the broker as my agent.
☐ See attached Signature Page Addendum [**RPI** Form 251]

Date: ____________, 20 ____
Name: ____________ Name: ____________

Signature: ____________ Signature: ____________

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

The unintended consequence of making an unnecessary disclosure about licensing is that other principals may believe they are getting some protection or care for the reason a licensee is involved as a principal in the transaction. Why else is the disclosure made?

Thus, by virtue of the disclosure, one's status is easily perceived to be larger than that of a principal to being one who is **holding themselves out as an agent** in the deal. Disclosures have consequences, as intended.

When agents hold themselves out to be specially qualified and informed in the subject matter expressed in their opinion regarding a real estate transaction, their opinion becomes a **positive statement of truth** on which a buyer or seller of lesser knowledge can rely. Thus, it is considered ill-advised for a licensee acting solely as a principal to disclose the existence of their license. [6]

If a member of CAR chooses to blindly follow its code of ethics when acting as a principal, they need to be aware that it exposes them to greater risk. Codes of ethics are fine, but they do not function as law or good advice, unless promulgated by government regulatory agencies such as existed with the DRE until deregulation of licensees in the mid-1990s.

The bottom line: if you are not using your license, you have no duty to disclose it.

6 **Cohen** v. **S & S Construction Co.** (1983) 151 CA3d 941

Chapter 4 Summary

Real estate law focuses strictly on defining agency duties, and the rights and limitations pertaining to the use of a real estate license. A licensee acts as an agent in a transaction only when they represent another person. Thus, real estate law only controls when one acts in the capacity of an agent, and a licensee cannot act as an agent for themselves.

Individuals acting as principals in real estate transactions are not subject to the rules governing licensees, unless they are also acting as an agent for a fee in the transaction. A person acts as a real estate licensee when they:

- negotiate the sale or purchase of property on behalf of another person; and
- expect to be compensated for their work.

If the licensee involved in a transaction is not acting on behalf of a principal, the licensee is selling, buying, leasing or financing real estate for their own account and is merely a principal in the transaction. It is the agency activity that mandates the further disclosure, not the licensee's participation as a principal (when coincidentally also a licensee).

However, when a licensee receives a brokerage fee on the sale of their own property or on the purchase of property for their own account, or leads the other party to believe they are that party's agent, they subject themselves to real estate agency requirements – as well as adverse tax consequences.

A licensee may unintentionally activate statutory responsibilities by disclosing their licensed status if the other principals believe they are getting some protection or care from its existence. By virtue of the disclosure, one's status may be perceived to change from that of a principal to one who is holding themselves out as an agent in the deal.

Chapter 4 Key Terms

Chapter 5

Inking the handshake: a written employment agreement has significance

Learning Objectives

After reading this chapter, you will be able to:

- understand the need for a written employment agreement to assure payment of the fee anticipated for providing services in a real estate related transaction;
- differentiate your rights and obligations under an exclusive listing employment versus an open listing employment; and
- distinguish the fee assurance offered by provisions in various types of listing agreements and purchase agreement provisions.

Key Terms

agency relationship
exclusive right-to-sell listing
fiduciary duty
listing agreement
open listing

Expectations lost for want of a signature

Real estate brokers and their agents habitually work to form strong personal bonds with potential clients by making themselves better known to likely buyers, sellers, borrowers, landlords and tenants of property.

Indeed, all professionals require some level of self-promotion to attract and retain clientele, a process called **branding**.

Through **FARM letter campaigns** and social networking media efforts, a broker and their agents seek to generate future business — employment — among potential clients in need of an agent to advise them and act on their behalf.

An agent's worth to potential clients becomes apparent when they share detailed market knowledge of current sales volume and pricing trends. More impressively, clients feel closer to agents who have the ability to express their understandings and give opinions about the various technical aspects of real estate transactions.

Communications with potential clients via *Facebook* or newsletters are too casual and passive to be construed as a personal service. Yet in the eyes of prospective clients, these informal approaches set the tone for future face-to-face discussions.

When employed by a client to sell, locate or finance property, the previous solicitation and branding efforts transform into a focused dedication. This dedication is the duty of *due diligence and advice* owed to the client to meet the client's objectives in the real estate transaction they seek through the employment.

Conceptually, most clients unfamiliar with real estate transactions willingly follow the advice and recommendations of the broker or agent they select to assist them. Thus, the agent who explains that arrangements for employing a broker are formalized in writing has little difficulty asking for and the client entering into a written *employment agreement*, commonly called a **listing**.

listing agreement
An employment contract used to retain a broker to render real estate transactional services as the agent of the client.

Brokers who use a handshake as their "documentation" are risking loss of an earned fee. Worse, they set a legally unacceptable standard for their agents and the brokerage industry. As the *gatekeepers* to entry into real estate transactions, a minimum level of control over the public participants compels the universal use of employment agreements with all of them.

It is a difficult task to work with another broker or agent who does not have the most basic control over the involvement of their client – a written employment agreement.

Employed to be 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**.

agency relationship
The scope of activities imposed on the broker arising out of the representation authorized by employment.

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.

fiduciary duty
The licensee's obligation as an agent to act with the utmost good faith and diligence for the benefit of the principal who employs them.

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] [See **RPI** Form 305]

The not-so-friendly oral fee agreement

An **oral agreement** to represent a client in a real estate transaction imposes an agency obligation on the broker and all their agents to act as a fiduciary to that client. This obligation under an oral agreement is no different than if a written and signed employment agreement existed.

However, a client's oral promise to pay a fee for the broker's services (or cause one to be paid as with a client-buyer) does not entitle the broker to enforce collection of the fee from their client. Others, however, may owe the fee the client orally agreed to pay, as discussed below.

Thus, all **fee agreements** need to be in writing and signed by the client before the broker can pursue the client for collection of the amount earned—no matter who was to pay it.[2]

Stated differently, an *oral agreement* obligates a broker to work diligently in the best interest of the client, but does not obligate the client to pay for the effort. However friendly a broker may be with their client, oral agreements do not provide enforceable assurance a fee earned will be paid by anyone.

An oral promise does not impose liability on the client to pay

Consider a real estate broker contacted by a prospective buyer interested in locating and acquiring property. It is agreed the broker will assist the buyer to locate suitable property for purchase. The buyer orally promises the broker a fee will be paid in the event the buyer purchases any property submitted to the buyer by the broker.

The broker, so assured, proceeds to locate suitable properties for presentation to the buyer for consideration. The buyer, interested in a property based on information submitted by the broker, contacts the seller directly. The buyer acquires the property without the broker's involvement. No fee is paid.

The broker, on discovering their client's acquisition of the property, demands payment of the promised fee earned. The buyer refuses to pay, claiming no writing signed by the buyer exists between the broker and the buyer for payment of a broker fee.

Is the broker entitled to the fee on the sale from the buyer who orally promised to pay?

No! Initially, the oral employment agreement with the client obligated the broker to fulfill fiduciary duties owed to the buyer, which the broker did.

1 Calif. Civil Code §2079.16
2 CC §1624(a)(4)

However, arrangements for the fee were also oral. When oral, the promise does not impose liability on the client to pay the broker a fee on their acquisition of property diligently located and faithfully submitted by the broker as orally agreed. [3]

A contract enforceable as a prerequisite

Entering into a written *employment agreement* immediately upon establishing an agency relationship with a buyer or seller will ensure all parties are on the same page for performance. [See **RPI** Form 102, 103 and 104]

The *written listing* contains the client's promise to either pay a fee or cause a fee to be paid by someone else, such as the seller when the buyer is the client in a sales transaction. The promise is given in exchange for the broker's promise to use **due diligence** in their efforts to meet the objectives sought by the client in the employment.

Consider a broker who enters into a listing agreement with a seller employing the broker to locate a buyer for their property. The listing agreement, written and signed by the seller, entitles the broker to a fee when within one year the property is sold, whether or not the broker is the procuring cause of the sale, called an **exclusive right-to-sell listing agreement**.

exclusive right-to-sell listing
A type of listing used by a seller's broker when employed by a property owner for a fixed period of time to diligently market a property for sale and locate a buyer to acquire it, for which the broker is due a fee regardless of who locates the buyer.

Within one year after entering into the employment, the seller agrees to sell the property to a buyer located by the seller (or another broker), not the broker. The sale is closed without the payment of a fee to the broker. The broker makes a demand on the seller for payment of the fee earned under their listing agreement when the property sold. The seller refuses, claiming the broker did nothing to "earn" a fee.

Is the broker entitled to a fee for the sale, even though they were not involved in the solicitation or sale of the property to the buyer?

Yes! Documentation of an obligation to pay a fee in the form of a written agreement signed by a client is the legislatively mandated and judicial requisite to the **right to enforce collection** of a brokerage fee from the seller. [4]

Earned fee interference: prospective economic advantage

Regardless of whether a signed, written listing agreement exists, no one may interfere with the **prospective economic advantage** a broker holds with their client — a relationship, written or oral, that establishes when a fee is earned and due to be paid.

Consider a seller who places a sign on their property stating, "For Sale — Contact Your Local Broker." Such a sign constitutes an *open listing* with local brokers, who have the opportunity to find ready, willing and able buyers and earn a fee if a buyer they present the property to purchases it.

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3 **Phillippe v. Shapell Industries, Inc.** (1987) 43 C3d 1247
4 **Crane v. McCormick** (1891) 92 C 176

After seeing the property, a potential buyer approaches a local broker. After counseling with the buyer regarding their needs, the broker brings the property to their attention. The broker does not obtain an oral or written promise from the potential buyer to assure payment of a fee. The broker promptly advises the seller about the inquiry, identifying the potential buyer as theirs.

The seller is directly approached by the potential buyer with an offer to purchase the property. The purchase agreement, which the seller accepts, does not provide for payment of a fee to the broker.

The broker learns their buyer purchased the property and makes a demand on the seller for payment of the fee earned on the sale. The seller refuses to pay, claiming the broker is not entitled to a fee on the sale since the broker did not have a written agreement with either the buyer or the seller entitling the broker to the fee.

Is the broker entitled to a fee from the seller for procuring the buyer even though there was no written employment agreement with either party?

Yes! The seller owes the broker a fee on the sale. Here, the seller knew of the broker's employment relationship with the buyer and intentionally avoided payment of the broker's fee by selling the property without further involving the broker — an interference with the broker's *prospective economic advantage* which evolved from the broker's employment by the buyer. [5]

Tortious conduct

Intentional interference with *prospective economic advantage* is considered **tortious conduct.** Such conduct imposes liability on the person collaborating with the client to avoid payment of the fee. When a writing does exist, those entering into it typically perform as agreed, rarely giving rise to collection efforts.

The tortious misconduct relates to the intentional disruption of an *economic relationship,* rather than the breach of a contractual promise to pay a fee.

Continuing the previous example, the seller knew of the broker's relationship with the potential buyer and interfered with that relationship by selling the property directly to the buyer without the broker's involvement. Thus, the seller's conduct deprived the broker of their fee on the sale, a loss due to the seller's disruption of the broker's prospective economic advantage created working with the buyer in the real estate transaction.[6]

Open versus exclusive listings

To set the parameters of an *agency relationship* undertaken with a client, a broker determines:

- the type of services to be provided; and
- the extent of assurances a fee will be paid for having entered into the employment.

5 **Buckaloo** v. **Johnson** (1975) 14 CA3d 815
6 **Zimmerman** v. **Bank of America** (1961) 191 CA2d 55

A wide variety of listing agreements exist, each different in the extent of the representation and type of services to be performed by the broker and the broker's agents, or the events which trigger payment of an earned fee.

Listings are generally classified under one of two categories:

- **open**; or
- **exclusive**.

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.

An **open listing**, sometimes called a *nonexclusive listing*, does not grant rights to the seller's broker and their agents to be the sole — exclusive — representative of the client. This is true whether the client is a buyer, tenant or borrower, or respectively a 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.

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 needs to be submitted before the listing expires or is revoked by withdrawal of the property from sale or by the termination of the agency.

Greater protection under the exclusive listing

In contrast to the open listing arrangement, an **exclusive listing** affords a broker the sole right to represent a buyer, owner or tenant. An *exclusive right-to-sell listing* also affords a real estate broker the greatest fee protection. It is the most commonly used type of employment. The right-to-sell agreement 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.

Under an exclusive right-to-sell agreement, the owner relinquishes their right to list the property with other brokers or defeat the right of the seller's broker to compensation by selling the property themselves, removing it from the market or prematurely terminating the employment.

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 fixed period of employment stated 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.[7]

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 or other brokers to sell the property; the seller and the broker work together in collaboration to achieve the sale.

Get it in writing

After exposing a potential buyer to properties listed in-house, agents too frequently expose the buyer to properties listed with other broker's offices. They perfunctorily do this without first reducing their employment to a written agreement authorizing them to locate suitable property.

Instead, they hope to write up a purchase offer to be signed by the buyer. And when they do, they often further aggravate their rights by using a purchase agreement form devoid of a fee setting provision to protect their fee in the body of the provisions agreed to by the buyer.

Worse, buyer's agents then rely on the inherently adversarial seller's agent to set the amount, assure enforceability and disburse the fee earned on their buyer's purchase. All the while, the buyer's broker takes no steps by way of escrow instructions to assure escrow will directly pay them the fee on closing.

An exclusive right-to-buy listing agreement between a buyer and a buyer's agent guarantees no time, money and talent are wasted locating property on behalf of this buyer, if they buy.

7 CC §1086(f)(1)

Chapter 5 Summary

A written listing specifies the activities a broker is obligated to undertake in their employment on behalf of the client in exchange for a fee. An oral agreement obligates a broker to work diligently in the best interest of the client, but does not obligate the client to pay for the effort. Thus, entering into a written employment agreement immediately upon establishing an agency relationship with a buyer or seller ensures all parties are on the same page for performance — and an earned fee is paid.

A wide variety of listing agreements exist, each different in the extent of the representation and type of services to be performed by the broker and the broker's agents, or the events which trigger payment of a fee.

Listings are generally classified under one of two categories:

- open; or
- exclusive.

An open listing does not grant rights to the seller's broker and their agents to be the sole representative of the client. 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.

In contrast to the open listing arrangement, an exclusive listing agreement 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. An exclusive right-to-sell listing affords a real estate broker the greatest fee protection and is the most commonly used type of employment.

Chapter 5 Key Terms

agency relationship .... **pg. 36**
exclusive right-to-sell .... **pg. 38**
fiduciary duty .... **pg. 36**
listing agreement .... **pg. 36**
open listing .... **pg. 40**

Chapter 6

A balance sheet reality check

Learning Objectives

This chapter will teach you to:

- prepare a balance sheet for your homeowner; and
- analyze homeowner assets and liabilities

Key Terms

illiquid asset

liability

statement of financial position

Underwater property: the family's black-hole asset

The *Great Recession* wiped out trillions of dollars of home asset wealth across the nation. However, few states experienced the severe rise and fall of prices in the real estate market as acutely as California.

1.5% of California's mortgaged homeowners are financially locked into houses that are **black-hole assets** going in 2020. Each month of continued ownership sucks up exponential sums of money compared to what the home will rent for — its economic value to the owner-occupant, called **implicit rent**.

Without a principal **cramdown**, foreclosures and short sales will continue as homeowners have no short-term or long-term relief since bankruptcy court authority was taken away from homeowners, not real estate investors, in 2005.

Two breeds of negative equity homeowners exist:

- those who are *fully aware* of their financial plight and have tried to get relief but cannot; and

- those who *aren't aware*, or are in deliberate disbelief, of their precarious financial footing.

Either way underwater homeowners view their financial condition, they represent a large portion of California homeowners who bought or refinanced after 2002 and are now paying on dead-end loans. These loans, while amortized, contribute nothing to the equity in the owner's home (but perform quite well for their lender's portfolios).

What metaphorical yardstick can a financially upside-down homeowner use to gauge his property's relation to the waterline?

A **balance sheet** is a worksheet used to list in dollar amounts all the homeowner's assets and liabilities. It is an ideal tool to decipher a homeowner's, and by extension the family's, financial status at a given time. The use of the balance sheet, also called a **statement of financial position**, is a simple exercise in financial planning which needs to be conducted by every household (and investor and businessperson) at the end of each year.

statement of financial position
A balance sheet prepared by a homeowner which lists the dollar amounts of all the homeowner's assets of value and liabilities.

Preparation of a balance sheet is especially instructive to families who purchased or refinanced after 2002 since they are likely underwater. Further, the primary bulk of a homeowner's assets and debt is typically comprised principally of their home. [See Figure 1, **RPI** Form 209-3]

In contrast, a *profit and loss worksheet* is a separate but tandem financial statement for reviewing the homeowner's monthly income and expenditures. It deals not with the value of the home or the mortgage amount, but lists the homeowner's cashflow:

- personal income;
- monthly payments; and
- ongoing obligations, including mortgage payments.

With a firm mental grasp on the family finances through completion of a balance sheet, forward-looking and prudent financial decisions can be made.

Family financial planning: using a balance sheet

The balance sheet approach to setting a homeowner's net worth is meaningful for a knowledgeable real estate broker or agent. This financial statement assists individuals in their estate building through the ownership of real estate.

Investors and families accounting for the dollar amount of the annual increase in the value of their assets usually do so after the end of each year. The analysis reveals whether the family is on track to meet long-term financial goals, or whether the family is insolvent and in need of a change in behavior or assets. The balance sheet also helps the family determine which assets to best spend their earnings on and which assets they need to discard.

liability
A financial debt or obligation owed to others.

A balance sheet distinguishes the relation between two basic financial categories: **assets** and **liabilities**. Assets are tangible and intangible items of value held by the homeowner. Among them are liquid assets which take the form of cash or something easily converted to cash, and include money held in a savings account and tradable stocks and bonds. [See Figure 1, **RPI** Form 209-3 §1 and 2]

Generally, the largest dollar-valued asset a homeowner will ever own is their home. It is historically considered an **illiquid asset** as its equity cannot quickly be converted to cash. With a *positive equity stake* in the home, the owner treats it as a valued asset and thus maintains and improves it. Over time, the property's equity buildup can be cashed-out by either further financing or sale.

illiquid asset
An asset that cannot be converted into cash quickly without cost.

Other items make up a homeowner's assets, such as funds held in retirement accounts, ownership interests in businesses and trust deed notes owned. Vehicles and equipment owned are also assets, as well as furniture, electronic equipment and any other item of recognized value, such as collectibles. [See **RPI** Form 209-3 §5 through 9]

Liabilities are the flip-side of the financial coin. Together, liabilities and net (or negative) worth are equal to the value of the assets. The formula is:

- assets *minus* liabilities equals net worth.

Liabilities included in a balance sheet are financial obligations and debts owed to others, including:

- real estate mortgages;
- auto loans;
- charge accounts;
- credit card balances;
- one year's amount of alimony/child support/lease payments; and
- loans collateralized by stocks, bonds or notes. [See Figure 1, **RPI** Form 209-3 §11 through 15]

Dear, our financial net-worth has shrunk…

A homeowner's *net worth* is revealed when their total liabilities are subtracted from the current FMV of their assets. The net worth is a primary determinant of financial wealth and needs to be known by all individuals, homeowners and otherwise. When net worth is positive, the homeowner is worth more than they owe to their creditors — the homeowner is *solvent*.

However, this balancing act is immediately upended when a high-value asset, such as the homeowner's residence, has a negative equity. If the negative equity is large enough, the value of the homeowner's other assets on a balance sheet is overwhelmed. Their net worth appears as a negative figure. Instead of a positive measure of wealth, the negative net worth is a measure of *insolvency*.

When insolvent, the homeowner is a candidate for *bankruptcy protection*. It is in this context that the agent reviews the pros and cons of the homeowner continuing to own and occupy the property.

Figure 1

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 legally used in your professional practice, go to realtypublications.com/forms

Consider a homeowner who purchased a home for $500,000 in 2004 with a 3.5% down payment. In the six years since the homeowner's purchase, the real estate market saw the home's value rise, then suddenly collapse as asset values plunged in 2008.

In 2014, the home is worth $250,000 (based on the sale prices of comparable properties sold in the prior six months). However, the homeowner still owes $437,600 to the lender ($45,000 less than the original loan amount due to debt amortization). Thus, instead of functioning as an asset of value to be retained, the homeowner's residence becomes a liability with negative $187,600 in equity, a property to be shed unless the mortgage can be discounted to bring the LTV to 94%.

Editor's note — This corrosive net worth phenomena driven by negative equity property is particularly rampant and damaging for those in the Baby Boomer generation since they have fewer years remaining in the workforce to recover.

Boomers experienced close to 50% losses in the stock market on two separate occasions in recent years (likely because they were told by their commissioned 401K investment counselors to put their money into stocks, not bonds, as they grew older).

They were hit a second time with the devastating loss of over 50% of the value of their homes, which too many refinanced to obtain additional funds and are now trying to sell so they can relocate.

Financial advice by the owner's agent

An agent reviewing homeownership with an owner needs to instruct the owner to keep **long-term estate building** in mind when considering the data provided in the balance sheet. The closer the relationship of the agent to the client, the tighter the bond between them. Financial planning is about as close as you can get, so do not leave it to unlicensed financial consultants to take the opportunity away when determining whether to buy or to sell real estate.

After the *balance sheet* is completed by the owner for review by their real estate agent, it will become clearer which assets need to be better managed. In this context, an upside-down house needs to be considered for disposal to free up monthly cash flow for more prudent family expenditures. The financial impact of a homeowner's current mortgage situation directly affects their annual increase in net worth and their ability to achieve long-term financial goals from their future income.

A negative equity homeowner diverts large sums of cash monthly, now and into the distant future, which exceed the rental value of the property they receive for their occupancy and will never be returned in any form. Thus, reaching reasonable long-term family goals is impossible with a *black-hole asset* on the balance sheet.

Chapter 6 Summary

All homeowners, especially those encumbered by negative equity, need to prepare a balance sheet to assess their net worth each year. Agents and their homeowners can then analyze the completed balance sheet to assess which assets are not desirable to be owned.

Chapter 6 Key Terms

Chapter 7

Contingency provisions

Learning Objectives

After reading this chapter, you will be able to:

- use contingency provisions when preparing a purchase agreement to condition the further performance or cancellation of the agreement by the buyer or seller;
- categorize contingency provisions based on whether an event or activity is to first occur or be approved before further performing on a purchase agreement;
- distinguish a condition precedent, requiring an event to occur before taking further action to close a purchase agreement, from a condition concurrent, requiring an activity to be performed without concern for the other person's performance; and
- determine how to eliminate or act on contingency provisions in a purchase agreement.

Key Terms

condition concurrent	**condition precedent**
event-occurrence contingency provision	**further-approval contingency provision**

Conditioning the close of escrow

The contents of a purchase agreement are a collection of provisions generally called **terms and conditions**. While *terms* focus on the price and the terms for payment of the price, *conditions* address:

- the **performance** of activities by the buyer and seller prior to closing; and
- **occurrence of events** required before escrow is able to close.

Thus, each condition which is the subject of a provision calls for an event or activity to either exist or come into existence, by its occurrence or approval,

event-occurrence contingency provision
A purchase agreement provision requiring an event or activity to take place which is not subject to the approval of the buyer or seller.

further-approval contingency provision
A purchase agreement provision requiring the approval of information, data, documents or reports by the buyer or seller.

before the purchase agreement may be enforced and escrow closed. Alternatively, the condition may be waived as though it was never part of the purchase agreement.

Conditions made the subject of **contingency provisions in a purchase agreement** are categorized based on whether they:

- are to occur (events and activities), called **event-occurrence contingencies**; or
- are to be approved (information, data, documents and reports) by one or both of the parties, called **further-approval contingencies** or *personal-satisfaction contingencies*.

These *contingency provisions* grant the buyer or seller, or both, the *power to terminate* any further performance of the purchase agreement if:

- an identified activity or event fails to occur; or
- a condition is not approved.

Precedent and concurrent

Conditions are also classified by the sequence or order in which they are to occur or be performed by the buyer or seller. Thus, the event or activity which is to occur or be approved as called for in the provision is classified as either:

- a **condition concurrent**; or
- a **condition precedent** .

A *condition concurrent* requires the performance of an activity by a person without concern for the other person's activities. A *condition precedent* requires the occurrence of an event or the performance of an activity by one person to be completed before the other person is required to perform an activity.

Further, conditions may be *breached* or *excused* on the failure of the event or activity to occur. Some conditions **are required to be performed**, such as the seller's delivery of title, making the failure to perform them a breach of the purchase agreement. Other conditions which are the subject of contingency provisions might not occur or be approved, thus excusing one or both parties from further performing and closing escrow.

However, under any type of contingency provision, the buyer or seller benefitting from the contingency holds an option to "do away with" any further performance of the purchase agreement and escrow instructions, called **cancellation**.

Contingent and non-contingent provisions

As another distinction for conditions in a purchase agreement, all contingency provisions are conditions, but not all conditions are contingencies.

Contingency provisions are unique as they deal with uncertainties. They authorize the cancellation of the purchase agreement and excuse a party from any further performance toward closing the purchase agreement and escrow. Other conditions are about events or activities which have to be met — performed — since they are not contingencies, in which case a failure to perform becomes a **breach**.

Conditions precedent are the subject of contingency provisions calling for the occurrence or approval of an event or activity which **may or may not occur**. Examples include:

condition precedent
A purchase agreement provision requiring the occurrence of an event or performance of an act by the other party before the buyer or seller is required to further perform.

- the buyer obtaining a written loan commitment;
- the recording of a purchase-assist loan;
- approving due diligence investigations; or
- the sale or acquisition of other property.

Here, the contingency provision may be eliminated by its occurrence and the transaction proceeds toward closing. Alternatively, when the event or approval is not forthcoming, the person authorized to cancel may exercise their right to terminate the transaction by cancellation, doing away with any further performance of the purchase agreement and escrow instructions.

Conditions concurrent are non-contingent, mandatory performance provisions calling for the buyer or seller to perform some required activity. If the activity does not occur, the purchase agreement has been breached by the person who promised to perform or was obligated to cause the activity or event to come about. Examples include the failure of the seller to:

condition concurrent
A purchase agreement provision requiring performance of an activity by a buyer or seller without concern for the performance of the other party.

- produce promised information, data, documents and reports on the property; or
- deliver a clearance, grant deed or title insurance policy as agreed.

The failure to deliver is a breach which allows the other person to either:

- terminate the transaction by notice of cancellation and recover their money losses; or
- pursue specific performance of the purchase agreement.

Eliminating contingency provisions

Before escrow is able to close, contingency provisions need to be eliminated. Contingency provisions (conditions precedent) included in purchase agreements are **eliminated** by either:

- *satisfaction* of the condition, accomplished by either an **approval** of the data, information, documents or reports identified as the subject of the provision by the person holding the right to terminate the transaction, or by the **occurrence** of the event or activity called for in the provision; or
- *waiver* (or expiration) of the right to cancel the transaction by the person authorized to cancel, if the identified event or activity has not been satisfied by its approval or occurrence.

Often, the buyer or seller does not have the right to terminate the transaction under a provision calling for that person to act. Thus, they cannot cancel and avoid closing the transaction. This is an example of a condition concurrent provision, not a contingency provision (condition precedent), since all parties are required to perform all their obligations remaining under the purchase agreement and escrow instructions and close escrow.

The buyer or seller acts without concern for the other person's performance under the purchase agreement, unless the other person is to first perform some activity before they are able to comply. For example, the seller needs to provide a *Natural Hazard Report* before the buyer is able to review and approve its contents. [See Figure 1, **RPI** Form 314]

The obligation of a buyer or seller to complete non-contingent (concurrent) activities is necessary on their part to close escrow. This performance requirement exists in spite of the fact the other person may not have yet fully performed, or that the other person has a right to later cancel the purchase agreement. For example, the inability of a buyer to originate a purchase-assist loan and cancel the transaction is an event that takes place after the seller has fully performed their concurrent activities by delivering all closing documents to escrow.

Content of a contingency provision

Regardless of the type of contingency involved, agents need to make sure the contingency provision is in writing, even though oral contingencies are generally enforceable (but troublesome to establish their existence). Written contingencies avoid confusion over content, enforceability and forgetfulness.

The content of a written contingency provision includes:

- a description of the event addressed in the contingency (i.e., what is to be approved or verified);
- the time period in which the event called for in the contingency provision has to occur;
- who has the right to cancel the purchase agreement if the event does not occur (i.e., whether the buyer, the seller, or both, is able to enforce the contingency provision by cancelling the transaction);
- any arrangements in the alternative to avoid cancellation if the contingency is not satisfied or waived (i.e., offsets to the price or time to cure the failure or defect); and
- the method for service of the notice of cancellation on the other person.

Provisions for uncertainties

Contingency provisions in a purchase agreement protect an agent's client from agreeing to do or cause to occur that which might not occur. The goal at closing is to avoid being forced to accept a situation inconsistent with the client's original expectations or ability to perform when they entered into the purchase agreement.

Without **authority to terminate** the agreement on the failure of the client's expectations, the client's inability or refusal to continue to further perform under the purchase agreement constitutes a breach. The client risks being held liable to the other person due to their breach, unless the client's nonperformance was justified by some pre-contract misrepresentation (or omission) of facts which led to the client's lost expectations.

To avoid a **breach or be excused** from closing escrow when expected events or activities do not occur, an *exit strategy* needs to be agreed to by inclusion of a provision in the purchase agreement.

Often events and conditions develop which do not meet the expectations or anticipations of the client during escrow. Their agent needs to **foresee the need** to condition the client's continued performance by making the event or activity the subject of a contingency provision included in the purchase agreement. [See **RPI** Form 150]

But before lacing a purchase agreement with the uncertainties created by contingency provisions, a prudent agent first attempts to gather information and clear uncertainties the client has about the property or the transaction *before submitting an offer*.

Use of contingency provisions

It is the buyer's agent who, along with the buyer, is the primary user of contingency provisions in purchase agreements.

From a buyer's point of view, and thus the buyer's agent's perspective, every activity, event or condition which is the responsibility of the buyer to further investigate and approve or cause to occur prior to closing needs to be the subject of a contingency provision in the purchase agreement. [See **RPI** Form 260 through 279]

Also for the benefit of buyers, the period for exercise of the right to cancel needs to be as long as possible. Thus, the right to cancel needs to be structured to expire no earlier than the date scheduled for the close of escrow. The possibility always exists that the event or approval needed by the buyer to close escrow is never going to occur.

When preparing the purchase agreement, the buyer's agent relies on their experience to decide which events and approvals the buyer is responsible for and thus their need to be the subject matter of a contingency provision.

Then, if the event does not occur, such as the recording of mortgage financing, or are unacceptable, such as the failure of the property on a due diligence investigation to meet expectations, the buyer may cancel and be excused from proceeding. Thus, the buyer is able to avoid closing and not be in breach on the purchase agreement.

Contingency provisions in practice

Many events and disclosures are the subject of contingency provisions contained in stock forms used by agents. [See **RPI** Form 159 §11]

However, the boilerplate wording used by different publishers of pre-printed contingency provisions varies greatly regarding:

- the time for gathering and delivering data, information, documents and reports;
- the time period for review of the material received or the occurrence of an event (such as a loan commitment or sale of other property);

- the date set for expiration of the right to cancel the transaction after failure of the event or approval to occur;
- whether a written waiver is to be delivered evidencing the elimination of the contingency provision, without which the other party is able to then cancel;
- the requirement of a written notice of cancellation if the right to cancel is exercised on failure of an event or condition to occur; and
- the time period for the other person's response to a notice of cancellation to cure the defect or failure, and thus avoid a termination of the purchase agreement.

Typically, several contingency provisions are included in a purchase agreement. Thus, a **uniform method** for terminating the agreement is employed. Termination provisions call for a written notice of cancellation, and how and to whom it is to be delivered, including instructions to escrow. [See **RPI** Form 150 §10.5]

Contingency provisions are considered to be the *grant of an option* to terminate a transaction by exercise of the right to cancel prior to the expiration of the option period.

The person authorized to cancel or otherwise benefit from a contingency provision who does not use the provision to cancel the purchase agreement need do nothing. They simply allow the "option period" for cancellation to expire.

A need does not exist to *approve or waive* the contingency in order to do away with the right to cancel and proceed to close escrow. However, some purchase agreements are worded to require active approval or waiver to keep the contract alive. This situation is not conducive to furthering performance and closing.[1]

Conditions not contingent

The condition of the property, namely the physical integrity of the land and improvements, too often fails to be disclosed to the buyer before a purchase agreement is entered into with the seller.

Most delayed disclosures fail to comply with the statutory mandates imposed on sellers and seller's agents to hand the information to prospective buyers as soon as possible (ASAP).[2]

The seller's agent has a mandated duty to visually inspect the listed property and note their observations and awareness of property conditions adversely affecting the value on the seller's statutory disclosure document, called a **Condition of Property or Transfer Disclosure Statement (TDS)**. [See **RPI** Form 304]

Not only is it *reasonably possible* for the seller's agent to deliver the TDS before their seller enters into a purchase agreement with a buyer, it is mandated by

1 **Beverly Way Associates** v. **Barham** (1990) 226 CA3d 49

2 Calif. Civil Code §§2079 et seq.; Calif. Attorney General Opinion 01-406 (August 24, 2001)

code and **case law** and the economic imperative of transparency to deliver property disclosures before a price is set in property transactions. Without prior disclosure, the placing of the property under contract is corrupted due to **asymmetric knowledge** of property facts by the buyer and seller.

An unavoidable contingency

However, **trade union purchase agreement forms published by the California Association of Realtors (CAR)** convert the failure of the seller's agent to deliver a TDS before the acceptance of an offer into an unavoidable contingency. Here, the contingency provision merely complies with the statutorily imposed penalty placed on the seller for failure of pre-acceptance disclosures. As the subject matter of the statutory contingency, the buyer is granted the right to cancel the transaction when the TDS is belatedly received, delayed until under contract.

If, on review of the tardy disclosures, the property conditions do not meet the expectations held by the buyer at the time they entered into the purchase agreement, *the buyer may cancel* the purchase agreement — all due to the tardy and misleading conduct of the seller's agent, a type of fraud called **deceit**.

However, if the buyer chooses not to cancel as provided by the contingency, the buyer may proceed and force the seller to close escrow, the buyer taking title to the defective property. Thus, the buyer becomes the owner of property which is not in the **condition or value** they were lead to believe existed when they entered into the purchase agreement. This misrepresentation is the result of omitted facts on the part of the seller and the seller's agent by the time of contracting. This situation exposes the seller's broker to liability for the lost value.

Seller's late delivery

Any significant discrepancies in the property's condition disclosed in the TDS, and not observed or known to the buyer before entering into the purchase agreement, allows the buyer to notify the seller of the defects and make a demand on the seller to cure them by:

- repair;
- replacement; or
- correction.

If the buyer fails to give notice, they have let their right expire to demand the correction of previously undisclosed defects noted in the untimely TDS and are now required to proceed to close escrow. [See **RPI** Form 269]

However, if the buyer makes a demand on the seller to cure defects discovered on their in-escrow review of the tardy TDS, the seller is required to make the corrections before closing. If the seller does not make the corrections, they suffer a reduction in price equivalent to the cost to cure the noticed defects.

Of course, the disclosure of the property's condition before the purchase agreement (or counteroffer) is accepted relieves the seller (and the buyer) of the need to activate this performance provision regarding repairs. [See **RPI** Form 150 §11.2]

The time set for delivery of data, information, documents and reports under a contingency provision for approval or disapproval, as well as the date set for delivery of a notice of cancellation given for any valid reason, is always subject to **time-essence rules.** These rules are liberally enforced to best meet the initial objectives of the buyer and seller to close the transaction on entering in the purchase agreement.[3]

Unless delivered and until satisfied

Frequently, a contingency provision calls for two events to occur in tandem, i.e., a condition concurrent (routine activity), which has to occur, followed by a condition precedent (approval), which may or may not occur.

Consider the seller of a condominium unit who provides documents on the **homeowners' association (HOA)** to the buyer (the condition concurrent) for the buyer's review (the condition precedent).

Here, the seller is required to deliver the HOA documents as a prerequisite to the buyer's review of their content for approval or disapproval. The seller needs to obtain the documents or otherwise cause them to be handed to the buyer. If the seller does not, they have breached the contingency provision and the purchase agreement. [See **RPI** Form 150 §11.9]

As for the buyer who receives the *HOA* documents, they are required to then enter upon a good-faith review of the document's content under their *further-approval contingency provision*. After the review and completion of any further inquiry or investigation (which might extend the time for cancellation) into the implications contained in the HOA document's content, the buyer is to either express approval by waiving or letting the right to cancel expire. However, if they have good reason and an honest belief that they cannot approve of their content, they disapprove the documents by cancelling the transaction.

Here, the seller is initially obligated (condition concurrent) to gather the documents and deliver them to the buyer without concern for what steps the buyer is taking to perform (conditions concurrent) any of their obligations under the purchase agreement, such as applying for a loan.

Seller's review of buyer creditworthiness

Consider another tandem-events provision in which the buyer agrees to execute a **promissory note** in favor of the seller in a carryback transaction. The buyer, in a further-approval contingency provision, agrees to prepare and hand the seller a **credit application** (a condition concurrent)**.** On receipt, the seller is to review and then approve or cancel the transaction (condition precedent) on a reasonable disapproval of the buyer's creditworthiness.

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3 **Fowler** v. **Ross** (1983) 142 CA3d 472

The buyer's obligation to deliver the *credit application* is a compulsory event they are required to perform. The failure to deliver the credit application is a *breach* of the further-approval provision since the buyer's delivery of the application is not conditioned on anyone (read: the seller) first doing something. [See **RPI** Form 150 §8.4]

On the other hand, the seller on receipt of the credit application is required to review the buyer's creditworthiness. However, they are not required to approve the buyer's creditworthiness, and if disapproved based on reasonable grounds, the seller is excused from closing escrow if they elect to cancel the transaction. [See **RPI** Form 150 §8.5]

Act to close without concern

Other contingency provisions require one person, such as the buyer, to first enter upon an activity (such as signing and returning escrow instructions) without concern for whether the other person, such as the seller, is performing their required obligations, such as obtaining a pest control clearance.

Consider a purchase agreement containing a contingency provision calling for the buyer to obtain a purchase-assist mortgage. If the buyer fails to obtain the mortgage as anticipated, the buyer has the option to cancel the transaction, excusing themselves from further performance.

However, the buyer is obligated to promptly initiate the loan application process without concern for whether the seller has commenced any performance of the seller's obligations, such as ordering out inspections and reports the seller is required to obtain.[4]

A person's performance of an activity which **has to occur** versus taking steps to bring about an event or approve a condition which **may or may not occur** is an important distinction to be made.

One is a **breach** of the purchase agreement if the mandatory activity does not occur; the other **excuses** any further performance by cancellation if the described event does not occur. Both failures permit the purchase agreement to be cancelled by the opposing party, but a breach carries with it **litigation and liability exposure**.

Litigation and liability exposure

For example, the buyer of a commercial income property is willing to purchase the property only if the seller cancels a disadvantageous lease held by a tenant. The buyer's agent prepares a purchase agreement with a provision calling for the seller to deliver title and assign all existing leases except the one the buyer is unwilling to accept.

While the seller believes they have the ability to negotiate a cancellation of the lease, the seller's agent does not want the seller committed to delivering title and then fail to be able to negotiate the cancellation of the lease.

Accepting the purchase agreement with provisions calling for delivery of title and assignment of all leases places the seller in breach if they are unable

4 **Landis** v. **Blomquist** (1967) 257 CA2d 533

to negotiate a cancellation of the objectionable lease. The seller risks being exposed to liability for the decrease in the value of the property resulting from the lease.

Here, the seller needs to submit a **counteroffer** prepared by the seller's agent calling for the delivery of title to be contingent on the seller's termination of the lease, an example of an *event-occurrence contingency provision*. This provision is also classified as a condition precedent as it might not occur and needs to be satisfied for the transaction to proceed to closing.

Thus, the seller is only obligated to make a good-faith effort to negotiate the cancellation of the lease. If the seller fails to deliver title clear of the lease, they may cancel the transaction and be excused from any further performance. Importantly, the seller is then free of any liability for the failure to deliver title as agreed.

Performing without concern

Many contingency provisions authorize the buyer to exercise their right to cancel at any time up to and including the date scheduled for closing if an identified condition or event fails to occur.

In the interim, the seller is required to fully perform all of their obligations to deliver to escrow in a timely manner all documents needed from the seller for escrow to close. After the seller has fully performed, the buyer, at the time of closing, has the option to cancel on failure of the condition or event.

The **rights of a seller** in the buyer's contingency provision include assurances that:

- the buyer needs to act on any cancellation before *the right to cancel expires*; and
- the cancellation is the result of a good-faith effort by the buyer to act reasonably to *satisfy the contingency* so the transaction is able to close.

Consider a purchase agreement containing a loan contingency. The buyer has the right to cancel they are unable to obtain a purchase-assist mortgage. [See **RPI** Form 150 §10.3]

However, the seller has not handed escrow any of the documents or information requested by escrow as needed to close. The buyer refuses to submit their loan application and fees to their lender until the seller fully performs all their obligations for escrow to close. The buyer claims it is futile for them to proceed if the seller has not performed.

In turn, the seller cancels the transaction, claiming the buyer has breached their duty to make a good-faith effort to eliminate the loan contingency by applying for the loan.

Here, the buyer's obligation to take steps to satisfy the loan contingency and the seller's obligation to deliver requested documents to escrow are *independent obligations*, examples of conditions concurrent. Thus, the buyer and seller have to each perform their part of the closing activities without concern for whether the other person is performing.

The time-essence contingency provision

Sellers who agree to loan contingency provisions for buyers often require a separate and specific *time-essence contingency provision* to assure themselves that the buyer will act promptly to arrange a mortgage.

In the provision, the buyer authorizes the seller to cancel the transaction if the buyer does not produce a loan commitment or a statement from a qualified lender by a specific date demonstrating that the buyer has been approved for a mortgage in the amount sought. [See **RPI** Form 150 §4.1]

In this instance, if the buyer fails to timely act on an application to negotiate a loan and arrange for a statement of their creditworthiness to be handed to the seller by the deadline for satisfaction of the condition, the seller is able to cancel the transaction.

Purchase agreement as binding

The existence of an oral or written contingency provision in a purchase agreement does not render the agreement void. On the contrary, when an offer is accepted, a **binding agreement** is formed. The overriding issue on forming a *binding purchase agreement* which contains a contingency provision is whether the purchase agreement will ever **become enforceable.** Enforceability occurs when the contingencies have been eliminated as satisfied or waived.

For example, the board of directors of a corporation decides the company needs to purchase a warehouse to store inventory. To meet the corporate objectives, the president, on behalf of their corporation, employs a broker who locates a suitable building. However, the property may be sold to another person before the board authorizes the corporation to enter into a purchase agreement to acquire it.

As the agent authorized to bind the corporation to perform under a purchase agreement, the president submits a signed purchase agreement offer to the seller's agent agreeing to buy the real estate, conditioned on the further approval of the board within 20 days of acceptance.

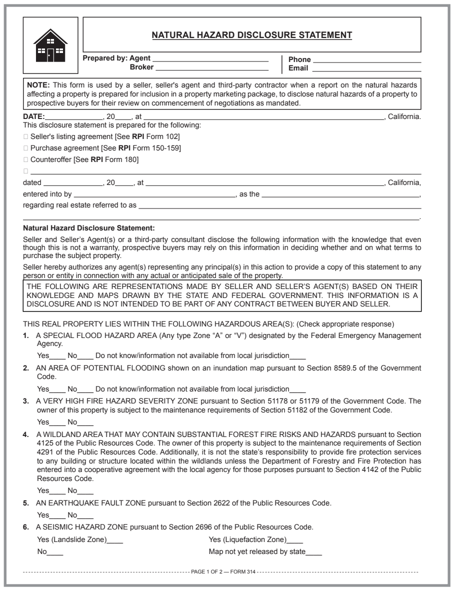
The seller accepts the offer after their agent explains the purchase agreement will not be enforceable until the board of directors approves the purchase, and thus eliminates the contingency.

The corporation, based on the offer submitted by its president and the seller's acceptance, has effectively taken the seller's property off the market while the president completes their *due diligence investigation*. Further, the board gets a "free look" by controlling the property before deciding on the property's suitability as a warehouse, or whether the terms of the purchase agreement are acceptable.

Figure 1

Form 314

Natural Hazard Disclosure Statement



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____

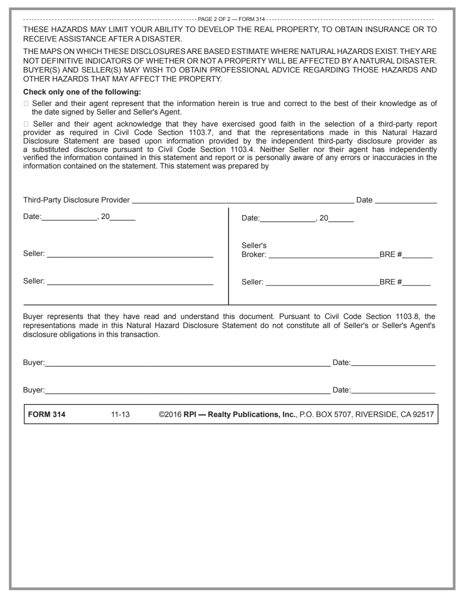
4. A WILDLAND AREA THAT MAY CONTAIN SUBSTANTIAL FOREST FIRE RISKS AND HAZARDS pursuant to Section 4125 of the Public Resources Code. The owner of this property is subject to the maintenance requirements of Section 4291 of the Public Resources Code. Additionally, it is not the state's responsibility to 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

For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to realtypublications.com/forms



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:__________

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Here, the seller has a *binding commitment* from the corporate buyer to purchase the real estate, subject to presenting the purchase agreement and the property selection to the board for approval or rejection and cancellation under the contingency provision.[5]

If conditions are unacceptable, the board rejects the purchase agreement by preparing a resolution stating their reasonable basis for exercising the corporation's rights under the contingency provision to disapprove of the property selection or the terms of purchase. A **notice of cancellation** is then prepared, signed and delivered to the seller, together with the corporate resolution, as required by the purchase agreement to terminate the transaction.[6] [See **RPI** Form 159]

5 **Moreland Development Company** v. **Gladstone Holmes, Inc.** (1982) 135 CA3d 973

6 **Jacobs** v. **Freeman** (1980) 104 CA3d 177

Chapter 7 Summary

The contents of a purchase agreement are a collection of provisions generally called terms and conditions. While terms focus on the price and the terms for payment of the price, conditions address:

- the performance by the buyer and seller of their closing activities; and
- occurrence of events required before escrow is able to close.

When conditions are the subject of contingency provisions, the conditions are categorized based on whether they:

- are to occur (events and activities), called event-occurrence contingencies; or
- are to be approved (information, data, documents and reports), called further-approval contingencies.

Further, provisions containing conditions are classified by the sequence in which they are to occur or be performed by the buyer or seller. Thus, the occurrence or approval called for is either:

- a condition precedent; or
- a condition concurrent.

A condition precedent requires the occurrence of an event or the performance of an activity by one person to be completed before the other person is required to perform an activity. A condition concurrent requires the performance of an activity by a person without concern for the other person's activities. Under any type of contingency provision, the buyer or seller benefitting from the contingency holds an option to "do away with" any further performance of the purchase agreement and escrow instructions, called cancellation.

Before escrow is able to close, contingency provisions have to be eliminated. Contingency provisions are eliminated by either:

- satisfaction of the condition; or
- waiver (or expiration) of the right to cancel the transaction by the person authorized to cancel.

Further, conditions may be breached or excused on failure to occur. Some conditions are required to be performed, such as the seller's delivery of title, making the failure to perform a breach of the purchase agreement. Other conditions which are the subject of contingency provisions might not occur or be approved, thus excusing one or both parties from further performing and closing escrow.

Chapter 7 Key Terms

condition concurrent .... **pg. 51**
condition precedent .... **pg. 51**
event-occurrence contingency provision .... **pg. 50**
further-approval contingency provision .... **pg. 50**

Arbitration: the independent beast

Chapter 8

Learning Objectives

After reading this chapter, you will be able to:

- identify the final and unappealable nature of arbitration awards, and the corresponding risk facing any party who agrees to binding arbitration;
- distinguish the limited circumstances for an erroneous arbitrator's award to be corrected; and
- contrast arbitration and litigation from mediation as the preferable method of dispute resolution.

Key Terms

arbitration	**attorney fee provision**
arbitrator	**mediation**

Lost right to correct a decision gone awry

Consider a seller who contacts a brokerage office to list their property for sale. The seller and seller's agent sign a listing agreement containing a provision calling for disputes to be submitted to **binding arbitration** — no judicial oversight permitted.

A buyer is located by a buyer's agent employed by the same broker. Both the agents and the broker are aware the buyer is financially unstable and may encounter difficulties closing the transaction. However, confirmation of the buyer's creditworthiness and net worth are not made the subject of a *contingency provision* by the buyer's agent who prepared the offer for the buyer. If included, a contingency provision authorizes the seller to cancel the purchase agreement if the seller determines the buyer's credit is unsatisfactory.

arbitration
A form of dispute resolution voluntarily agreed to in contracts authorizing a third-party arbitrator to issue a binding award which cannot be reviewed and corrected by a court of law.

The buyer's financial status is not disclosed to the seller when the seller's agent submits the buyer's offer. The supervising broker fails to catch or correct the oversight.

The seller accepts the purchase agreement offer which provides for payment of a fee to the broker. Each agent is to receive a share of any fee their broker receives on the sale. Each agent's share is based on formulas agreed to in their separate written employment agreements with the broker.

Later, the buyer fails to close the transaction due to their financial condition. The seller discovers that the seller's agent, broker and buyer's agent all knew of the buyer's financial condition. The seller makes a demand on the broker and both agents for the seller's losses on the failed transaction, claiming the buyer's financial condition was a **material fact** the agents and broker knew about and failed to disclose.

Binding arbitration as a loose noose

arbitrator
A neutral third-party appointed to hear a dispute who is authorized to make a final decision awarding judgment in favor of one of the parties.

Continuing the previous example, the dispute is submitted to *binding arbitration*. The **arbitrator** awards money damages to the seller based on the professional misconduct of the seller's agent and employing broker for failure to disclose their knowledge of the buyer's unstable financial status — the broker being *vicariously liable* as the employer of the seller's agent who failed to make the disclosure.

Further, the arbitrator issues the seller a money award against the buyer's agent. The arbitrator erroneously rules the buyer's agent and the seller's agent were "partners" since they shared the fee the broker received on the transaction. Thus, the buyer's agent is improperly held liable as a business partner of the seller's agent for the seller's money damages resulting from the misconduct of the seller's agent.

The buyer's agent seeks to vacate the portion of the arbitration award holding them liable as a "partner" of the seller's agent, claiming the arbitrator incorrectly applied *partnership law* to a real estate agency and employment relationship controlled by other laws.

Can the award against the buyer's agent be corrected by a court since the arbitrator wrongfully applied partnership and agency law?

No! An arbitrator's award, based on an erroneous application of law, is not subject to **judicial review** since a judicial review of the arbitrator's award was not included as a condition of an award in the arbitration provision. The arbitrator acted within their powers granted by the arbitration provision, even though they applied the wrong law and produced an erroneous result.

A court of law confronted with a binding arbitration agreement cannot review the arbitrator's award for errors of fact or law even if the error is obvious and causes substantial injustice.[1]

1 **Hall** v. **Superior Court** (1993) 18 CA4th 427

The arbitration provision

Many pre-printed brokerage and purchase agreements, such as those published by the California Association of Realtors (CAR), perfunctorily include a boilerplate **arbitration provision.** The *arbitration provision* included in a purchase agreement, listing or lease agreement *forms a contract* with an arbitrator.

Thus, the provision itself constitutes a separate and independent agreement between the arbitrator and each person who initials the provision.[2]

An arbitration provision in a real estate purchase agreement or listing:

- forms an arbitration agreement between the arbitrator and each person who agrees to be bound by the provision;[3] and
- defines the arbitrator's powers and the limitations on those powers.

The rights of the person agreeing to arbitration are established by the incorporation in the provision of arbitration statutes, applicable law limitations and discovery policies. Also controlling are the rules adopted by the arbitrator named in the provision, such as the *American Arbitration Association*.

Unless the arbitration provision states an arbitration award is "subject to judicial review," the award resulting from arbitration brought under the clause is **binding and final**, with limited exceptions discussed below.

Without **judicial review** of an award in an arbitration action, the parties have no assurance the award will be either fair or correct —it is *arbitrary* by name.

*Editor's note — **RPI's** purchase agreements and addenda do not contain either an arbitration provision or an attorney fee provision as a matter of policy in an concerted effort to reduce the risk of litigation to brokers and agents by making litigation less economically feasible for sellers and buyers — and their attorneys.*

Limited grounds for correction

Any defect in an arbitrator's award resulting from an error of fact or law, no matter how flagrant, is neither reviewable nor correctable, unless:

- the arbitrator exceeded their authorized powers;
- the arbitrator acted with fraud or corruption;
- the arbitrator failed to disclose grounds for their disqualification of a dispute;
- the award was procured by corruption, fraud or other misconduct; or
- the refusal of the arbitrators to postpone the hearing substantially prejudiced the rights of the party.[4]

2 **Prima Paint Corporation** v. **Flood & Conklin Mfg. Co.** (1967) 388 US 395

3 Calif. Code of Civil Procedure §1297.71

4 CCP §1286.2

An arbitrator, unlike a judge in a court of law, is not bound by the rules of law controlling conduct when arbitrating a dispute. Even when the arbitrator agrees to follow applicable California law, their **erroneous award**, unlike an award of a court, cannot be corrected by any judicial review.

The arbitrator's award is final and binding on all parties, unless:

- the parties have agreed the arbitrator's award is subject to "judicial review"; or
- the arbitrator exceeded their powers set by the arbitration provision.

Otherwise, no judicial oversight exists, by petition or appeal, to correct an arbitrator's *erroneous award*.

The capricious arbitrator's award

Consider a buyer and seller of real estate who enter into a purchase agreement containing an arbitration clause. They both initial the provision.

Prior to closing, the seller discovers the property has significantly greater value than the price the buyer has agreed to pay in the purchase agreement, a condition brought about by a sharply rising real estate market.

Motivated by their belief the property's value will continue to rise to price levels other buyers will be willing to pay, the seller refuses to close the sale.

The buyer files a "demand for arbitration" with the arbitrator, claiming the seller breached the purchase agreement. The buyer no longer wants the property and does not seek their alternative remedy of **specific performance** of the purchase agreement. The buyer seeks only to recover their **money losses** amounting to the difference between the purchase price they agreed to pay and the increased value of the property on the date of the seller's breach.

Prior to completion of the arbitration hearings, the value of the property drops significantly due to a cyclical local economic downturn. The arbitrator is aware the property's current value has fallen below the sales price agreed to in the purchase agreement, as well as the increased value at the time of the seller's breach.

Not the requested award

Continuing our previous example the arbitrator then issues an award in favor of the buyer. However, the award is not for the money losses the buyer asked for and was entitled to. Instead of the requested money award, the arbitrator's award grants the buyer the **right to purchase** the property for a price equal to its current fair market value, a remedy not available under law and not agreed to by the buyer or seller.

The buyer now petitions the court to vacate the arbitration award and remand the case for a money award as requested in the arbitration. The buyer claims the arbitrator exceeded their powers by awarding a result not contemplated by the law controlling the purchase agreement nor sought by the parties.

Did the arbitrator exceed their powers, act corruptly or prejudice the rights of the parties by awarding an equitable remedy (specific performance) which was in absolute conflict with the purchase agreement and beyond any expectations of either the buyer or the seller under applicable law?

No! The arbitrator was not corrupt and did not exceed their powers in awarding the buyer the right to purchase the property at its current market value. The erroneous award was drawn from the arbitrator's (mis)interpretation of the purchase agreement and the law.

Here, the remedy awarded a buyer by an arbitrator in binding arbitration is not reviewable by a court of law as long as the remedy has some remotely conceivable relationship to the contract.[5]

Commercial uncertainty

When individuals enter into a purchase agreement, each person has expectations about their and the other person's performance as defined by the terms of the agreement and set by existing law, also known as **certainty of contract**. Without certainty in the real estate market, contracting to buy and sell becomes a commercial uncertainty, a condition is tantamount to anarchy.

Yet by agreeing in the purchase agreement to binding arbitration, not only is a person forced to accept an arbitrator's incorrect application of law, they are forced to proceed with arbitration and accept an award **impossible to predict**.

Arbitrator's powers exceeded

Although an arbitrator is not bound to follow the law when issuing an award, an arbitrator *exceeds their powers* when they attempt to also **enforce** their award — conduct reserved for a court of law after the award has been reduced to a judgment by the court.[6]

An arbitrator also exceeds their powers when they impose fines on a party to arbitration for failure to comply with the arbitration award. An arbitrator does not have the power to impose **economic sanctions**, such as penalties and fines.

However, if an arbitration agreement authorizes the arbitrator to appoint a receiver or impose fines, the arbitrator then has the power to do so, despite the general prohibition barring arbitrators from enforcing their awards.[7]

Attorney fees as a power

Now consider a buyer and seller who enter into a purchase agreement containing both an arbitration provision, which they all initial, and an **attorney fee provision**. The *attorney fee provision* entitles the party who prevails in an action to be awarded attorney fees.

5 **Advanced Micro Devices, Inc.** v. **Intel Corporation** (1994) 9 C4th 362
6 **Marsch** v. **Williams** (1994) 23 CA4th 238
7 **Mastrobuono** v. **Shearson Lehman Hutton, Inc.** (1995) 514 US 52

attorney fee provision
A provision in a contract specifying the prevailing party to a dispute is to receive attorney fees if litigation results from the contract.

The buyer terminates the purchase agreement and seeks to recover all their transactional costs, claiming the seller breached the agreement. As agreed, the dispute is submitted to binding arbitration. The arbitrator rules in favor of the seller, but denies the seller's request for attorney fees as called for under the attorney fee provision.

The seller seeks a correction of the arbitration award in a court of law, claiming the arbitrator exceeded their powers by denying an award of attorney fees as agreed in the purchase agreement.

Here, the arbitrator exceeded their powers by failing to award attorney fees. The seller, as the prevailing party, was entitled to an award of attorney fees by a provision in the purchase agreement which was the subject of the arbitration. If the agreement underlying the dispute contains an attorney fee provision, the arbitrator will award attorney fees to the prevailing party.[8]

However, the attorney fee dilemma has a flip side. Not only will the arbitrator award attorney fees to the winner if the recovery of fees is called for in the purchase agreement, the arbitrator determines the amount of attorney fees to be awarded — an amount which is not subject to court review.[9]

The myth surrounding arbitration

The real estate market has become flooded with agents and brokers inculcated to reassure their buyers and sellers that initialing the *arbitration provision* is "standard practice." When guidance is given to clients by their agents, it is that arbitration bears multiple benefits with no comment on the risks. This advice is incorrect.

Most homebuyers and misguided real estate agents know little about arbitration beyond the pretext it is less costly and more efficient than litigation. The myth of arbitration's benefits is so ingrained by repetition over time it has become an unquestioned real estate mantra — literally a false fact believed to be true.

Most agents do not have sufficient knowledge or awareness to develop an opinion on arbitration, nor do most buyers and sellers know enough to inquire about it. Thus, arbitration's virtues are passed down as custom, while harmful widespread ignorance of its risks persists among agents and sweatshop brokers. People are harmed by this arrogance.

Mediation buttressed by judicial certainty

Arbitration was born out of a genuine desire to save on court costs, expedite the dispute resolution process and generally improve the efficiency of the real estate marketplace. In practice, however, arbitration often results in absurd legal consequences, in direct conflict with the reasons and practical purposes for its inception. There is a very simple remedy — the soft, more effective medicine of **mediation**.

Mediation is an informal, confidential, non-binding legal process. When agreed to, the buyer and seller are compelled to use it in good faith. Designed

8 **DiMarco** v. **Chaney** (1995) 31 CA4th 1809

9 DiMarco, *supra*

to help the parties reach an accord, mediation puts disputes to rest without litigation, while still allowing for judicial intervention if a resolution cannot be found.

mediation
An informal, non-binding dispute resolution voluntarily agreed to in which a third-party mediator works to bring the disputing parties to their own decision to resolve their dispute.

Rather than requiring parties to a purchase agreement to actively initial away their rights to a fair and reviewable judicial determination, mediation passively allows for a mutually acceptable termination of a dispute.

In the process, a neutral third-party — the mediator — acts as an avuncular facilitator. The mediator encourages the disputing parties to arrive at their own decision. They do this by fostering an environment of discussions, asking questions while listening for a commonality of thoughts needed for settlement and resolution. Mediators are trained to help craft that conclusion and end disputes.

Mediation works

Also, while a mediation agreement requires participation, either party can withdraw from the process.

In addition to these benefits, the use of mediation also provides a solution to a dispute without adding to and falling subject to the backlog of cases burdening the legal system.

Most importantly, mediation works. The Los Angeles Superior court system reports that 63% of cases ordered into mediation are resolved. Nationwide, the mediation success rate ranges between 60%-90%.[10]

Arbitration, like mediation, is a confidential process structured as an alternative to litigating judicially. However, the two parties in contention do not come to their own conclusions in arbitration—the neutral third party appointed to hear the case makes a final decision awarding judgment in favor of one of the parties. This decision is binding under arbitration provisions when included and initialed in purchase agreements. The arbitrator's award, when erroneous, cannot be reviewed and corrected by a court of law.

This finality of an arbitrator's decision naturally causes arbitrators to lack proper care in their decision-making. Appeals to review a faulty decision are prohibited. Thus, an arbitrator's erroneous decision cannot be corrected regardless of how bizarre the outcome may be, for instance, the ordered marriage of the buyer's son to the seller's sister.

The reality of arbitration

The reality about arbitration provisions is that they do not belong in real estate purchase agreements. These provisions are never included in trust deeds, and are hardly ever in rental or lease agreements as all remedies in landlord-tenant law are judicial. They are omitted for good reason since rules of law, not an "arbitrary" arbitrator, need to control results.

Arbitration provisions lead to:

- frequent misapplication and misinterpretation of the law;

10 Final Report of Colorado Governor's Task Force on Civil Justice Reform, Exhibit 7

- erroneous awards;
- a bar to discovery in preparation for hearings;
- waiver of the right to judicial review; and
- a lack of legal precedent for future application to conduct of buyers, sellers, brokers and agents.

Many agents, due to an unfounded fear they might be engaging in the *unauthorized practice of law* or of *killing the deal*, refuse to educate their client on known adverse ramifications of initialing the arbitration provision.

Agents will be left with little room for such error over the next couple of decades. The pricing of property will stabilize under the pressure of rising mortgage rates driven by the fallout from the financial crisis of 2008 of zero-bound interest rates.

Explaining the consequences of an arbitration provision a broker and their agents request their clients to initial is not engaging in the unauthorized practice of law. It is their duty as a fiduciary to explain transaction documentation to the best of their knowledge, nothing less and nothing more. This counseling is sufficient to alert the client to the need for possible further inquiry.

Alternatives to the arbitration provision

The purchase agreement published by CAR includes an arbitration provision, exposing a broker's clients who initial it to the risks of arbitration. However, readily available alternatives exist:

- use a purchase agreement form that does not include an arbitration provision; or
- counsel clients they are not required to initial the provision in order to enter into a binding agreement or to close the deal.

The first solution is a no-brainer. There are many real estate forms superior to those produced by the trade unions which do not include an arbitration provision.

*Editor's note — **RPI** has been publishing California real estate purchase agreements free of the provision since 1978.*

If some brokers stalwartly refuse to change their forms provider, or an agent's broker refuses to permit change, the broker or agent has the ability to:

- inform the client of the consequences involved in agreeing to binding arbitration;
- advise them they are not required to initial the provision to form a binding contract – even if the other party initials the provisions and your client does not;
- verify that a mediation provision is included in the purchase agreement; and
- make sure an attorney fees provision is omitted, to discourage litigation.

To do otherwise is to act at their peril for discouraging resolution of a future dispute and failing to mitigate their risk of involvement in arbitration or litigation.

Avoiding arbitration as a licensee

Consider a broker or agent who becomes a member of a local trade association. As part of the membership agreement, the licensee agrees to binding arbitration for disputes arising between them and other association members.

The arbitration panel that hears and decides disputes between members is composed of other members of the local association who have little to no legal training.

These local arbitration panels frequently base their decisions on moral or social beliefs and local customs they have personally adopted, rather than on controlling legal principles. Preference and bias towards a particular member of the association is more likely since the members of the arbitration panel are acquainted with or know about the members involved in the dispute. Yet, these panels are said to consist of ***"neutral"*** arbitrators.

The panels are also very much aware the decisions they render are not appealable or reversible. Their award is final and binding.

Relinquished rights to a court trial

However, the primary problem with arbitration proceedings heard by a local association's arbitration panel is the feeling held by most brokers and agents compelled to arbitrate that they are being railroaded through a process that disregards their rights, whether or not they are violated.

Further, by becoming a member of a local trade association, brokers and agents are forced to relinquish their rights to a court trial and an appeal to correct an erroneous decision rendered in disputes with other members.

However, brokers and agents employed by a broker who is an association member can avoid the complications imposed on them by membership. To do so, and still comply with their broker's desire to satisfy the local trade association's annual monetary demands arising out of their association with the broker, they can pay the same amount in "nonmember dues" and become "paid nonmembers."[11]

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

Chapter 8 Summary

A form of dispute resolution voluntarily agreed to in contracts authorizing a third-party arbitrator to issue a binding award which cannot be reviewed and corrected by a court of law. Arbitration was born out of a genuine desire to save on court costs, expedite the dispute resolution process and generally improve the efficiency of the real estate marketplace. However, in practice, arbitration often results in absurd legal consequences, in direct conflict with the reasons and practical purposes for its inception.

Arbitration provisions lead to:

- frequent misapplication and misinterpretation of the law;
- erroneous awards;
- a bar to discovery in preparation for hearings;
- waiver of the right to judicial review; and
- a lack of legal precedent for future conduct of buyers, sellers, brokers and agents.

The arbitrator's award is final and binding on all parties, unless:

- the parties have agreed the arbitrator's award is subject to "judicial review"; or
- the arbitrator exceeded their powers set by the arbitration provision.

Alternatively, mediation allows for a mutually acceptable termination of a dispute in which a mediator guides the disputing parties to arrive at their own decision.

To avoid exposing clients to the risk of arbitration, prudent brokers and agents:

- use a purchase agreement form that does not include an arbitration provision; or
- counsel clients they are not required to initial a boilerplate arbitration provision in order to enter into a binding agreement or to close the deal.

Chapter 8 Key Terms

Chapter 9

Time to perform

Learning Objectives

After reading this chapter, you will be able to:

- identify conduct which places a buyer or seller in a real estate transaction in default on a material condition permitting the other person to terminate the purchase agreement;
- establish when a buyer or seller may exercise their right to cancel and terminate a purchase agreement;
- allow for extensions of time to perform to avoid premature termination of a purchase agreement; and
- recognize conduct which constitutes a person's waiver of their right to cancel due to a time-essence provision.

Key Terms

authorization-to-extend provision

condition concurrent

condition precedent

Notice of Cancellation

seller-may-cancel provision

time-essence provision

The litigious time-essence provision

The seemingly harmless **time-is-of-the-essence provision** stands stark amongst the boilerplate provisions of purchase agreement forms purchased by some California publishers, such as the California Association of Realtors (CAR). By its plain words, the *time-essence provision* gives notice to the buyer and seller that their compliance by the date set in other provisions in the purchase agreement which call for an event to occur or an activity to be performed is **essential to the continuation** of the transaction.

time-essence provision
A purchase agreement provision establishing that dates for performance of any activity or occurrence of an event are to be strictly enforced as essential to the continuation of the transaction.

Thus, the apparent bargain built into the purchase agreement by the presence of the time-essence provision gives the buyer or seller the right to **immediately cancel** the transaction on:

- the failure of an event to occur; or
- failure of the other party to act, usually by approval, by the appointed date.

By virtue of the number of tasks a buyer undertakes to close a transaction — contrasted with the very few tasks imposed on a seller — the time-essence clause "stacks the odds" against the buyer. This condition exists even though the buyer and all third-parties involved on their behalf may have acted with diligence at all times, or that a particular event or activity is not material for the transaction to proceed to closing.

Further, for a vast majority of agents who work diligently to clear conditions and close a transaction, the time-essence clause places an unreasonable **risk of cancellation** on a transaction. Foreseeable delays in closing a transaction exist in all real estate sales.

Worse yet, the time-essence clause has, over the years, consistently demonstrated an ability to **produce litigation** over rights to money or ownership which have been lost or forfeited by a cancellation typically initiated by the seller.

*Editor's note — **RPI** purchase agreement forms do not contain a time-essence clause. Instead, the purchase agreements authorize agents to extend performance dates by up to one month, destroying any claim the performance is material and thus cancellation is the appropriate remedy. [See **RPI** Form 150 §10.2]*

Purpose of the time-essence provision

The stated purpose for including a time-essence clause in a purchase agreement is to **protect the seller from delays** in the buyer's payment of the sales price. Delays "tie up" both the seller's ownership of the real estate and receipt of the net sales proceeds beyond the date or period fixed for the transfer of ownership.

Another less logical theory is the purported inability of courts to estimate the compensation owed a seller for losses resulting from a delay in the close of escrow due to the buyer's failure to perform by the date agreed.

However, delays in closing of a few days — or even a few weeks or more — rarely cause any compensable loss of money, property value, rights or property for the person attempting to cancel due to the passing of a performance deadline. Typically, the cancellation by a seller is motivated not by time, but by greater profits to be had elsewhere.

Even if a money loss is incurred due to a delay in performance, the loss is usually sustained by the seller and is easily calculable. Seller losses typically consist of *lost rental value* or *carrying costs* of the property for the period beyond the appointed closing date to the actual date of closing. An infrequent exception which occurs generally arises out of the seller's actions in different transactions, such as the seller's reliance on the closing of a sale to complete some other transaction.

A buyer's losses on a seller's default usually arise out of:

- a missed closing deadline needed in order to receive tax benefits; or
- a locked-in (low) interest rate mortgage.

Termination of rights

An effective **Notice of Cancellation** interferes with the completion of a transaction as initially envisioned by the buyer and seller when they entered into the purchase agreement and escrow instructions.

Notice of Cancellation
A notice from either the buyer or seller given to the other party cancelling the transaction.

On a proper cancellation for cause, the person terminating the purchase agreement transaction **does not need to further perform** any act called for, including the close of escrow. Further, the transaction has been terminated and the obligations of both the buyer and seller to further perform no longer exist. [See **RPI** Form 183]

For example, the person who **properly cancels** a purchase agreement has the unfettered right:

- in the case of a seller, **to retain ownership** or resell the property to other buyers at a higher price; and
- in the case of a buyer, to keep their funds or use them to purchase other property on more favorable terms.

These rights to act, free of purchase agreement and escrow obligations, are the very objectives met by cancelling the purchase and escrow agreements. The alternative to cancelling both agreements is an attempt to keep the transaction together by determining the additional time reasonably needed by the other person to perform as originally contemplated, and then granting an extension of time in which to do so.

If the "grace period" of additional time is granted, and then expires without compliance, a cancellation for failure to perform is understandable by all involved, and enforceable.[1]

Still, an effective **cancellation** by one person forfeits the rights held by the other to close the transaction and receive the benefits bargained for on entering into the purchase agreement. Further, on an effective cancellation, all parties involved are adversely affected by the cancellation's ripple effects since they all lose the time and effort they invested to get the transaction closed, including:

- the agents;
- escrow;
- lender; and
- title company.

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1 **Fowler** v. **Ross** (1983) 142 CA3d 472

For example, when a seller cancels, the buyer loses, by *forfeiture*, their contract right to become the owner of the property. Conversely, if the buyer cancels, the seller loses the right to receive funds and be relieved of the obligation of ownership.

Thus, a cancellation by either the buyer or seller, if proper and enforceable, is the final moment in the life of a purchase agreement and escrow. Cancellation spells the end to all expectations held by everyone directly or indirectly affiliated with the sale.

Editor's note — For simplicity's sake, the following discussion will mostly refer to the timing of a seller's cancellation. However, the discussion fully applies to a buyer's cancellation as well.

Cancellation factors

For a seller to successfully cancel an escrow based on the failure of an event to occur or a condition to be approved, the **purchase agreement** or escrow instructions are to contain:

- a clear **description of the event** which is to occur or the **condition** to be approved;
- an appointed date or **expiration of a time** period by which the event or approval described is to occur; and
- a written provision stating in clear and unmistakable wording, understandable to the buyer, that the seller has the *right to cancel* the transaction as the consequence of a failure of the event or the approval to occur by the appointed date. [See Chapter 7]

If provisions in the purchase agreement or escrow instructions meet all of the above criteria, the seller may **cancel** if:

- the seller has performed all acts which are required to precede, by agreement or necessity, the event or approval triggering the cancellation (in other words, the seller cannot be in default);
- the event or approval **fails to occur** by the appointed date; and
- the seller **performs or stands ready**, willing and able to perform all other acts necessary on the part of the seller to close the transaction on the appointed date for the failed event or approval.

The notice given by the existence of the time-essence provision advises the buyer their performance of the event which is to occur or be brought about by the date scheduled is **critical to the continuation** of the purchase agreement and escrow instructions. Thus, the time-essence provision sets the buyer's reasonable expectations of the consequences of their failure to perform, i.e., the risk that the seller may cancel the transaction and the buyer's right to buy the property will be *forfeited*.

However, the consequences of the failure of the buyer to perform or for an approval or event to occur depend upon the type of **time-related provision** contained in the purchase agreement and escrow instructions.

The different provisions which may be included are:

- a **time-essence provision**, which gives the seller the right to cancel if the event or approval of a condition called for does not occur by an appointed date;
- a **seller-may-cancel contingency** provision, which authorizes the seller to cancel if the condition or event does not occur, whether or not a time-essence clause exists;
- an **authorization-to-extend** provision, which grants the agents the power to extend performance dates up to 30 days (or other wording indicating an accommodation for delays), whether or not a time-essence clause or a *seller-may-cancel clause* exists [See **RPI** Form 150 §10.2]; and
- an *extension of time granted* by the seller, typically in supplemental escrow instructions, with wording imposing strict adherence to the new performance deadlines and authorizing the seller to cancel on expiration of the extension if the event or approval is not forthcoming.

seller-may-cancel provision
A purchase agreement provision authorizing the seller to cancel if a specified condition or event does not occur, whether or not the agreement contains a time-essence provision.

authorization-to-extend provision
A purchase agreement provision granting authority to extend performance dates before the transaction may be cancelled.

Elements of a default

Before either a buyer or seller may effectively cancel a transaction, they are required to *place the other person in default*. Thus, in order for a person to exercise the right to cancel, that person cannot also be in default themselves on the date scheduled for the other person's performance or the event to occur.

For the buyer or seller to place the other in default, three transactional facts need to exist:

- a date crucial to the continuation of the transaction needs to have passed;
- the condition called for in the purchase agreement did not occur by the scheduled date; and
- the person cancelling is required to have fully performed all activities required in order for the other person to perform by the scheduled date, called **conditions precedent**, and have performed or be ready, willing and able to perform, at the time of cancellation, all activities they were obligated to perform in order to close escrow, called **conditions concurrent**. [See Chapter 7]

Was the cancellation timely?

The **setting of a time** for an act or event to occur does not, by itself, automatically allow a purchase agreement transaction to be terminated by one person when the appointed date has passed and the other person has not yet performed.

To permit a cancellation immediately following the expiration of the appointed time for performance, the purchase agreement or escrow instructions needs to clearly state it is the intention of both parties that the failure by one or the other person to perform by the appointed day is to subject their contract rights to forfeiture.

Thus, clear cut wording throughout the purchase and escrow documents needs to consistently manifest an intent to **make time for performance crucial** to the continued existence of the transaction. If not, the appointed date has insufficient significance to justify instant cancellation.

For example, sometimes the only wording regarding any right to cancel a transaction appears in the escrow instructions. Escrow is generally instructed to close at any time after the date scheduled for closing if escrow is in a position to do so, provided escrow has not yet received instructions to cancel escrow and return documents and funds.

Thus, in this example, neither the purchase agreement nor the escrow instructions contain a clause stating "time is of the essence in this agreement." Further, no clear, unequivocal or unmistakable wording in any contingency provision shows an intent on the part of the buyer and seller to make time of the essence, such as wording giving the seller or buyer the "right to cancel" on the failure of either the other person to perform a described activity or for an event to occur by a scheduled date.

Under these examples, which lack time-essence provisions, the time appointed for the delivery of such items as funds for closing or clearance of encumbrances from title is merely a "target date" preliminary to establishing the right to cancel.

Time to close extended by notice

To establish the **right to cancel** when time is not stated or established in the purchase agreement or escrow instructions as crucial, the person in default needs to be **given notice** that the date set as the "new deadline" will be strictly adhered to.

Further, the person in default needs to be given a realistic period of time after receiving a notice to perform before any cancellation is considered effective. Continued nonperformance past the new deadline date noticed will be treated as a **default** and escrow may immediately be canceled. [See Form 181-1 accompanying this chapter]

For example, a purchase agreement calls for a buyer to close escrow within 45 days after acceptance. No time-essence clause, cancellation provisions or agent *authorization to extend* performance dates exists. [See **RPI** Form 150 §12.2]

The seller agrees with the buyer's request to extend the date of closing an additional 30 days during which the buyer is to complete their arrangements to close escrow. Two days after the extension expires, the seller cancels the transaction.

Is the seller's cancellation of the transaction effective?

Yes! The 30-day extension was a **reasonable amount of time** for the buyer to perform before the seller **exercised** their right to cancel. A further unilateral extension of time is not needed for the cancellation to be reasonable and effective.[2]

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2 Fowler, *supra*

Form 181-1

Notice To Perform And Intent To Cancel

NOTICE TO PERFORM AND INTENT TO CANCEL

NOTE: This form is used by the agent of the party seeking performance under a purchase agreement when the other party has failed to perform, to notify the other party the agreement will be cancelled if they fail to perform by a specified date.

DATE: _____________, 20______, at ____, California.

1. This notice regards the performance of a Purchase Agreement

1.1 entered into between ____, as the Seller,

and ____, as the Buyer,

1.2 dated ____________, 20_____, at ____, California,

1.3 regarding real estate referred to as ____, and

1.4 escrowed with ____,

escrow number ________________________, under instructions dated __________________, 20_______.

NOTICE TO PERFORM:

2. Demand is hereby made on you under the above referenced agreement and escrow instructions to perform

2.1 on or before ________________, 20______,

2.2 as follows: ____

____

____

____

____

____

____

____

____

____

____

____

3. It is the intent of the undersigned to cancel this transaction if the performance demanded of you in this notice does not occur during the time period given.

I agree to this notice.
Date: ____________________, 20 __________
By: ____

Signature: ____
By: ____

Signature: ____

FORM 181-1 09-15

The seller on notice

Consider an example of strict compliance with performance dates established as "deadlines," after which the purchase agreement and escrow are able to be terminated by cancellation for failure of the described activity or event to take place. The purchase agreement contains a simple time-essence clause. Authority is not granted to the agents to extend performance dates if the appointed date for performance proves to be an inadequate amount of time for either the buyer or seller to complete or bring about all of their closing activities.

Consistent with the time-essence clause in the purchase agreement, the escrow instructions authorize escrow to close at any time after expiration of the escrow period, unless escrow receives instructions calling for the return of documents and funds.

One day after the passing of the date scheduled for closing, the buyer cancels escrow. Twelve days later, the seller, using diligence at all times, is able to clear title and close. The seller challenges the buyer's cancellation as premature and ineffective, claiming the buyer is required to grant the additional time needed to close escrow before the buyer is able to **forfeit the seller's right** to enforce the buyer's promise to purchase the property.

Is the seller entitled to the additional time needed to close escrow?

No! The seller was **on notice** by the existence of the time-essence clause in the purchase agreement and the wording of the escrow instructions that the buyer had the right to cancel on failure of escrow to close by the date scheduled. No provision in any document expressed an intent which was contrary to the time-essence provision in the purchase agreement.

Thus, the buyer's cancellation, one day after the appointed closing date, was in accordance with the **intent stated** in the purchase agreement and escrow instructions, i.e., that timely performance was essential to the continuation of the agreement.

More importantly, **escrow was authorized** to return the money and instruments on the demand of either the buyer or seller if the closing did not occur on or before the date set. Thus, the buyer was not required to grant the additional time reasonably necessary for the seller to close the transaction.[3]

Intent in conflict with time-essence clause

Consider a sale under a purchase agreement which contains a provision **authorizing the agents to extend** the time for performance of any act for a "period not to exceed one month." The purchase agreement also includes a boilerplate provision that "time is the essence of this agreement."

Escrow is for a 60-day period, the end of which is the appointed date for closing the transaction. As usual, the escrow instructions state escrow may close at any time after the date scheduled for closing, unless instructions to the contrary have been received.

On the date scheduled for closing, escrow is not in a position to close due to the buyer's inability to immediately record their purchase-assist loan. The seller immediately cancels escrow in an attempt to terminate the transaction, claiming time was of the essence by agreement.

Is the seller able to cancel without giving an extension of time when both a time-essence and an authority-to-extend provision exist?

No! The bargain struck by the conflicting provisions controlling performance dates did not contemplate time for the occurrence of activities or events by their appointed dates to be so essential that the transaction may be cancelled on the mere passing of the appointed date. The use of a purchase agreement (or escrow instructions) containing wording that "time is of the essence" does not allow for the forfeiture of contract rights on a failure to perform within the agreed time period when **other provisions express a contrary intent**.

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3 **Ward** v. **Downey** (1950) 95 CA2d 680

10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

Figure 1

Excerpt of Form 150

Purchase Agreement

When logically possible, courts ignore boilerplate time-essence clauses and enforce the original bargain, if no financial harm results from the delay.

Here, the purchase agreement (or escrow instructions) gave the agents the unconditional right to extend performance dates. Thus, being able to close by the date set for closing escrow is hardly considered crucial to the continued viability of the transaction. Accordingly, the seller has to give the buyer a **reasonable amount of time** to close escrow, i.e., the additional days needed to record the buyer's loan before the buyer's failure to perform justified exercising any cancellation rights. [See Form 181-1]

Default needed to justify cancellation

Before a buyer or seller may consider cancelling a transaction, the other person has to have **defaulted** on their completion of an activity or an event has failed to occur.

For example, a seller cancels a 30-day escrow the day after the date it is scheduled to close. The purchase agreement granted the agents authorization to extend performance dates, including the date for closing, up to 30 days. [See Figure 1]

Thirty-three days later, for a total of 63 days from the date of acceptance, the buyer, using diligence in the pursuit of a loan, obtains final loan approval and has all the funds needed to close escrow.

Is the seller's cancellation effective without first giving an extension of additional time for closing when the buyer has not performed by the date scheduled for the close of escrow?

No! The buyer is not yet in default. Sixty-three days is a reasonable period of time for the buyer to obtain the purchase-assist mortgage funds agreed to in the purchase agreement. Most instructive for buyers and agents, time for closing was not made crucial to the continuation of the agreement.

Thus, a reasonable period of time has to pass before the buyer is in default. Only when the buyer is in default on expiration of a reasonable time extension may the seller **exercise** their right to cancel.[4]

Reasonable period to open escrow

Now consider an agent who prepares a purchase agreement and inadvertently fails to set a fixed time period for the opening of escrow. However, the purchase agreement does state an appointed date for closing escrow as 60 days from the date the purchase agreement was entered into.

4 **Henry** v. **Sharma** (1984) 154 CA3d 665

The buyer fails to sign and return escrow instructions to open escrow. The seller cancels the transaction 12 days after the date escrow was scheduled to close.

Was the buyer in default at the time of cancellation?

Yes! The buyer was in default for their failure to sign and return escrow instructions. The buyer had an obligation to open escrow within an unstated period of time. Since the time for opening escrow was not agreed to, a **reasonable period of time** for opening escrow is allowed.

A reasonable period for opening escrow is a date sufficiently in advance of the date set for the close of escrow to give escrow enough time to perform its tasks by the date scheduled for closing. The cancellation 12 days after the closing date was effective to terminate the transaction. A reasonable period for the buyer to open escrow ended well before the scheduled closing date.

The buyer, having failed to open escrow before the closing date, was in default on the closing date. Thus, the buyer lost their right to buy the property since they did not cure the default by opening escrow before the date set for closing and the seller's cancellation.[5]

However, a one day delay by a buyer before signing and delivering instructions to open escrow does not allow a seller to cancel the transaction and avoid closing escrow. Reasonably, a **one day delay in opening escrow** is not a default at all, even when time is unequivocally declared to be of the essence in the purchase agreement.

To cancel you need to first perform

Consider a seller who wants to cancel a transaction since the buyer is in default under the purchase agreement or escrow instructions. Before the seller may cancel, the seller is required to:

- **perform all acts** and cause all events to occur which, by agreement or necessity, are the seller's obligation and need to occur before the buyer becomes obligated to perform, called **conditions precedent**, such as delivering disclosures, reports, etc., or completing repairs requiring the buyer's approval [See Chapter 7];
- **fully perform all activities** and obligations imposed on the seller which are to **occur at the same time** as the buyer's performance, without concern for whether the buyer has performed, called **conditions concurrent**, such as handing escrow a grant deed and all other information and items required of the seller for escrow to clear title and close [See Chapter 7]; and
- **perform or demonstrate** they are able to perform all other activities or bring about events which are the obligation of the seller for closing the transaction, whether or not the buyer ever performs, called **conditions subsequent**, such as meeting any requirements of the buyer's lender for repairs or clearances.

condition precedent
A purchase agreement provision requiring the occurrence of an event or performance of an act by the other party before the buyer or seller is required to further perform.

condition concurrent
A purchase agreement provision requiring performance of an activity by a buyer or seller without concern for the performance of the other party.

5 **Consolidated World Investments, Inc.** v. **Lido Preferred Ltd.** (1992) 9 CA4th 373

Thus, while the buyer may have failed to perform by the time agreed, the seller may not cancel until the seller has performed or stands ready, willing and able to perform under the above three conditions (precedent, concurrent and subsequent), conditions which exist in most purchase agreements and escrow instructions.

When failure to fund is not a default

On the date set for the close of escrow, buyers often have not deposited their down payment funds into escrow as called for in the purchase agreement and escrow instructions. When the deposit of closing funds or the lender's wire of loan funds does not occur as scheduled, the buyer clearly has not yet performed their obligation to close escrow. However, the failure to fund does not necessarily mean the buyer is in default.

The question which arises for a seller who is attempting to cancel when time has been established as essential and the buyer or the buyer's lender has not delivered closing funds, is whether the buyer is either in **default** or is **not yet obligated** to deposit funds.

Escrow, as a matter of custom, will not call for a wire of closing funds from the mortgage lender or the buyer until **escrow is in a position to close**. Escrows, as an entirely practical matter, do not want closing funds sitting in an escrow which is not yet ready to close.

Specifically, before escrow calls for closing funds, the seller needs to have already fully performed by providing documents so the conveyance of title is able to be insured and property clearances, prorates and adjustments may be delivered and accounted for as called for in the escrow instructions. If the seller has not delivered instruments so escrow is able to be in a position to close by the date scheduled for closing, escrow will not make a demand on the buyer or lender for funds.

Thus, the buyer has no obligation to deposit any money into escrow and is not in default until escrow has received the lender's documents and requests the buyer's funds. Until the buyer is in default due to a failure to timely respond to escrow's request for funds, any attempt by the seller to cancel is premature and ineffective.

A condition precedent

Escrow instructions usually state the buyer is to deposit funds for use by escrow **provided the seller has performed**. Thus, the obligation of the buyer to deposit closing funds is subject to the seller first performing, a *condition precedent* to the buyer's performance. Therefore, the buyer's "failure" to deposit funds before escrow is in a position to close is **excused**. [See **RPI** Form 150 §12.2]

Consider a seller who is unable to convey title to a buyer and deliver a title insurance policy by the closing date called for in the purchase agreement and escrow instructions. The title company cannot issue a policy as ordered due to encumbrances affecting title which have not been released and the amounts needed for discharge and payoff have not yet been determined.

Here, the time for closing has arrived and the seller cannot deliver a marketable title as agreed. Thus, until the seller obtains title insurance for their deed, the buyer is not in default for not yet depositing their funds.

Cancellation right waived by conduct

Even when the date scheduled for a buyer or seller to perform is established as crucial, **inconsistent conduct** by the person entitled to cancel constitutes a **waiver** of their right to cancel. Once the right to immediately cancel has been waived, the person who failed to perform by the agreed deadline is **no longer in default**. Until the person who failed to perform is placed in default again, the right to cancel cannot be exercised.

For example, the date set for escrow to close arrives. The seller has not yet handed escrow clearances which are required before escrow may close.

A few days after escrow is scheduled to close, the seller deposits the clearances with escrow. The buyer then deposits their closing funds on a call from escrow.

Two days later, the seller cancels escrow, claiming the buyer was in default since they failed to deposit their funds by the appointed date.

Here, the cancellation is ineffective and the buyer is entitled to close escrow. The seller **waived their right** to cancel, time having been of the essence, by conducting themselves without concern for the passing of the appointed date for closing. The seller failed to deliver documents or information sufficiently in advance for escrow to meet the deadline.[6]

Affirmative conduct by the person entitled to cancel

However, a **waiver by inaction** does not occur simply because a person's right to cancel the transaction is not immediately exercised on the failure of the other person to perform or an event to occur. **Affirmative conduct** needs to occur by the person entitled to cancel, not just mere inaction, before the right to cancel under a time-essence situation is waived.

After a waiver of a date scheduled for approval of a condition or occurrence of an event, time needs to be **reinstated as crucial** to the continuance of the transaction, or a reasonable, additional period of time needs to have passed after waiver of the right to cancel, before the transaction can be cancelled.

Time is best reinstated as essential to the continuation of the transaction by notifying the person who needs to perform they are required to perform by the end of an additional period of time, set with sufficient duration as needed to provide them with a realistic opportunity to perform.

If performance is not forthcoming during the additional period of time, the transaction may be promptly cancelled since **strict compliance** with the extension is now enforceable.

6 **Katemis** v. **Westerlind** (1953) 120 CA2d 537

Chapter 9 Summary

A time-essence provision gives notice to the buyer and seller that their compliance by a set time for an event to occur or a condition to be met is essential to the continuation of the transaction. For a vast majority of agents who work diligently to clear conditions and close a transaction, the time-essence clause places a risk of cancellation on a transaction. However, foreseeable delays in closing a transaction exist in all real estate sales.

An effective Notice of Cancellation interferes with the completion of a transaction as initially envisioned by the buyer and seller at the time they entered into the purchase agreement and escrow instructions. On a proper cancellation, the person terminating the purchase agreement does not need to further perform any act called for, including the close of escrow. Further, the transaction has been terminated and the obligations of both the buyer and seller to further perform no longer exist.

To establish the right to cancel when time is not stated or established in the purchase agreement or escrow instructions as crucial, the party in default needs to be given notice that the date set as the "new deadline" will be strictly adhered to. Further, the person in default needs to be given a realistic period of time after being given a notice to perform before any cancellation is considered effective.

Before either a buyer or seller may effectively cancel a transaction, they are required to "place the other person in default" and cannot also be in default themselves on the date scheduled for the other person's performance or the event to occur. For the buyer or seller to place the other in default, three transactional facts need to exist:

- a date crucial to the continuation of the transaction needs to have passed;
- the condition called for in the purchase agreement did not occur by the scheduled date; and
- the person canceling is required to have fully performed all activities required and be ready, willing and able to perform, at the time of cancellation, all activities they were obligated to perform in order to close escrow.

Even when the date scheduled for a buyer or seller to perform is established as crucial, inconsistent conduct by the person entitled to cancel constitutes a waiver of their right to cancel. Once the right to immediately cancel has been waived, the person who failed to perform by the agreed deadline is no longer in default. Until the person who failed to perform is placed in default again, the right to cancel cannot be exercised.

Chapter 9 Key Terms

Chapter 10

Options and the right of first refusal to buy

Learning Objectives

After reading this chapter, you will be able to:

- identify and differentiate between the various agreements granting a tenant the right to buy;
- understand how different lease provisions impact the right to buy; and
- advise tenants how to properly exercise their right to buy agreements.

Key Terms

call option
option period
option to buy
option to extend
option to renew
right of first refusal

Tenants with rights to acquire the premises

Tenants often need to invest substantial dollar amounts in tenant improvements to tailor newly leased premises to their needs. Whether contracted for by the tenant or the landlord, the tenant pays for the improvements in:

- a lump sum;
- upfront expenditures; or
- payments amortized over the initial term of the lease, calculated by the landlord and included in the monthly rent.

Installation of racks, cabinets, shelving, trade fixtures, lighting and other interior tenant improvements will also be paid for by the tenant. Further, the business builds up a significant degree of goodwill with customers due to the fixed location over a number of years. Thus, the location and improvements become part of the income generating value of the tenant's business.

option to extend
An agreement granting a tenant the right to extend possession under the original lease agreement on terms set out in the option to extend.

All these expenditures will be lost if the landlord refuses to extend the lease, or if their demands for increased rent under an **option to extend** the lease compel the tenant to relocate. A retail tenant with even a small degree of insight into their future operations at the location will attempt to negotiate some sort of option to purchase the property.

The tenant who has paid rent that includes the amortization of TIs paid by the landlord needs to negotiate an *option to extend* at a lesser rental rate than during the initial term. Here the tenant has already paid for the tenant improvements on the property, a monthly payment that should not be again paid under an option to extend or renew the lease.

An option to purchase included in a lease agreement is distinct from:

- the purchase rights held by a tenant under a right of first refusal; or
- the ownership rights held by a buyer under a lease-option sales arrangement. [See **RPI** Form 163]

Option to buy vs. right of first refusal

A landlord grants a tenant an option to purchase by entering into either:

- an irrevocable right to buy the property within a specific time period, called an **option to buy**; or
- a pre-emptive right to buy the property if the landlord later decides to sell the property, called a **right of first refusal**.

option to buy
An agreement granting an irrevocable right to buy property within a specific time period.

right of first refusal
A pre-emptive right to buy a property if the owner decides to sell.

The *option to buy* is typically evidenced by a separate agreement attached to the lease agreement. An option to buy includes terms of purchase, none of which are related to the lease of the property. The option to buy is to always be referenced in the lease agreement and attached as an addendum.

An option to buy contains all terms needed to form an enforceable purchase agreement for the acquisition of the real estate. The tenant holding an option to buy has the discretionary right to buy or not to buy on the sales terms stated in the option. To exercise the option, the tenant needs to do so within an agreed-to time period. No variations are allowed. Thus, the option is a purchase agreement offer irrevocably agreed to by the seller to sell, but the buyer has not agreed to buy. [See Form 161 accompanying this chapter]

To actually buy the property under an option, the tenant exercises their right to buy through acceptance of the irrevocable offer to sell granted by the option. Conversely, the *right of first refusal* is a short agreement with its provisions either included in the body of the lease agreement or by an addendum. Unlike the option to buy, the right of first refusal provisions rarely contain any terms of a sale.

The option agreement

Under an option to buy agreement, the tenant is not obligated to buy the leased property. The tenant is merely given the right to buy if they so choose. This is a type of **call option**. [See **RPI** Form 163]

For the option to be enforceable, the purchase price of the property and terms of payment on exercise of the option need to be included in the option agreement. If the dollar amount is not set as a specific amount in the option agreement, the purchase price may be stated as the fair market value of the property at the time the option is exercised.

call option
An agreement giving a buyer the right to buy property within a specified time or upon an event at a specified price with terms for payment.

The right to buy needs to be exercised by the tenant within a specified time period, called the **option period**. The option period typically runs until the lease expires, including extensions/renewals, or is terminated. [See Form 161 §4]

option period
The specified time period during which the tenant can exercise their right to buy under an option agreement.

If the option is not exercised precisely as agreed during the *option period*, the option period expires of its own accord. On expiration, the option no longer exists and the tenant is without an enforceable right to acquire the property.[1]

When options to renew or extend are negotiated as part of the leasing arrangements, the expiration of the option to buy is tied by agreement to either:

- the expiration of the initial lease term; or
- the expiration of any renewal, extension or continuation of the tenant's lawful possession.

For example, a tenant rents space under a ten-year lease with an *option to extend* the term of the lease. The tenant also holds an option to buy the leased property. The option references the lease term as the period for exercise of the option to buy.

If the lease is later extended, the option period is automatically extended with the extension of the lease. Here, the option to buy allows the tenant to exercise the option during the lease term which includes any extensions.[2]

Now consider a lease agreement which contains an **option to renew** the lease agreement instead of an option to extend. This is a distinction with a complication. The renewal option requires the preparation and signing of a new lease agreement on identical terms to the original lease agreement. The initial lease agreement, by way of a referenced attachment, provided the tenant with an option to buy which can be exercised prior to the expiration of the lease.

option to renew
An agreement granting a tenant the right to continue in possession upon expiration of the existing lease under a new lease agreement on the same conditions as the expiring lease agreement on terms for payment of rent set out in the option to renew.

On renewal of the lease agreement, the tenant needs to ensure the option to buy is not left to expire at the end of the initial lease term. The new lease agreement is a different contract and needs to also reference the option to buy (as part of the identical terms of the original lease) since a new lease is not an extension of any of the terms of the original lease.[3]

1 **Bekins Moving & Storage Co.** v. **Prudential Insurance Company of America** (1985) 176 CA3d 245
2 **In re Marriage of Joaquin** (1987) 193 CA3d 1529
3 In re Marriage of Joaquin, *supra*

Form 161

Standard Option to Purchase

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STANDARD OPTION TO PURCHASE
Irrevocable Right-to-Buy

NOTE: This form is used by a leasing or sales agent when offers to rent or buy a property include a purchase option exercisable without extensions, to prepare an option as an irrevocable offer to sell with a price and terms for payment exercisable during a single period as an attachment to a lease agreement or an offer to grant an option.

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

1. **OPTION MONEY:**
Optionor herewith receives from Optionee option money in the amount of $_____________________, evidenced by: ☐ cash, ☐ check, or ☐ ________________________, given in consideration for this option to purchase real property.
2. **REAL PROPERTY UNDER OPTION:**
Address ____
Legal description/Assessor's parcel number ____
3. **ADDITIONAL CONSIDERATION:**
As further consideration for this option, Optionee is to obtain at their expense and deliver to Optionor prior to expiration % of this option the following checked items regarding the property:
☐ Property survey report by licensed California surveyors ☐ Off-site improvement plans
☐ Architectural plans and specifications ☐ Soil engineer's report
☐ On-site engineering plans ☐ Land use study
☐ Zoning ordinance request ☐ Application for a conditional use permit
☐ Application for a parcel map or waiver ☐ ______________________________________
4. **OPTION PERIOD:**
Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property on the terms stated, for a period commencing with the acceptance of this option and expiring ________________, 20_____, or ☐ on termination of Optionee's leasehold interest in the property.
5. **EXERCISE OF OPTION:**
Optionee may exercise this option during the option period by:
5.1 Signing escrow instructions identical in provisions to those attached as **Exhibit A** and delivering the instructions to escrow [See **RPI** Form 401];
5.2 Depositing cash in escrow of $______________; and
5.3 Delivering an escrow-certified copy of the signed escrow instructions to Optionor within the option period, in person or by both certified and regular mail.
6. **ESCROW CONTRACT:**
In the event this option is exercised, the transaction will be escrowed with ______________________________.
6.1 Escrow will close within ______ days after exercise.
7. **DELIVERY OF TITLE:**
On Optionee's exercise of this option, Optionor will timely place all documents and instruments into escrow required of the Optionor as necessary for escrow to close as scheduled.
8. **BROKERAGE FEE:**
Optionor agrees to pay a brokerage fee of $_____________, or ______% of the selling price, IF:
8.1 This option is exercised;
8.2 Within one year after expiration of option period and any extension or renewal, Optionor enters into an agreement to option, sell, lease or exchange with Optionee, or their assigns or successors; or
8.3 Optionor wrongfully prevents the exercise of this option:
8.4 Fee payable to Broker(s) ____,
8.5 Optionor and Optionee acknowledge receipt of the Agency Law Disclosure. [See **RPI** Form 305]
9. **SALE TERMS:**
Price of $______________ payable as follows:
9.1 ☐ All cash.
9.2 Cash down payment in the amount of $______________.
9.3 ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by___________________________, with an unpaid principal balance of $______________, payable $______________ monthly, including interest not exceeding _____%, ☐ ARM, type ________________________, plus a monthly tax/insurance impound payment of $______________. ______________________________________
a. At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price. [See **RPI** Form 415]
b. The impound account to be transferred: ☐ charged, or ☐ without charge, to Optionee.

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The right of first refusal to buy

A tenant's right to buy under a right of first refusal agreement can be triggered by any indication of the landlord's decision to sell the property, including:

- listing or advertising the property for sale;
- offering the property for sale to a buyer;
- accepting an offer or making a counteroffer involving a sale to a buyer; and
- granting a purchase option.

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9.4 ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ________________________, with an unpaid principal balance of $_______________, payable $_______________ monthly, including interest not exceeding ______%, ☐ ARM, type ______________________________, due _______________, 20______.

9.5 A note for the balance of the purchase price in the amount of $_______________ to be executed by Optionee in favor of Optionor and secured by a trust deed on the property junior to the above referenced financing, payable $_______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due ____________ years after closing.

a. This note and trust deed to contain provisions to be provided by Optionor for:
☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐____

b. ☐ The attached Financial Disclosure Statement is an addendum to this agreement (mandatory on four-or-less residential units). [See **RPI** Form 300]

c. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **RPI** Form 412]

10. GENERAL PROVISONS:

10.1 ☐ **See attached addendum for additional provisions.** [See **RPI** Form 250]

10.2 Attached as addenda are the following checked disclosures mandated on four-or-less residential units:

a. ☐ Condition of Property Disclosure — Transfer Disclosure Statement (TDS) [See **RPI** Form 304]

b. ☐ Natural Hazard Disclosure Statement [See **RPI** Form 314]

c. ☐ Disclosure of Sexual Predator Database [See **RPI** Form 319]

d. ☐ Hazard Disclosure Booklet, and related Optionor disclosures, containing Environmental Hazards, Lead-based Paint and Earthquake Safety [See **RPI** Forms 313 and 315]

e. ☐ Documentation on any Homeowners' Association (HOA) involved. [See **RPI** Form 309]

f. ☐ Notice of Supplemental Property Tax Bill [See **RPI** Form 317]

10.3 Possession of the property to be delivered on:
☐ close of escrow, or ☐ see attached Occupancy Agreement. [See **RPI** Forms 271 and 272]

10.4 Both parties reserve their rights to assign, and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice.

11. EXPIRATION OF OPTION:

This offer to sell will be deemed expired if not accepted by exercise during the option period.

11.1 This option contract will automatically terminate by expiration on _____________, 20______.

OPTIONOR'S BROKER:__________________________	**OPTIONEE'S BROKER:**__________________________
Broker's CalBRE #: __________________________	Broker's CalBRE #: __________________________
Buyer's Agent: __________________________	Agent's Name: __________________________
Agent's CalBRE #: __________________________	Agent's CalBRE #: __________________________
Signature: __________________________	Signature: __________________________
Is the agent of: ☐ Optionor exclusively ☐ Both Optionor and Optionee.	Is the agent of: ☐ Optionee exclusively. ☐ Both Optionor and Optionee.
Address: __________________________ __________________________	Address: __________________________ __________________________
Phone: ______________ Cell: ______________	Phone: ______________ Cell: ______________
Email: __________________________	Email: __________________________
I hereby grant this option and agree to the terms stated above.	**I hereby accept this option and agree to the terms stated above.**
Date: ______________ , 20_______	Date: ______________, 20________
Optionor: __________________________	Optionee: __________________________
Signature: __________________________	Signature: __________________________
Signature: __________________________	Signature: __________________________
Address:__________________________ __________________________	Address: __________________________ __________________________
Phone: ______________ Fax: ______________	Phone: ______________ Fax: ______________
Email: __________________________	Email: __________________________

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Form 161

Standard Option to Purchase

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As shown, the landlord does not need to first agree to sell the leased property by entering into a purchase agreement with another person to trigger the right of first refusal.

For example, a buyer contacts the landlord of leased commercial property to make an offer to purchase the property. The buyer is informed the major tenant holds the right to buy the property under a right of first refusal provision in the lease.

The buyer attempts to circumvent the right of first refusal by negotiating an option to buy the property, exercisable only after the tenant's right of first refusal expires. The landlord grants the buyer an option to buy the property. The granting of the option — an irrevocable offer to sell — now binds the landlord unconditionally to sell the property if the option is exercised.

Here, the landlord's granting of the option to sell the property is a clear indication of their intention to sell, triggering the right of first refusal. The tenant is now allowed to purchase the property on the same terms as contained in the buyer's option.[4]

Editor's note — The right of first refusal is not triggered by conveyance of the property to the landlord's heirs on the landlord's death. The heirs take title subject to the right of first refusal. However, the right of first refusal is triggered by a sale of the property ordered by the probate court or entered into by the heirs. To exercise the right of first refusal, the tenant needs to match the highest offer submitted in open bidding and approved by the court, or the listing or sale of the property by an executor.[5]

Once notice of the landlord's decision to sell is delivered to the tenant, the right of first refusal is transformed into an option to buy. Control of the transaction then passes to the tenant holding the right of first refusal. The tenant's position under the right of first refusal is converted to that of an optionee on terms set by the landlord, unless the right of first refusal provisions set some or all of the terms.

The landlord may not now retract their decision to sell the property without breaching the right of first refusal provision.

Matching the back-up offer

The landlord subject to a right of first refusal held by a tenant is obligated to notify the tenant of the terms of any sales listing, option to buy, offer to purchase, counteroffer or acceptance of an offer to purchase which triggers the tenant's right to buy under the right of first refusal provision. [See Form 579 accompanying this chapter]

The tenant who decides to purchase the property needs to then agree to match the sales terms within the time period set in the right of first refusal provision. Failure to do so is a failure to exercise their right of first refusal, resulting in a loss of their right to buy.

Consider a tenant who holds a right of first refusal on the industrial property they lease. A buyer makes an offer to purchase the property. The terms for the payment of the price in the buyer's offer include cash and an assumption of the existing first trust deed on the property.

The property is also encumbered with a nonrecourse second trust deed to be paid off and reconveyed on closing under the terms of the buyer's offer. The landlord accepts the offer and notifies the tenant, giving the tenant the opportunity to match the buyer's offer under the right of first refusal provision in the lease agreement.

4 **Rollins** v. **Stokes** (1981) 123 CA3d 701

5 **Estate of Patterson** (1980) 108 CA3d 197

Form 579

Right of First Refusal to Buy

RIGHT OF FIRST REFUSAL TO BUY

Addendum

NOTE: This form is used by a leasing agent or prospective tenant when negotiating a rental or lease agreement, to provide in an addendum the landlord's grant to the tenant of a right of first refusal to purchase the leased premises.

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

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a rental or lease agreement

1.1 ☐ of same date, or dated _____________, 20______, at _________________________, California,
1.2 entered into by ____, as the Tenant, and
1.3 ____, as the Landlord,
1.4 regarding the leased premises referred to as ____
____.

AGREEMENT:

In addition to the terms of the agreement referenced above, Tenant and Landlord agree to the following.

Right of first refusal to buy:

2. Landlord hereby grants Tenant a right of first refusal to purchase the leased premises, for a term commencing _____________, 20______, and expiring ____________, 20______, or ☐ on termination of Tenant's right of occupancy.

3. If Landlord decides to sell the premises during the term of Tenant's right of first refusal, Landlord will notify Tenant of the terms on which Landlord is willing to sell. [See **RPI** Form 579-2]

3.1 Tenant has the option, for a period of ______ days after receiving Landlord's written notice sent by certified mail or personal delivery, to agree to purchase the premises on the terms stated in the notice.

3.2 If Tenant fails to exercise the option within the option period, Landlord has the right to sell the premises to a third party on the same terms stated in Landlord's notice to Tenant.

3.3 Any sale on different terms reinstates the Tenant's right of first refusal.

4. If Landlord has not closed a sale of the property within six (6) ______ months after Tenant's receipt of Landlord's notice, Tenant's right of first refusal is reinstated.

5. ____
____
____
____
____

Tenant	Landlord
Tenant: I agree to the terms stated above.	**Landlord: I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**RPI** Form 251]	☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: ______________, 20_______	Date: ______________, 20_______
Tenant: ______________________	Landlord: ______________________
By: ______________________	By: ______________________
Tenant: ______________________	Landlord: ______________________
By: ______________________	By: ______________________

FORM 579 03-15

The tenant exercises their right of first refusal by agreeing to purchase the property at the same price. However, the tenant alters the terms for payment of that price as they will assume both the existing first trust deed and nonrecourse second, paying the remainder of the price in cash.

The landlord rejects the tenant's conditions and refuses to sell to the tenant.

Here, the landlord needs to comply with the tenant's terms for payment of the price since they are the financial equivalent of the proposed sale. The tenant need merely provide the same net financial result to the landlord as the offer being matched — a cash-out of the landlord's equity in the property.

The tenant's performance under the right of first refusal does not need to be identical in all aspects to the buyer's offer.

Thus, the landlord needs to perform and deliver title to the tenant. Here the landlord's net proceeds, economic benefits and liabilities resulting from the terms for performance set by the tenant are the same as those the landlord experiences under the purchase offer which triggered the right of first refusal.[6]

Now consider a buyer who offers to purchase property leased to a tenant who holds a right of first refusal. The terms in the buyer's purchase agreement call for a cash down payment and a note executed by the buyer for the balance of the landlord's equity. The note is to be secured by a trust deed on other property with adequate value as security.

The landlord accepts the offer and notifies the tenant, who agrees to match the buyer's offer. However, the value of the property offered by the tenant as security is inadequate, causing the landlord to refuse to accept it.

Here, the tenant's offer is not financially equivalent to the buyer's offer since the value of the security offered by the tenant is inadequate, even if the note is identical. In the tenant's offer, the risk of loss on default has been increased.

The landlord is not obligated to accept the tenant's deficient exercise of their preemptive right to buy. Here, the tenant's deficient offer constitutes a waiver of the tenant's right to buy. The landlord may now sell the property to the buyer — but only on the terms initially agreed to with the buyer or the right of first refusal is reinstated.[7]

Reinstatement of the right of first refusal

A right of first refusal provision is automatically reinstated when:

- the landlord agrees to sell the property on terms different from those terms offered to the tenant; or
- the property remains unsold after the running of an agreed-to period of time following the tenant's waiver of the right to buy. [See Form 579 §4]

Consider a landlord who, under a right of first refusal, notifies their tenant of the purchase terms on which they have listed the property for sale. The tenant chooses not to exercise their option to buy at the price and on the terms offered. The landlord later modifies the listing by lowering the sales price or altering the terms for payment of the price.

The price reduction or modification of terms automatically reinstates the tenant's right of first refusal obligating the landlord to re-notify the tenant of

6 **C. Robert Nattress & Associates** v. **CIDCO** (1986) 184 CA3d 55

7 **McCulloch** v. **M & C Beauty Colleges** (1987) 194 CA3d 1338

Figure 1

Form 163

Lease-Option – Contract for Deed

LEASE-OPTION

Contract for Deed

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

NOTE: This form is used by an agent when a seller holds out property for sale under a lease-option sale arrangement, to structure the change in ownership as a lease-option sale with the seller conveying title on the buyer's full performance of the lease and exercise of the option.

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

FACTS:

1. This lease agreement and option to purchase is entered into by Lessor/Optionor and Lessee/Optionee, regarding property situated in the City of __________________, County of ________________California, referred to as ____.
Personal property, ☐ see attached Personal Property Inventory [See **RPI** Form 256], ______________________

2. This agreement is comprised of this three page form and the following checked attachments:
☐ Credit Application [See **RPI** Form 302]
☐ Residential Earthquake Hazards Report [See **RPI** Form 315]
☐ Occupant's Operating Expense Sheet [See **RPI** Form 562]
☐ Addendum — General Use [See **RPI** Form 250]
☐ Notice of Your Supplemental Property Tax Bill [See **RPI** Form 317]
☐ Natural Hazard Disclosure Statement [See **RPI** Form 314]
☐ Financial Disclosure Statement [See **RPI** Form 309]
☐ Brokerage Fee Addendum [See **RPI** Form 273]
☐ Lead-Based Paint Disclosure [See **RPI** Form 313]
☐ Condition of Property Disclosure [See **RPI** Form 304]

3. Term of Lease:
This lease commences ____________, 20_____ and continues until ____________, 20_____.
3.1 The lease terminates on the last day of the term without further notice.
3.2 If Lessee holds over, Lessee to be liable for rent at the daily rate of $____________.

4. Rent: Lessee to pay, in advance, a base monthly rent of $____________ due on the _____ day of each calendar month.
4.1 Rent to be paid by: ☐ personal check made payable to ________________, or ☐ ________________.
4.2 Rent to be tendered by: ☐ mail, or ☐ personal delivery.
4.3 Lessee to pay a late charge of six percent of all rent amounts due in the event rent is not received within ten days of the due date.
4.4 Lessee to pay $____________ for each rent check returned for insufficient funds and thereafter pay rent by cash or cashier's check.

5. Additional Rent: In addition to the base monthly rent, Lessee to pay additional monthly rent equal to the increased costs incurred by Lessor after entering into this lease-option, due to:
a. ☐ variable/adjustable interest rate on existing loans secured by the property;
b. ☐ variable/adjustable monthly principal or acceleration of existing loans secured by the property;
c. ☐ property taxes on the property;
d. ☐ fire and extended coverage insurance premiums on the property;
e. ☐ any Homeowners' Association (HOA) assessments;
f. ☐ any special or improvement assessments on the property; and
g. ☐ any other expenditures required of Lessor to protect his interest.
5.1 The additional monthly rent will be the actual monthly cost increase and 1/12th of any annual cost increase
5.2 The additional monthly rent is due on, or beginning with, the monthly rent payment next due following notice to Lessee by Lessor.

6. Utilities: Lessee will pay all costs of public utilities to the property, including any required deposits, installation, or service fees.

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7. Maintenance of Premises: Lessee agrees to maintain and perform all necessary repairs to the property during the lease term at his sole expense.

8. Insurance: Lessee will maintain at their sole expense, naming Lessor as an additional insured:
8.1 ☐ A standard fire insurance policy with extended coverage, vandalism and malicious mischief endorsements, fully covering the replacement cost of all structures on the property during the entire term of the lease; and
8.2 ☐ Public liability and property damage insurance with a single combined liability limit of at least $300,000 and property damage limits of at least $100,000, insuring against all liability of Lessee arising out of Lessee's use or occupancy of the premises.

9. Use of the Property: The property is to be used only as a private residence occupied by Lessee and for no other purpose. Lessee will comply with all laws regarding the use of the property, and will not allow any waste or nuisance to occur on the property.

10. Assignment and Subletting: Lessee will not assign this lease, nor sublet or encumber any interest in the property without the prior written consent of Lessor. Any transfer of an interest in the property by Lessee without the prior written consent of Lessor will, at the option of Lessor, terminate this lease and call for payment of all sums due.

11. Waiver of Damage: Lessee releases Lessor from liability for loss or damage to Lessee or any property of Lessee caused by water leakage, breaking pipes, theft, vandalism, or any other cause beyond the reasonable control of Lessor

12. Hold Harmless: Lessee will indemnify Lessor from liability, damages, and/or expenses arising from the death or injury of any person, including Lessee, or from the damage or destruction of any property, including property owned by Lessee, caused or allegedly caused by some condition of the property, or some act or omission of Lessee or any other person.

OPTION TO PURCHASE:

13. Option Money: Optionor acknowledges receipt of option money in the amount of $____________, given in consideration for this option to purchase the property leased.

14. Option Period: Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property under the sales terms for a period commencing with the acceptance of this option and expiring on termination of the lease.

15. Exercise of Option: Optionee may exercise this option during the option period by:
15.1 Preparing and signing escrow instructions with ______________________________________;
15.2 Depositing cash in Escrow of $____________; and
15.3 Delivering a certified copy of the signed escrow instructions to Optionor within the option period in person or by certified mail.

16. Delivery of Title: Within _____ days after exercise, Optionor and Optionee will place in Escrow all documents and instruments necessary to close.

17. Sale Terms: The purchase price is $____________, payable:
17.1 ☐ In cash.
17.2 ☐ Down payment in the amount of $____________.
17.3 The cash price or down payment to be credited for $____________ of option money paid, and for _____%, or $____________, of each payment of base monthly rent.
17.4 ☐ Take title subject to, or ☐ Assume, the existing trust deed note with an approximate unpaid balance of $____________, currently payable $____________ monthly, including principal and interest at _____%, ☐ adjustable, monthly impounds being an additional $____________.
17.5 ☐ Take title subject to, or ☐ Assume, a trust deed note with a principal balance of $____________, currently payable $____________ monthly, including principal and interest at _____%, due ____________.
17.6 Loan balance differences to be adjusted in: ☐ cash, ☐ §17.8 Note, or ☐ price.
17.7 ☐ Assume bonds or assessment liens of record in the approximate amount of $____________.
17.8 A Note for the balance of the purchase price in the amount of $____________, to be executed by Buyer in favor of Seller and secured by a trust deed on the property, payable $____________ monthly, or more, commencing one month after closing, including interest at _____%, due ____________ years after closing.
a. The Note and Trust Deed will not contain provisions for due-on clauses, prepayment penalties, or late charges.
b. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **RPI** Form 412]
c. ☐ The Note is an All-Inclusive Trust Deed Note.

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d. As additional security, Optionee to execute a security agreement and file a UCC-1 financing statement on any personal property included in the price.

18. General Provisions:
18.1 Lessee/Optionee and Lessor/Optionor acknowledge receipt of the Agency Law Disclosure. [See **RPI** Form 305]
18.2 Optionee's transfer of any interest in this option terminates the option.
18.3 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.
18.4 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.

19. Power of Sale: If this document is characterized as a security device, on default of rental payments or failure to exercise the option, the Lessor/Optionor may call all sums due and elect to proceed with a power of sale by a trustee substituted under Civil Code §2934(a), noticed and held in accordance with Civil Code §§2924 et seq.

20. Lessor/Optionor Default: If the Lessor/Optionor defaults on any obligation impairing the Lessee/Optionee's interest under this agreement, Lessee/Optionee may cure the default and demand reimbursement from the Lessor/Optionor of the amount advanced, and if not paid, deduct the amount paid from periodic payments and the purchase price due the Lessor/Optionor.

21. Expiration of Option: This option to purchase will be deemed expired if not exercised during the option period, and if not previously terminated, will automatically expire/terminate on ____________, 20_____.

22. Brokerage Fee: Optionor to pay brokerage fees as follows:
22.1 _____% of the option money on receipt; plus
22.2 _____% of each month's base rent on receipt; and
22.3 $____________ on exercise of the option.
22.4 Optionee's Broker and Optionor's Broker, respectively, to share the brokerage fee _____:_____.

23. ____

Lessee/ Optionee's Broker: ______________________	Lessor/ Optionor's Broker: ______________________
By: ______________________	By: ______________________
Is the agent of: ☐ Lessee/Optionee exclusively; or ☐ Both Parties.	Is the agent of: ☐ Lessor/Optionor exclusively; or ☐ Both Parties.
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_____
Lessee/Optionee: ______________________	Lessor/Optionor: ______________________
Signature: ______________________	Signature: ______________________
Lessee/Optionee: ______________________	Lessor/Optionor: ______________________
Signature: ______________________	Signature: ______________________
Address: ______________________	Address: ______________________
Phone: ____________ Cell: ____________	Phone: ____________ Cell: ____________
Email: ______________________	Email: ______________________

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new terms for purchase of the property. The tenant only waived their right of first refusal for a sale based on the terms originally given to them by the landlord, not on the different price or set of terms.

When a buyer purchases the property on terms other than those offered to the tenant, the buyer takes title subject to the tenant's preemptive right to buy. This right is reinstated due to the sale on different terms. Thus, the buyer needs to sell to the tenant on the same price and terms the buyer paid. The buyer had either actual or constructive notice of the tenant's unrecorded right to acquire the property due to the tenant's possession of the property.

Chapter 10 Summary

A landlord gives a tenant the right to acquire the rented property by granting either an option to buy or the right of first refusal. The right to buy under an option to buy needs to be exercised by the tenant within the option period. The option period typically runs until the lease term expires or is terminated.

A tenant's right to buy under a right of first refusal agreement is triggered by any indication of the landlord's decision to sell the property. To exercise the right of first refusal, the tenant needs to agree to match the sales terms set by the landlord within the time period set in the right of first refusal provision.

Chapter 10 Key Terms

Chapter 11

A seller's residence in foreclosure

Learning Objectives

After reading this chapter, you will be able to:

- document an equity purchase (EP) transaction between an owner-occupant seller of a one-to-four unit residential property in foreclosure and an EP investor who acquires the property for dealer or rental investment purposes;
- identify the specific rules controlling an EP investor acquisition;
- advise on a seller-in-foreclosure's five-business-day right to cancel an EP transaction;
- explain to EP investors a seller-in-foreclosure's two-year right to rescind a closed purchase transaction; and
- instruct an EP investor how to avoid exploiting an element of oppression or surprise to exact unreasonably favorable terms from the seller.

Key Terms

equity purchase (EP)
equity purchase investor
five-business-day right to cancel
notice of rescission
oppression
post-closing surprise
unconscionable advantage

The equity purchase investor scheme

An **equity purchase (EP) transaction** takes place when the seller-occupant of a one-to-four unit residential property in foreclosure conveys the property to a buyer who acquires it for:

- rental investment; or
- dealer purposes.

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

equity purchase (EP)
When a seller-occupied, one-to-four unit residential property in foreclosure is acquired for dealer or rental investment purposes.

equity purchase (EP) investor
The buyer of an owner-occupied, one-to-four unit residential property in foreclosure who will not occupy the property as their primarily residence.

Editor's note – Alternatively, when a buyer acquires the seller-in-foreclosure's residence for use as the buyer's personal residence, an EP transaction has not taken place and the EP rules do not apply.

Equity purchase law applies to all buyers who are *EP investors, regardless of the number of EP transactions the investor completes. The EP investor does not need to be in the business of buying homes in foreclosure for EP law to apply.*[1]

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

The EP agreement

EP law controls the type of form used to document the EP sale. The EP agreement signed by an EP investor will:

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

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

*Editor's note — **RPI's** Equity Purchase Agreement, Form 156, complies with all statutory requirements and properly sets forth the notice to the seller-in-foreclosure of their right to cancel. [See **RPI** Form 156]*

Cancellation within five business days

five-business-day right to cancel
An owner-occupant seller of a one-to-four unit residential property who has entered into a purchase agreement with an EP investor has the right to cancel the agreement during a five-business-day period commencing on notice of the right to cancel.

Upon entering into an agreement to sell their principal residence, a seller-in-foreclosure has a **five-business-day right to cancel** the EP agreement. During this time period, the seller is permitted to cancel the sale, with or without cause.

The *statutory right to cancel within five-business-days* is included in boilerplate language contained in equity purchase agreements. If the seller cancels before the period expires, the sale under the purchase agreement may not close. Since an English language EP agreement includes proper font and notice to the seller of their five-business-day right to cancel, an EP agreement negotiated in English is assured compliance with EP law.

The seller's *cancellation period* expires at:

- midnight (12:00 a.m.) of the *fifth business day* following the day the seller enters into an EP agreement with an EP investor; or
- 8:00 a.m. of the day scheduled for the *trustee's sale*, if it is to occur first.[4]

---

1 **Segura** v. **McBride** (1992) 5 CA4th 1028
2 Calif. Civil Code §§1695.2, 1695.3, 1695.5
3 Segura, *supra*
4 CC §1695.4(a)

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

Right to rescind

Failure to use a purchase agreement containing the mandatory notice of right to cancel allows the seller to cancel the sales agreement and escrow until proper notice and the time for cancellation has run. Further, the seller is permitted to **rescind** a sale even after it is closed when the notice of right to cancel was not delivered more than five business days before closing. The right to rescind the closed sales transaction and recover ownership of the property remains until the running of five business days after notice is ultimately given.

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

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

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

Prohibited activities during the right to cancel period

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

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

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

5 CC §1695.4(b)
6 CC §1695.1(d)
7 CC §1695.6(b)

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

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

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

False representations prohibited

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

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

These rules also apply to the EP investor's agent for reason the agent is a licensee.

Post-closing rescission rights, penalties

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

The seller's *rescission* needs to be based on evidence of unconscionable conduct the EP investor engaged in with regards to the transaction. The seller's two-year right to rescind and recover the property from the EP investor cannot be waived by the seller.[11]

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

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

The EP investor is liable for any of the seller's money losses caused by failure of the EP investor or their agent to comply with EP law. The seller-

8 CC §1695.4(b)
9 CC §1695.6(c)
10 CC §1695.6(d)
11 CC §§1695.10, 1965.14
12 CC §1695.15

in-foreclosure has four years from the date of the EP investor's violation to recover their money losses and penalties. If the EP investor is found to have transferred or encumbered the property before the cancellation period expires after notice, the EP investor is subject to:

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

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

Brokers limited to listing property

Equity purchase legislation regulates brokers when they act as a **buyer's agent** for EP investors who attempt to buy an owner-occupant's home that is in foreclosure.

The broker **representing an EP investor** needs to, when negotiating an EP transaction, deliver to all parties to the transaction a written *EP disclosure statement* that the buyer's agent representing the EP investor is a **licensed** real estate broker.

The broker needs to also provide **proof of licensure** to the seller-in-foreclosure showing the broker holds a current, valid California real estate license.[15]

If the buyer's agent fails to deliver either the **EP disclosure statement** or the proof of licensure to the relevant parties, the EP agreement is **voidable** at the discretion of the seller any time before escrow closes.

Also, the EP investor is liable to the seller-in-foreclosure for any **losses arising** out of the buyer's agent's nondisclosure of licensing requirements.[16]

However, the EP investor is entitled to **equitable indemnity** from their agent, a reimbursement for the seller's losses caused by the agent's nondisclosure. *Equitable indemnity* is available to the EP investor who, without active fault on his part, is forced by legal obligation to pay for losses created by his agent's nondisclosure.[17]

A licensee as the EP investor

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

13 CC §1695.7
14 CC §1695.8
15 CC §1695.17(a)
16 CC §1695.17(b)
17 **San Francisco Examiner Division, Hearst Publishing Company** v. **Sweat** (1967) 248 CA2d 493

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

Conversely, a DRE licensee, while employed as the seller's broker by a seller-in-foreclosure to locate a buyer, may decide to directly or indirectly buy their client's property. This is not prohibited for brokers in any type of market. However, a broker needs to disclose to their seller-client that the broker is also acting as a principal in the transaction, in addition to being, or having been, the seller's agent.[18]

Representing the seller

Brokers who consider the risks of litigation are less inclined to solicit and accept a listing from a seller-in-foreclosure than from a seller of comparable property not in foreclosure.

However, short sales reentered the sales market in 2008 as property values dropped 50%. By 2011, short sales were a significant part of the sales transactions handled by agents working in single family residence (SFR) sales. More germane to the EP laws, by 2013 investors became the dominate short sale buyers of SFRs in foreclosure.

The 2008 recession left 1/2 of mortgaged homes in California with price drops to below the mortgage amounts, known as **negative equity**. Short sales with lenders discounting the mortgage balance for a payoff before the foreclosure sale became the norm for EP investor acquisitions. But EP transactions they were, even though the owner occupant had no equity to sell and thus no EP losses for recovery if EP law violations occurred.

The recovery will eventually bring permanent price increases from the rebalanced post-boom prices of 2008. With a sufficient price increase, seller-in-foreclosure sales will again have positive equity positions and net sales proceeds for the seller if not lost due to EP violations.

Reluctance to list

The broker's reluctance to list a home in foreclosure arises from the fact a home with a positive equity, unless sold and escrow closed before the date of the trustee's foreclosure sale, will be lost by their client to foreclosure. Without locating a buyer – one who will occupy or is an investor – and closing a sale, the broker has failed to meet their seller's expectations under the listing, i.e., to salvage their equity before it is lost to foreclosure.

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

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

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

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

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

Also at issue is the seller's lack of funds to maintain the property to provide the necessary "curb appeal" to draw homebuyers (rather than investors).[19]

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

Two-year right of rescission

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

notice of rescission
Notice given by a seller-in-foreclosure to an equity purchase (EP) investor to exercise the seller's two-year right of rescission and restoration on a sale.

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

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

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

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

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

No! The EP investor's title remains subject to the seller-in-foreclosure's *right of rescission* for two years after closing. If at any time during the two years following the close of escrow and the recording of the grant deed the seller

19 CC §§2903

believes the EP investor's **conduct and the price** paid gave the EP investor an *unconscionable advantage*, the seller has the option to attempt to rescind the transaction and recover the property they sold, called **restoration**.[20]

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

The unconscionable advantage

unconscionable advantage
When an equity purchase (EP) investor exploits an element of oppression or surprise to exact unreasonably favorable terms.

The two-year rescission period only allows a seller-in-foreclosure to recover property if they can demonstrate the EP investor took **unconscionable advantage** of them when negotiating the purchase of the property.

Showing the existence of an *unconscionable advantage* in the **EP investor's conduct** is problematic for both the seller-in-foreclosure and the EP investor. The legislature has not defined what exactly constitutes an act of unconscionable advantage by the buyer.

What was a reasonable sales price under the circumstances surrounding the seller-in-foreclosure when the transaction was entered into might appear to be unconscionable to the seller in the future due to market factors and inflation, not the conduct of the EP investor. Thus, an EP investor assumes the risk that a rising economy may provoke the seller into attempting to rescind (for the wrong legal reason).

If real estate values rise rapidly and significantly, the "greed factor" may set in, turning a formerly desperate seller-in-foreclosure into an astute rescinding seller.

However, any increase in the value of the property after acceptance of the EP investor's offer may not be considered. The test of unconscionable advantage is not based on events occurring after the seller-in-foreclosure enters into the purchase agreement.

Market circumstances existing at the time of the negotiations or when the parties entered into the agreement are the economic considerations which form one of the two elements for testing unconscionable advantage.[21]

Proof of unconscionable advantage

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

- the purchase price or method of payment was unreasonably favorable to the EP investor, known as **substantive unconscionability**; and

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20 Calif. Civil Code §1695.14

21 **Colton** v. **Stanford** (1890) 82 C 351

- the lack of a meaningful choice of action for the seller-in-foreclosure when negotiating to sell to the EP investor, known as **procedural unconscionability**.

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

Further, unconscionable *methods of payment* include:

- carryback paper with an interest below the applicable federal rate (AFR) when the price is low and a long amortization or remote due date bears no relationship to current market conditions;
- an equity exchange of overpriced land, stock, gems, metals or zero coupon bonds with a long maturity; or
- any form of payment which is uncollectible, unredeemable or having no present worth.

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

Un-American activity coupled with a low price

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

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

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

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

oppression
When no real negotiations occur between an equity purchase (EP) investor and a seller-in-foreclosure and are not realistic due to a "take it or leave it" environment created by the EP investor's abuse of the inequality in bargaining power.

post-closing surprise
The post-closing discovery of negative terms and conditions which are hidden in the wording of an equity purchase (EP) agreement or escrow instructions.

The greater the marketplace oppression or post-closing surprise discovered in the transaction, the less an unreasonably favorable price paid by an EP investor is tolerated.[22]

Structuring the EP agreement

Consider an EP investor seeking an investment in SFRs. The EP investor contacts their real estate broker. The broker locates an owner-occupied SFR encumbered by a trust deed lien on which an *NOD* has been recorded.

The investor is aware they need to comply with California's EP laws when preparing and submitting an offer to purchase the property. [See Figure 1, **RPI** Form 156]

Terms of the purchase

The EP investor is willing to purchase the SFR by:

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

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

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

The conditions of the trust deed note are:

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

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

However, only *HUD*, not the lender, has the right to call a HUD-insured loan. The likelihood of HUD calling any loan that is kept current is remote. Thus, the EP investor takes title "subject to" the loan and its due-on-sale clause with minimal interference from the lender. In this way, assumption fees and a loan modification are avoided, which runs up the cost of acquisition.

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

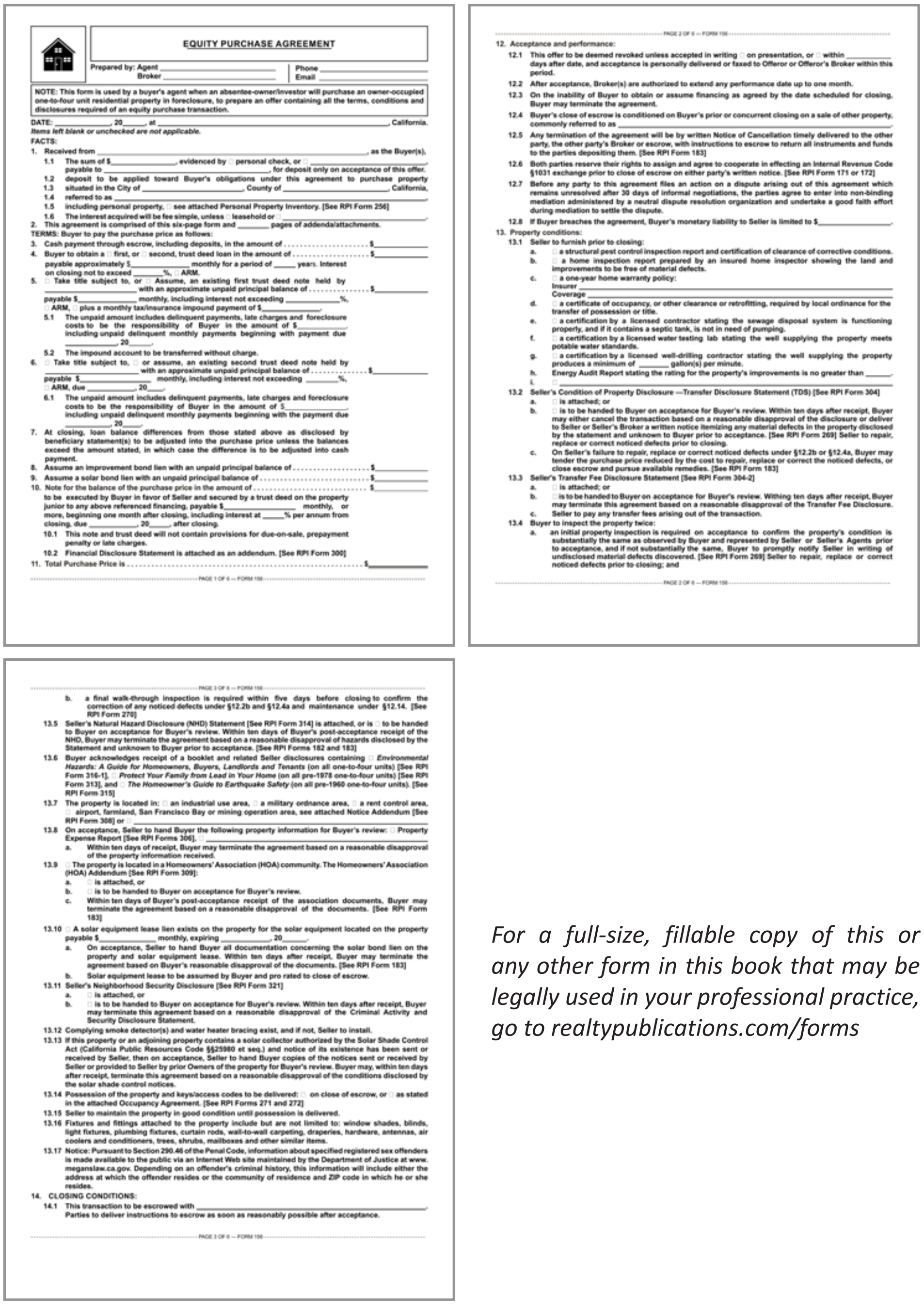

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Figure 1

Form 156

Equity Purchase Agreement

Pages 1 - 3

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

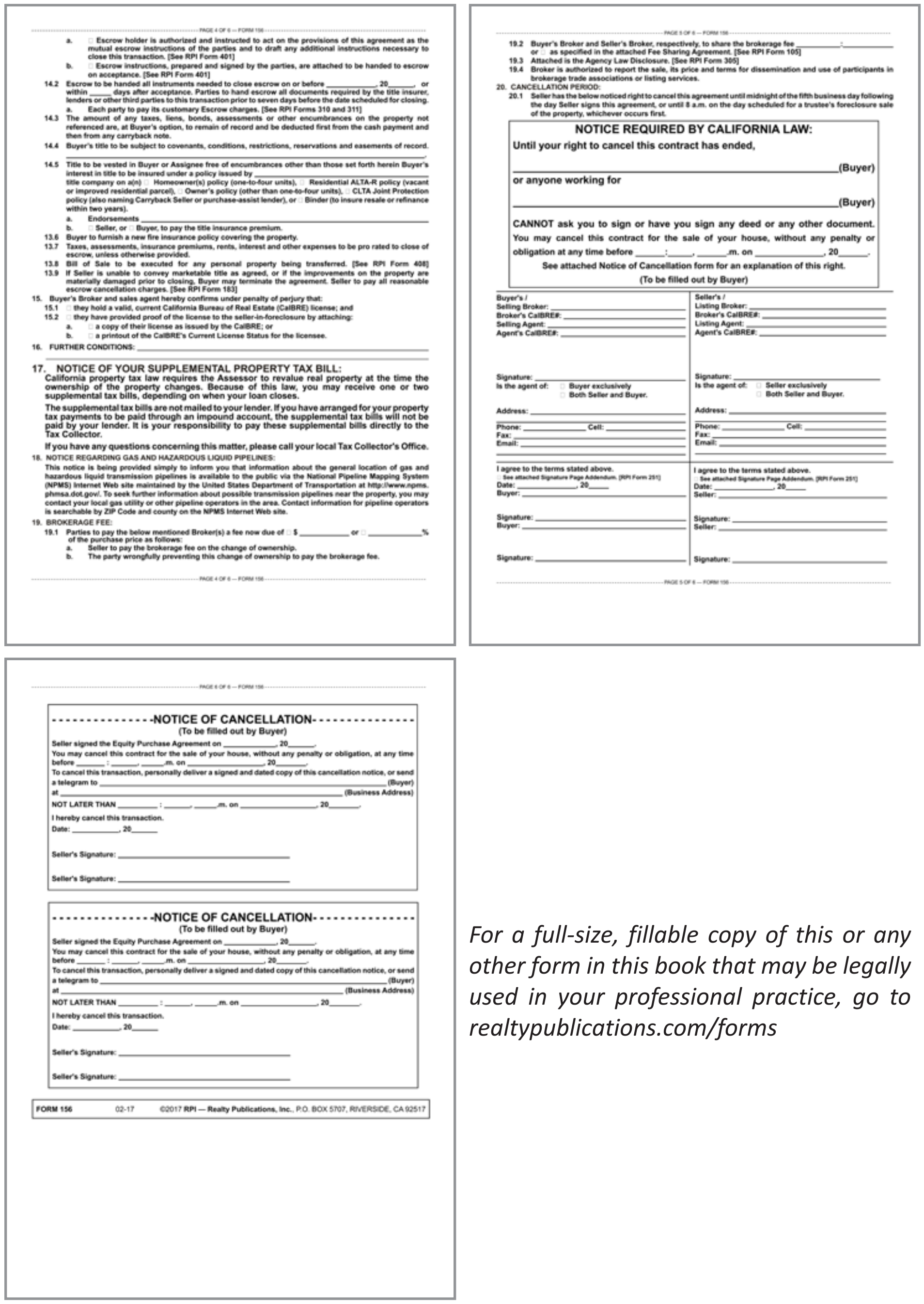
Tax-wise, the payment of the delinquent principal and interest (PI) payments — not the taxes and impounds (TI) — is reported as part of the EP investor's original costs of acquisition. The interest paid by the investor that accrued

Figure 1

Form 156

Equity Purchase Agreement

Pages 4 - 6



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a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See RPI Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See RPI Form 401]

14.2 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]

14.3 The amount of any taxes, liens, bonds, assessments or other encumbrances on the property not referenced are, at Buyer's option, to remain of record and be deducted first from the cash payment and then from any carryback note.

14.4 Buyer's title to be subject to covenants, conditions, restrictions, reservations and easements of record. ____________.

14.5 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein Buyer's interest in title to be insured under a policy issued by ____________ title company on a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements ____________

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

13.6 Buyer to furnish a new fire insurance policy covering the property.

13.7 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

13.8 Bill of Sale to be executed for any personal property being transferred. [See RPI Form 408]

13.9 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]

15. Buyer's Broker and sales agent hereby confirms under penalty of perjury that:

15.1 ☐ they hold a valid, current California Bureau of Real Estate (CalBRE) license; and

15.2 ☐ they have provided proof of the license to the seller-in-foreclosure by attaching:

a. ☐ a copy of their license as issued by the CalBRE; or

b. ☐ a printout of the CalBRE's Current License Status for the licensee.

16. FURTHER CONDITIONS: ____________

17. 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.

18. 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.

19. BROKERAGE FEE:

19.1 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.

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19.2 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]

19.3 Attached is the Agency Law Disclosure. [See RPI Form 305]

19.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

20. CANCELLATION PERIOD:

20.1 Seller has the below noticed right to cancel this agreement until midnight of the fifth business day following the day Seller signs this agreement, or until 8 a.m. on the day scheduled for a trustee's foreclosure sale of the property, whichever occurs first.

NOTICE REQUIRED BY CALIFORNIA LAW:

Until your right to cancel this contract has ended,

____________(Buyer)

or anyone working for

____________(Buyer)

CANNOT ask you to sign or have you sign any deed or any other document. You may cancel this contract for the sale of your house, without any penalty or obligation at any time before _____:_____, _____.m. on ____________, 20_____.

See attached Notice of Cancellation form for an explanation of this right.

(To be filled out by Buyer)

Buyer's / Selling Broker: ____ Broker's CalBRE#: ____ Selling Agent: ____ Agent's CalBRE#: ____	Seller's / Listing Broker: ____ Broker's CalBRE#: ____ Listing Agent: ____ Agent's CalBRE#: ____
Signature: ____ Is the agent of: ☐ Buyer exclusively ☐ Both Seller and Buyer.	Signature: ____ Is the agent of: ☐ Seller exclusively ☐ Both Seller and Buyer.
Address: ____ Phone: ____ Cell: ____ Fax: ____ Email: ____	Address: ____ Phone: ____ Cell: ____ Fax: ____ Email: ____
I agree to the terms stated above. ☐ See attached Signature Page Addendum. [RPI Form 251] Date: ____, 20____ Buyer: ____ Signature: ____ Buyer: ____ Signature: ____	I agree to the terms stated above. ☐ See attached Signature Page Addendum. [RPI Form 251] Date: ____, 20____ Seller: ____ Signature: ____ Seller: ____ Signature: ____

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-NOTICE OF CANCELLATION-

(To be filled out by Buyer)

Seller signed the Equity Purchase Agreement on ____________, 20______.

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

To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send a telegram to ____________ (Buyer)

at ____________ (Business Address)

NOT LATER THAN ______ : ______, ______.m. on ____________, 20______.

I hereby cancel this transaction.

Date: ____________, 20______

Seller's Signature: ____________

Seller's Signature: ____________

-NOTICE OF CANCELLATION-

(To be filled out by Buyer)

Seller signed the Equity Purchase Agreement on ____________, 20______.

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

To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send a telegram to ____________ (Buyer)

at ____________ (Business Address)

NOT LATER THAN ______ : ______, ______.m. on ____________, 20______.

I hereby cancel this transaction.

Date: ____________, 20______

Seller's Signature: ____________

Seller's Signature: ____________

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before acquiring the property is an expense of the seller-in-foreclosure, not the investor. Thus, the payment of the seller's debts assumed/taken over by the investor needs to be *capitalized* as part of their cost basis in the property.[23]

23 Internal Revenue Code §1012

Cost basis on acquisition

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

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

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

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

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

Chapter 11 Summary

An equity purchase (EP) transaction takes place when the seller-occupant of a one-to-four unit residential property in foreclosure conveys the property to a buyer who acquires it for:

- rental investment; or
- dealer purposes.

The non-occupying buyer taking title to the residence of a seller-in-foreclosure is called an EP investor. Unique statutory rules apply to all EP transactions.

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

Upon entering into an agreement to sell their principal residence and after proper notice of their rights, a seller-in-foreclosure has a statutory five-business-day right to cancel the EP agreement with or without cause.

When the cancellation period expires for lack of a cancellation, the purchase agreement becomes enforceable and escrow is closed, unless other contingencies exist.

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

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

Chapter 11 Key Terms

Chapter 12

To default, or not to default

Learning Objectives

This chapter will teach you:

- the long-term financial benefits of strategic default for an underwater homeowner; and
- the benefits of principal reductions for lenders, homeowners and the economy.

Key Terms

negative equity

strategic default

put option

Emotions and irrational disbeliefs about losing a home

Traditionally, a mortgage lender's underwriting practice requires a homeowner to inject sufficient equity into their home in the form of a *down payment*. This ensures the buyer views payment of the mortgage as necessary to protect the equity in the home. The larger the down payment is, the greater the safeguard against default.

However, as lenders moved toward less restrictive credit risk lending models in the mid-2000s, they relied increasingly on:

- *credit scores* generated by agencies to gauge borrower fitness as a homeowner and propensity to repay debts; and
- the security of a home's fast rising value as assurance the loan balance will be recovered on a default.

Thus, a buyer's down payment and property qualification took a back seat to the credit score as a measure of loan qualification. Lenders based their decision to go exclusively with the credit score upon studies which showed that borrowers with optimum and medium credit scores have a 0.9% and 4% chance of default, respectively.

For instance, during the *Millennium Boom*, many buyers with optimum credit scores were not asked to make a down payment to qualify for mortgages with loan-to-value ratios (LTVs) of 100% or more. Both lenders and Wall Street bond dealers (along with their rating agencies) thought the fast-rising prices of real estate to more than make up for the lack of down payment in the event of default and resort to the security.

They methodically presumed a future equity spread in the home, and that as collateral homebuyers had an incentive to pay. As a result, permitting LTVs above the traditionally safe 80% threshold became common practice during the five-year *Millennium Boom* which preceded the *Great Recession* of 2008-2009.

Underwater and deeply insolvent

All this structure fell apart in 2008-2009 when Wall Street lost the means to issue bonds to fund mortgage lenders and their borrowers. Many homebuyers with upper-echelon credit scores who bought during the boom were then stranded in homes worth half their mortgage balance, a condition called **negative equity**, more colorfully referred to as being *"underwater."*

negative equity
The condition of a property owner owing more on a mortgage than the current fair market value (FMV) of the encumbered property.

What are underwater homeowners to do? The logical choice for many distressed owners who are employed is **strategic default**. This is especially relevant in California, a *nonrecourse state*. Here, a 1.5% of mortgaged homeowners had negative equity in 2020. The disappearance of speculators has led to a rise in home values that continues in 2021.

strategic default
The intentional default on a mortgage, forcing the lender to foreclose and acquire the property in satisfaction of the mortgage debt.

But if *strategic default* is the perfectly rational, legal and financially beneficial choice, why are so few deliberately defaulting?

The forces pushing homeowners against the tide of logic and influencing them to keep paying their distressed, dead-end mortgages is the subject of a paper titled *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis*, by Brent T. White of the University of Arizona College of Law.

The social control mechanisms White discusses are:

- the emotional desire to avoid *shame and guilt*; and
- the fear of adverse *financial consequences* due to a foreclosure.

His point is widely observable. There is no shortage of seemingly authoritative voices extolling the responsible homeowner and their ethical duty to pay (no matter the debt amount). Representatives of the federal administration in 2009 advised that the upstanding, moral choice for homeowners is to "stay and pay." Essentially, underwater homeowners were admonished by government to do good so the lenders do well.

Previously in 2008, the U.S. Treasury accused nonpaying homeowners of failing to honor a "moral obligation" to pay.

Unfortunately, what is a personal financial decision has become a talking point for moral prognosticators. But there is no *moral obligation* to pay that any lender in California can enforce; only *legal obligations* exist in housing mortgage arrangements. For the past 75 years, since the 1930s dawn of non-recourse anti-deficiency laws in California, the lender has been legally barred from obtaining a money judgment against a homeowner to collect for the homeowner's failure to pay on a purchase-assist mortgage, economically called a **put option**.

put option
The option built into the provisions of every trust deed allowing the buyer to force the lender to buy the property for the remaining mortgage amount.

Contained in all trust deeds, the *put option* can also be seen as a means of holding lenders' feet to the fire: make sure the risk is sound when the mortgage is originated or end up with a deed-in-lieu, or worse, foreclosure and a loss.

To label the credit crisis and the epidemic of negative equity a "moral crisis" and an "ethical failing" on behalf of homeowners is to lose sight of the nuance of fault. Admittedly, some buyers are guilty of biting off more house than they were able to chew (or agreeing to too great a price). However, the vast majority of homeowners carrying negative equity today do so as a result of the poorly managed national mortgage market.

The Fed's hoped for result vs. competitive advantage

Wall Street failed to regulate itself the way the Federal Reserve, Congress and the White House believed (or hoped) it would. Like rickety scaffolding, a systemically corrupt credit rating system was constructed to package mortgage-backed bonds (MBBs) of dubious ratings. The mortgage process became based on ever-rising home prices and borrower credit scores rather than the historically reliable 80% LTV standard.

Aided by the U.S. Treasury's 9/11-influenced decision to constantly look backward in an effort to keep rates low, lenders were able to produce reams of mortgages. This production line fed the avaricious Wall Street bankers who bought and peddled the paper into the bond market.

There is clear and damning evidence now coming out on a weekly basis of *systemic failure* and corruption throughout the U.S. banking and financial systems. These perverse conditions paved the way for the mortgage and housing crisis.

Yet, distressed homeowners remain the politically popular party to blame (together with mortgage loan brokers and appraisers as lobbied by lenders through Congress) for the negative equity epidemic. Thus, homebuyers and homeowners refinancing are forced to passively shoulder a disproportionate amount of fault.

Cramdowns are the solution

Modifying underwater mortgages by a *cramdown* of the principal balance should be a lender's "logically beneficial and morally responsible" response to a crisis which they alone facilitated. However, lenders and loan servicers have deliberately avoided calls to meaningfully modify bad loans.

The mortgage documentation prepared by the lender and signed by the borrower contains a contractual *put option*. This option forgives the loan debt in exchange for delivering the property — title and possession — to the lender.

The process is *simply foreclosure*. Thus, lenders are legally bound to accept the property in lieu of payment. Homeowners have a choice. They may pay the loan and keep the property, or default, exercising their option to force the lender to take the property.

It is not as if lenders were ignorant of the deteriorating state of the nation's mortgage market during the millennium boom, or had zero warning of the impending bust. They as insiders even bet the market would go bust. As with all novices, most homeowners and individual investors on Wall Street relied on the expertise of financial professionals to be in-the-know about the health of the mortgage market. They were, but were not about to tell the public.

But as the housing and the financial system were being run into the ground (in tandem) by *lousy underwriting standards* and the observable build-up of extreme regional and huge national housing bubbles, these professionals sounded no alarms and took no preventative steps. Rather, homeowners were offered first and second mortgages at 125% the value of their homes — homes that would lose tens (and in California, hundreds) of thousands of dollars in value in a matter of two years.

An example from Sam and Chris

To illustrate the point, take the fictional couple in White's paper: Sam and Chris. They purchased their three bedroom home in Salinas, California for $585,000 in January 2006 (the average price of a home of this size in Salinas that year). The couple had optimum credit scores, reliable income and qualified for a fixed rate (6.5% APR) loan with zero down. These terms gave them a total monthly payment of $4,300, or just shy of 31% of their gross monthly income. With two children, the couple barely made ends meet to cover expenses and pay a mortgage on what was their first home.

Traditional underwriting standards would have required the couple to make a down payment of about 20% of the value of the home, bringing the LTV to 80%. During the boom, however, borrower fitness was evaluated based on credit scores, not sound lending principles.

The LTV of the couple's home in 2006 at the time of purchase was 100%. Prices of homes peaked in Salinas and throughout all of California in the first quarter of 2006.

With the beginning of the Great Recession in 2007, the housing market fell apart. Five years later, Sam and Chris still owe about $560,000 on their home.

However, as of the second quarter of 2013, their home was only worth about \$233,000, with nearby homes renting for about \$1,450 per month (\$2,850 less than their \$4,300 monthly payment). What is the couple to do?

Sam and Chris consider walking

Continuing our previous example the couple intends to stay in their home until their children finish at the local high school (ten years from now). However, the cost to the family is massive in its destruction of their personal wealth. Over ten years, Sam and Chris would save approximately \$342,000 in monthly payments by walking away and simply renting a comparable home next door. On the other hand, the couple could have stuck with their \$560,000 mortgage. To do so would take over 40 years for the home to resurface from its current mortgage amount, appreciating at its historical trend-line rate in California of 3.5%.

Alternatively, the couple can *walk away*, rent for a couple of years, and then buy a replacement home of comparable quality. In the process, they would save hugely on costs each month and over time.

On a larger scale, to walk away now will allow for the California recovery to take place much sooner. The money saved by defaulting will otherwise be sunk into an underwater property (roughly \$3,000 per month in this scenario). By defaulting, the money is injected into local, regional and state economies through purchases of goods and services (including education) for the family. Collectively, this will allow individuals like Sam and Chris to provide their families an overall better quality of life, and a much higher standard of living.

Like nearly a third of the 6,200,000 California homeowners with mortgaged homes at the time, Sam and Chris were faced with two choices:

- they can either continue paying the *dead-end loan*, lugging the negative equity of their home as an albatross around their necks for the rest of their working lives; or
- *default* and save hundreds of thousands of dollars.

Nationwide, only 3% of underwater homeowners strategically default. Lenders know this fact, and fully enforce it to their advantage.

Stay and pay or walk away

But many more negative-equity homeowners need to walk away from the property. With the savings, they will build up valuable retirement savings and improve their living conditions, for which credit is of no importance. Considering that this issue afflicted 3.5% of California homeowners in 2018, homeowners like Sam and Chris who chose to "stay and pay" impeded the state's economic recovery.

Despite the preponderance of evidence to the contrary, society's senior arbiters of political and public opinion disbelieve the facts. They demand homeowners flog themselves for their poor decisions by paying their underwater mortgages to defend the lenders from loss and insolvency. The government calls for homeowners to remember their moral obligations, never suggesting that we are a country of laws which guarantee a legal result.

A contributing factor is fellow neighbors who persist to make the irrational decision to continue paying their dead-end mortgages. These are the same persons who righteously demand justice for homeowners who decide to exercise their legal right not to pay.

Thus, homeowners searching for answers or help from among their peers are met mostly with shame, fear-mongering and disinformation. This thinking keeps distressed and ill-informed homeowners in a *financially catatonic state*.

In one corner, we have the lenders who made terrible decisions in their risk assessment of homebuyers and homeowners during the excessively credit-driven economy of the 2000s, the insidious *financial accelerator event*. They are fighting to recover the money they lent the homeowner.

In the other corner, we have the California homeowner who — encouraged by government subsidies and homeownership slogans framed and guided by mortgage lenders, builders and brokers — signed onto a mortgage for more than 100% of the value of their home. What is a nation thus divided to do?

What to expect from unmotivated lenders

Lenders have reacted unfavorably to struggling homeowners. Given time, the lenders will prove themselves right, but only at a horrid permanent expense to families who own these underwater homes. Lenders have shown less willingness to mediate than is warranted, considering the homeowner's option to *strategically default*. But homeowners are not willing to protest, a passive bunch the lenders take advantage of.

A homeowner who contacts their lender is almost always told they need to default before the lender will help. This move is deliberately intended to leave a blemish on the homeowner's credit score before mediation can begin.

Next, after defaulting as instructed by the lender, the homeowner is threatened with foreclosure if they do not pay late fees and past due amounts. Only after those amounts are paid (or more frequently added to the loan balance) will the lender agree to a common loan modification plan (read: scam). Worse, most modification plans tend to be anything but helpful.

Extend and pretend

The scam is referred to as **"extend and pretend."** The arrangements initially appear to be helpful to the homeowner since their monthly payment is lowered. However, each monthly payment made by the homeowner is only allocated to a portion of the interest due on the loan. Eventually, the loan resets and the payment adjusts upward to fully amortize the loan. At the end of the modification, the homeowner will be right back where they started, only years in the future.

Thus, the lender takes money from the homeowner during the temporary modification period (extending the owner's stay in the home), pretending to help. In reality, the lenders are playing a money-making trick at the expense of distressed and emotional homeowners.

The intelligent move: stop paying, wait for the foreclosure sale, then pack up and pay rent elsewhere until the crisis has passed. For modified loans, a re-default becomes a double hit on their credit score.

However, always making timely payments on rent, utilities, credit cards and a car loan, repairs the defaulting homeowner's credit rating within a couple of years for scores that were previously perfect.

Coupled with a *letter of explanation* about the sole cause of the blemish (mortgage default), the homeowner's credit score will absolutely weather the financial crisis — especially if the homeowner's job remains intact and the owner pays all other debts as agreed. [See **RPI** Form 217-1]

A study cited by White's paper shows a defaulting homeowner can most often secure new lines of credit in as little as *18 months* after default. Even the Federal Housing Administration (FHA) will insure a loan to a *bankrupted* or foreclosed homeowner after only two years. Besides, the cash savings derived from defaulting will mitigate most future need for credit.

With prior planning for the financing of purchases to be made during the period prior to defaulting, the homeowner avoids the credit score penalties lenders so want imposed on defaulting homeowners.

All things considered, a temporarily damaged credit score should be the least of a distressed homeowner's concerns.

Struggling to get by

Over time, negative equity is far more damaging to a family than losing a home to foreclosure or taking a temporary hit to one's credit rating. Credit heals and can be rebuilt quite quickly under a single event blemish. But supporting a negative equity property compounded by lost savings in this game equals a prolonged retirement age (if ever) and decades of struggling to "get by."

Imagine watching a neighbor purchase a new car, make repairs to their home or send their children to college. All the while, you the underwater homeowner are never fully able to enjoy ownership benefits from your property, living one large unforeseen expense away from financial ruin. With lenders refusing to aid the over-encumbered homeowner and the federal government reticent to enact effective measures while intimidating homeowners into paying, the rational choice is to walk away.

Chapter 12 Summary

Choosing to strategically default is often the best option for negative equity homeowners. Freed of their black hole asset, these formerly underwater homeowners can now contribute to the economy and live a more comfortable lifestyle.

Chapter 12 Key Terms

Chapter 13

A return to ownership for foreclosed homeowners and short sellers?

Learning Objectives

After reading this chapter, you will be able to:

- understand the role foreclosed homeowners play in a housing recovery;
- identify the economic and credit factors which influence a foreclosed homeowner's eventual return to homeownership; and
- analyze default rates of the recent past to determine future demand.

Key Terms

strategic default **subprime mortgage**

Singling out foreclosed homeowners

Once a homeowner loses their home to **foreclosure** or **short sale**, what is the likelihood they will return to homeownership?

To answer this question, the Federal Reserve Bank (the Fed)'s economists tracked a sample of mortgages from the first quarter of 1999 to the fourth quarter of 2011. They then singled out the point at which a mortgage balance was satisfied and the trust deed mortgage was reconveyed**.**

Editor's note —The Fed's researchers used national data, thus their sample of defaults included both nonjudicial and judicial foreclosures. However, the type of foreclosure had surprisingly little relationship to when borrowers returned to the mortgage market. In fact, judicially foreclosed borrowers returned to borrow again more quickly than their nonjudicially foreclosed counterparts. The difference was within one-to-two percentage points.

A tale of two types of borrowers

Borrowers were split into two diametrically opposed groups based on their mortgage payoff history:

- borrowers who were in *good standing* on their mortgage prior to payoff; and
- borrowers who were subject to a foreclosure or short sale.

Editor's note — For simplicity, we will refer to borrowers who lost their homes to foreclosure or short sale as ***foreclosed homeowners*** *since credit reporting agencies treat these events the same. The Fed's data takes into account both types of former homeowners, but does not analyze a distinction in behavior between them.*

35% of borrowers in good standing on payoff of their mortgages had taken out new mortgages within the 12-year sample period. That means nearly two-thirds did not return to buy a home by obtaining purchase-assist financing.

In contrast, only 13% of foreclosed homeowners had taken out new mortgages within the 12-year period. Since our concern is whether these foreclosed homeowners return to buy a home, let's delve further into the Fed's research.

The effect of the Great Recession

The 12-year sample period encompasses the credit crunch of the *Great Recession*. To review the recession's effects, researchers compared foreclosed homeowners' return to the market before and after the Great Recession hit.

Foreclosed homeowners were separated according to the year of their foreclosure:

- 2001 and 2003, in the thick of the housing boom; and
- 2008, during the Great Recession.

Foreclosed homeowners from the 2001 and 2003 period were four times more likely than 2008 foreclosed homeowners to buy a home (with a mortgage) within the first three years after a foreclosure or short sale.

Editor's note — Why only three year time periods? Data for 2008 defaults does not extend further than 3.75 years beyond the default date and comparisons need to be made between comparable time periods.

subprime mortgage
A mortgage made to a borrower based on loose underwriting standards and resulting in a high risk of default.

What accounts for the difference? 2001 and 2003 foreclosed homeowners had **subprime mortgages** at their disposal. The loose underwriting standards of these loans gave even foreclosed homeowners easy access to new mortgage money. In contrast, 2008 foreclosed homeowners were stonewalled — barred — in the credit crunch.

Though more likely to return to homeownership than 2008 foreclosed homeowners, the majority of 2001 and 2003 foreclosed homeowners did not return within the sample period. Only 25% of the 2001 and 2003 foreclosed homeowners returned to the market to buy again within three years, even with thriving economies and readily available financing.

Credit scores play a role

Researchers then sliced up the pool of foreclosed homeowners by credit score at the time of mortgage origination:

- **prime foreclosed homeowners** with credit scores higher than 650; and
- **subprime foreclosed homeowners** with credit scores of 650 or lower. Following the foreclosure or short sale, both *prime* and *subprime* foreclosed homeowners' credit scores dropped below 600.

However, by the end of the 12-year sample period, around 35% of prime borrowers had taken out new mortgages. Only 10% of subprime borrowers had taken out new mortgages.

Why did prime foreclosed homeowners fare so much better than subprime foreclosed homeowners?

This is a crucial question. A large chunk of the loans made and foreclosed on during the 2008 recession and recovery were subprime loans. If credit scores are a factor, this will direct future buyer behavior.

And as it turns out, credit improvement plays a pivotal role in determining which foreclosed homeowners return to the market. Foreclosed homeowners who increased their credit scores by more than 100 points were more likely to return to the market within five years of their default.

Further, another Fed research paper found that credit score recovery was slower for recent foreclosed homeowners (2008-2010, in this second study) than earlier (2001-2006) foreclosed homeowners. The recent foreclosed homeowners were subject to economic fallout of the **financial crisis**. Sudden unemployment or underemployment created a long-term economic problem for many households, and persisted after the foreclosure or short sale.

A sustained lack of income creates a **vicious feedback loop**: lack of income leads to delinquency, delinquency leads to more expensive credit, more expensive credit leads to lack of disposable income, which leads back to delinquencies…and so forth.

Pre-default behavior impacts recovery

In theory, credit score recovery can occur as soon as two years after a major derogatory credit event if the defaulter pays all their other bills on time. [See Figure 1, **RPI** Form 217-2]

But how many homeowners took stock of their situations and prepared for default in advance?

Not many. Lack of meaningful government guidance, post-bust, left homeowners to navigate the financial crisis on their own. Most negative equity homeowners continued (and continue) to pay on their underwater homes. The only government guidance discussed *moral obligations*, not legal obligations or prudence.

Figure 1

Form 217-2

Derogatory Credit Explanation Letter

DEROGATORY CREDIT EXPLANATION LETTER

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

NOTE: This form is used by a borrower, on their agent's recommendation, when the borrower receives a negative credit score usage notice in response to their application for a consumer mortgage, to provide the mortgage loan originator (MLO) or lender with an explanation of derogatory items on the borrower's credit report.

The borrower's letter prepared on page two and three assists the MLO or lender in determining creditworthiness by explaining why the derogatory items exist, what steps have been taken to resolve them and why derogatory items will no longer arise.

INSTRUCTIONS:

In **Section 1** on page two, enter the application number for the loan rejected by MLO or Lender due to derogatory item(s) listed on your credit report.

In **Section 2** on page two, check the box or write the name of the Credit Bureau which issued the credit report containing the derogatory item(s) which are now negatively affecting your ability to obtain a Mortgage.

In **Section 3** on page two, in chronological order, list the derogatory item(s) which appear on your credit report. Include:

1) the name of the creditor;
2) the date the derogatory item(s) was added to your credit report; and
3) the amount of money involved in the derogatory item(s).

In **Section 4** on page two and three, provide an explanation for each derogatory item(s) which appears on your credit report you have obtained. Each explanation is in response to the corresponding derogatory item(s) listed in **Section 3**. For example, the explanation in **Section 4.1** will be in response to the derogatory item(s) of **Section 3.1**.

It is important to clearly describe the history of the derogatory item(s). Begin your explanation at a point necessary to establish the full context of the derogatory item(s), but do not include unnecessary data.

Be honest regarding the personal circumstances which colluded to create the derogatory item(s). If the item(s) was the result of your own negligence, acknowledge your mistake candidly. Approach the item(s) from a perspective which exhibits your reformed financial habits.

Discuss the steps and actions which have been taken to remedy the derogatory item(s). In your acknowledgment of the item(s), portray your present understanding of the necessity to repay debt. Provide concrete examples of how your financial health has improved and itemize what steps have been taken to ensure that similar negative item(s) will not occur again.

Check the box in **Section 5** on page three if additional pages of explanation are needed to thoroughly explain the derogatory item(s), and indicate the number of pages attached.

It is advised you attach supplementary documentation to evidence your explanation(s) provided in **Section 4**. Supplementary documentation adds weight and legitimacy to your explanation. For example:

1) job loss claims can be supported by layoff notices and unemployment records;
2) divorce based claims can be evidenced by divorce court and tax documents;
3) inability to work resulting from injury can be documented with workers' compensation records; and
4) spousal abuse can be shown with medical reports and police records.

Check the box in **Section 6** on page three if you've attached any supplementary documentation and indicate how may pages are attached. In **Section 6.1**, identify the nature of the supplementary documentation and reference what derogatory item(s) from **Section 3** and what explanation from **Section 4** the documents relate to.

Be truthful, persuasive and personal in your completion of the explanation letter.

PAGE 1 OF 3 — FORM 217-2

DEROGATORY CREDIT EXPLANATION LETTER

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

TO LENDER:	**FROM BORROWER:**
Address ____________	Address ____________
Phone ________ Cell ________	Phone ________ Cell ________
Email ____________	Email ____________

1. This letter is regarding the loan application number ____________.

2. Name of Credit Bureau that issued report:

☐ Equifax
PO BOX 740241, Atlanta, GA 30374
1-800-685-1111

☐ Experian
PO BOX 2002, Allen, TX 75013
1-888-397-3742

☐ TransUnion
PO BOX 1000, Chester, PA, 19022
1-800-888-4213

☐ Name: ____________
Address: ____________
Phone: ____________

3. Derogatory item(s) listed on the credit report:

3.1 ____________

3.2 ____________

3.3 ____________

3.4 ____________

3.5 ____________

4. This letter is intended to explain each derogatory item on my credit report you have obtained. Each explanation is in response to the corresponding derogatory item(s) listed above.

4.1 ____________

PAGE 2 OF 3 — FORM 217-2

PAGE 3 OF 3 — FORM 217-2

4.2 ____________

4.3 ____________

4.4 ____________

4.5 ____________

5. ☐ See attached ______ pages of additional explanations.

6. ☐ See attached ______ pages of supplementary documentation.

6.1 Attached supplementary documentation is described as ____________

The above explanations are true and correct	**The above explanations are true and correct**
☐ See Signature Page Addendum. [**RPI** Form 251]	☐ See Signature Page Addendum. [**RPI** Form 251]
Date: ________, 20____	Date: ________, 20____
Borrower: ____________	Co-Borrower: ____________
Signature: ____________	Signature: ____________

FORM 217-2 03-11

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Consider the impact: homeowners who pay on their underwater homes are basically losing their money to lenders. They merely divert money away from paying other bills or buying goods and services, and place themselves at risk of loss of the diverted money. This risk is realized when an economic shock – lost job, ill health, divorce, etc. – hits. They're left with their money depleted, and no home equity or additional savings to show for all their mortgage payments.

strategic default
The intentional default on a mortgage, forcing the lender to foreclose and acquire the property in satisfaction of the mortgage debt.

Recovery from this situation is much more difficult than had the homeowner first put their financial house in order intelligently, then **strategically defaulted.**

Homebuyer demand will return

The Fed's analysis looks at the nature of the defaults of the recent past to determine future *demand*. The housing recovery we have experienced thus far corroborates their findings.

It will take a long time for foreclosed homeowners to return to the market, longer than it has taken in the past. Instead of 15 years, it may be 20, or even more, before some return. Most are not likely to return at all, opting to be tenants.

This does not mean that demand is dead, or the real estate industry is in decline. It's merely a **reality check**. The pace of homeowners added during the boom was simply not sustainable, and it won't be recreated in the recovery. Instead, expect more renters, and more opportunities for branching out into property management.

Chapter 13 Summary

Once a homeowner loses their home to foreclosure or short sale, what is the likelihood they will return to homeownership?

Homeowners foreclosed in 2001 and 2003 had subprime mortgages at their disposal. The loose underwriting standards of these loans gave even foreclosed owners easy access to new mortgage money. Accordingly, homeowners foreclosed in 2001 and 2003 were four times more likely than 2008 foreclosed homeowners to buy a home (with a mortgage) within the first three years after a foreclosure or short sale.

However, only 25% of the 2001 and 2003 foreclosed homeowners returned to the market to buy again within three years, even with thriving economies and readily available financing. In contrast, homeowners foreclosed in 2008 were barred from purchase-assist financing in the credit crunch. It will take a long time for foreclosed homeowners to return to the market, longer than it has taken in the past.

Credit improvement plays a pivotal role in determining which foreclosed homeowners return to the market. Foreclosed homeowners who increased their credit scores by more than 100 points were more likely to return to the market within five years of their default.

Chapter 13 Key Terms


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Chapter 14

Qualifying a negative equity homeowner for a short sale

Learning Objectives

In this chapter, you will learn to:

- qualify a homeowner for a short payoff;
- set a broker price opinion (BPO);
- negotiate a short sale with a first and second lien holder; and
- counsel a homeowner on the tax and credit score implications of a short sale.

Key Terms

broker price opinion (BPO)

hardship letter

Home Affordable Foreclosure Alternative (HAFA)

Home Affordable Modification Program (HAMP)

loss mitigation

nonrecourse

recourse

short payoff

The new and present normal, sort of

The **short sale** resurfaced in this recovery to become a commonplace feature of the home resale market. The dire job environment left in the wake of the *Great Recession* brought this on.

Although foreclosures returned to historically normal levels in 2016, 20% of multiple listing service (MLS) sales transactions statewide was a short sale in 2012 - the result of the financial fallout from:

- the massively inflated real estate prices of the past decade; and

- the current lack of job opportunities for *unemployed* or *underemployed* homeowners.

These unemployed and underemployed casualties of our Great Recession often view a short payoff as the respectable alternative to losing their home through a *foreclosure* sale. To accomplish their short sale objective, they fully expect even an inexperienced agent with "short sale training" seminars under their belt to properly structure the listing and purchase offers. They also expect them to successfully negotiate with the lender to rid themselves of both the house and the mortgage debt.

An uphill battle

Negotiating with a lender for a short payoff is not a straight-forward or routine task. Any agent facilitating short sale negotiations with the homeowner's lender needs to first thoroughly understand:

- *California anti-deficiency law* barring lender collection of property value deficiencies on purchase-assist mortgage foreclosures and short payoffs;
- the *trust deed foreclosure process* and documentation, as well as time periods for reinstatement and redemption prior to the trustee's sale and elimination of ownership;
- complications over clearing the title of any *junior financing* encumbering the property in situations where the amount of the first is either less or more than the short sale net proceeds; and
- the homeowner's income and net worth financial situation.

This knowledge, combined with first-hand experience actually negotiating short payoffs with a lender, is the pedigree of a "short sale specialist."

Before you take a listing, do the math

Roughly one in five short sales buyers enter into in Southern California actually close. Agents who struggle to get listings and earn fees are tempted to take any short sale listing that comes across their desk. However, a **short payoff** listing becomes a massive waste of time, effort and goodwill if the lender is not going to consent to a discount.

short payoff
A sale in which the lender accepts the net proceeds at closing in full satisfaction of a greater amount of mortgage debt.

The lender's consent is based on facts readily available to the seller's agent at the time the listing is being negotiated. Thus, an agent's forward-oriented investigation can anticipate lender approval or rejection before taking the listing and conserve the agent's time, talent, reputation and money. For agents, a basic litmus test to discern which short sale listings are worth the time begins by asking the following questions:

1. *Is the mortgage's LTV ratio more or less than 94%?*

If a homeowner owes less than the home is worth (read: the loan-to-value ratio (LTV) is less than 94%), the issue of a short payoff is non-existent. The net sales proceeds are more than enough to pay the loan in full.

The agent can arrive at the LTV by first estimating the property's fair market value (FMV) by way of a **broker price opinion (BPO)**. The agent sets a *BPO* by downloading a *property profile* (title condition) for the home and a printout of recent sales in the surrounding area from a title company website. This is the agent's first step in any seller counseling and listing effort.

broker price opinion (BPO)
An agent's opinion of a property's fair market value (FMV) based on recent comparable sales.

2. *How many liens are on the property?*

If there are any junior liens encumbering the property, each lender needs to be dealt with to clear title of their trust deed lien before a short sale can close.

Occasionally, the same lender holds both the first and second mortgage on a home, the piggy-back financing of the *Millennium Boom*. Holding all the liens on the property, the lender will handle negotiations as though one amount was owed them.

If the answers to the above are promising, the owner and the agent enter into a listing agreement. The agent adds a provision to the *listing agreement* stating:

"The owner will first qualify with the mortgage lender for a discounted payoff of the loan and reconveyance of the trust deed on a sale of the home at which time the agent will begin marketing the property in search of a buyer." [See **RPI** Form 102-1]

The agent instructs the owner to contact their lender and discuss how to proceed on a short sale.

If the lender qualifies the homeowner for a short sale, the lender receives the net sales proceeds in full settlement of the combined debts.

Qualifying for a short sale

On contacting the lender, the owner is referred to the lender's **loss mitigation** specialist, sometimes called a negotiator. In response, the owner is sent a short sale information packet, requesting they deliver the following to the lender:

loss mitigation
A strategy to lessen the amount of loss a lender incurs due to a default by the property owner.

- *Authorization to release information to an agent.* This document signed by the homeowner gives the lender permission to deal with and furnish information about the mortgage to the homeowner's real estate agent. Without this authority, lenders will not communicate with anyone acting on behalf of the homeowner, making the document a priority. [See **RPI** Form 124 accompanying this chapter]
- **A hardship letter**. The lender first determines whether or not the homeowner is financially qualified to make payments on the mortgage. For this, the homeowner prepares a letter detailing their current personal and financial situation. The homeowner explains

hardship letter
A statement detailing a distressed homeowner's financial situation, delivered to the lender to determine if the homeowner qualifies for a short sale.

their inadequate sources of income, or that they were laid off and have been unable to find a new job. The homeowner also discloses whether they are the only wage earner in their household. [See **RPI** Form 217-1]

- *The homeowner's most recent pay stubs, bank statements and tax* returns. The lender wants to confirm the homeowner is purchasing only necessities in lieu of making mortgage payments (i.e. groceries, car repairs and school supplies). Tax returns are used to verify annual income. The lender may also require the owner to fill out a *financial statement* (equivalent to an application for a loan). With it, the lender determines whether the owner has other assets available as a source of funds to voluntarily pay off the mortgage without a discount (i.e. cash on hand, equity in other property, stocks/bonds, etc.).
- *Proof of occupancy*. The homeowner provides the lender with a utility bill in the owner's name at the property address to prove they occupy the residence and don't rent it to others.

Editor's note —When a buyer's agent finds a property listed as a short sale, the first question the agent needs to ask the seller's agent is ***"Have you qualified your homeowner for a shortpay with the lender?"***

A buyer's agent needs to protect their buyer, along with everyone's time and energy, by being assured the seller has been qualified for a shortpay before spending any additional time putting together an offer from their buyer.

A different lender holds a second

If a lender other than the first trust deed lender holds the second mortgage, one of two situations exists:

- the net sales proceeds satisfy the first trust deed, but not the second; or
- the net sales proceeds do not satisfy the first trust deed, and by extension do not satisfy the second.

In the first situation, the net sales proceeds are more than sufficient to fully satisfy the first trust deed on closing. In this situation, the seller's agent negotiates solely with the junior trust deed holder(s). The junior trust deed holder needs to consent to accept the balance of the net proceeds remaining (after paying the first trust deed lender, who has priority to the funds) in exchange for a reconveyance of their junior trust deed.

Here, the second lender - not the first - is initially contacted when taking the listing to qualify the seller for a short payoff of the second. If the second concludes the seller qualifies for a discounted payoff, then the purchase agreement entered into by the seller is submitted to the second lender for shortpay consent (together with a HUD-1 estimated closing statement).

At that point, the second lender orders out the appraisal, determines the property value and reviews the appropriateness of the net sales proceeds. Only then will they allow the short sale to close by discounting the amount owed them.

The second fact situation is traumatic for everyone involved in clearing title. Here, the seller's agent has to deal with both lenders. The second trust deed lender will demand some amount of money from the net sales proceeds before they will consent to cancel their debt and reconvey their trust deed lien.

As a result, the seller's agent will need to be sufficiently innovative at the outset of negotiations. To begin, the agent knows the second needs to be dealt with if the first is to be paid off by a short sale. Thus, the first lender needs to agree to let the second participate for a few thousand dollars in the net sales proceeds (which first lenders also understand).

Then negotiations with the second lender need to keep the second from being so greedy (they have nothing to lose) as to kill the transaction. At all times, agents need to resist any requests by the lenders for the brokers to cut their fees agreed to in the purchase agreement. [See **RPI** Form 150-1]

Keep an eye on your buyer

The processing times on the lenders' end vary widely. The typical short sale takes three to five months, but any one of many factors involved can deny the seller's agent success. Too frequently at time of closing, the lender will demand more net proceeds, and thus call for the buyer to pay a higher price than agreed to with the owner.

On the other end of the deal, the length and uncertainty of a short payoff transaction often triggers a buyer's decision to withdraw their offer or just abandon it as hopeless. Buyers and buyer's agents are too often left "out of the loop" by the seller's agent during the short sale process.

To keep the deal alive, buyers need to be given frequent updates to ensure the process is on the right track and moving. Buyer's agents need to stay in contact with the seller's agent, at least weekly, for status updates to be passed on to the buyer.

Frustrated buyers often locate and purchase other property, canceling or abandoning their purchase agreements during the approval process. Loss of the buyer nullifies all the work done by the lender. Once the seller accepts another buyer's purchase offer and submits documentation to the lender for approval, the loss mitigation specialist assigned to the file starts the approval and appraisal process all over again.

Home Affordable Foreclosure Alternatives (HAFA)
A government program aimed at assisting homeowners to avoid foreclosures by offering incentives for homeowners and lenders to complete short sales.

Further delayed for HAFA benefits

The short sale process was often delayed by yet another monkey wrench —**Home Affordable Foreclosure Alternatives (HAFA)** money for the seller. The *HAFA* program, which expired December 31st, 2016, was aimed at helping homeowners avoid foreclosure by providing short sale incentives. It was a supplement to the **Home Affordable Modification Program (HAMP)** rolled out in spring 2009 and expired in 2016.

Home Affordable Modification Program (HAMP)
A government program aimed at assisting homeowners to receive a loan modification in lieu of foreclosure.

HAFA provided incentives for homeowners, lenders and agents to consider a short sale rather than a foreclosure sale. *Homeowners* participating in a HAFA short sale received:

- $3,000 to help cover their cost of relocation;

- full release from future deficiency liability for the first mortgage (as cash contributions are not allowed in a HAFA transaction); and
- standard timeframes for each step of the process.

Lenders participating in a HAFA short sale received:

- $1,500 to cover administrative costs; and
- up to $2,000 for allowing a total of $6,000 in net sales proceeds to be distributed to junior lienholders.

Agents representing a homeowner in a HAFA short sale received:

- fee protection since lenders are prohibited from requiring a reduction in a real estate fee agreed upon in the listing agreement (up to 6%).

In order for a homeowner to have been eligible for HAFA:

- the property needed to be the homeowner's principal residence;
- the mortgage needed to be a first lien originated before January 1, 2009;
- the mortgage needed to be delinquent or default imminent;
- the current unpaid principal balance needed to be equal to or less than $729,750;
- the homeowner's total monthly mortgage payment needed to exceed 31% of their gross income; and
- the homeowner needed to first apply for a loan modification through HAMP.

Lenders needed to consider a HAMP homeowner for HAFA within 30 calendar days after the homeowner:

- failed to successfully complete a trial period under a HAMP modification;
- missed at least two consecutive payments after a HAMP modification; or
- requested a short sale or deed-in-lieu of foreclosure.

HAFA qualified

After all HAFA qualifications had been met, the homeowner could have requested a short sale consent from their lender. In turn, their lender would have sent them a HAFA *Short Sale Agreement (SSA)* to be signed by the homeowner and real estate agent within *14 calendar days* of receipt. The SSA would have been returned by the agent to the lender's loss mitigation specialist. [See HAFA Form 184]

The lender would have given the homeowner an initial period of *120 calendar days* to sell their home after receipt of the signed SSA, which could have been extended up to 12 months (during which time the owner would not have been making payments). Once an offer to purchase the home were to be accepted, the homeowner (or their agent) would have needed to submit a Request for Approval of Short Sale (RASS) to the lender within *three business days* after executing a purchase agreement, including:

- a copy of the purchase agreement and all addenda;

- buyer documentation of funds or pre-approval from a lender; and
- information on the status of subordinate liens and any negotiations with subordinate lienholders. [See HAFA Form 185]

After receiving the RASS, the lender would have approved or denied the request within *ten business days*.

This separate HAFA application, documentation and processing time would have been completed before the lender even began its own short sale approval process. Thus, you would have had another delay of around three months. If the lender refused to approve the short payoff after HAFA approved the owner, the transaction with the buyer would have been terminated, unless somehow revived by negotiations to resolve the lender's reasons for disapproval of the short sale.

If the sale were terminated, the HAFA process would have started all over again for this seller (and the seller's agent) upon acceptance of the next buyer's short sale purchase offer.

The credit score effect

According to a *Fair Isaac Corporation (FICO)* study, a foreclosure has the *same effect* on an underwater homeowner's credit score as a short sale. Thus, FICO scores damaged by either a short sale or a foreclosure sale have the same estimated recovery time.

However, a *non-defaulting* homeowner will experience slightly less damage to their credit score than a defaulting homeowner who received a short sale or foreclosure. Thus, agents need to counsel homeowners who are able to continue making payments while pursuing a short sale to do so, if the lender is willing to cooperate.

Previously, the agent would have advised that the homeowner needs to default before the lender will consider a short sale. However, beginning in 2012, lenders have become more willing to consider short sales for homeowners who are current on their payments. In order to qualify, the homeowner needs to demonstrate a *hardship*. Acceptable hardships vary by lender, but commonly include negative equity, the need to relocate for a job or to escape a neighborhood blighted by vacant, foreclosed homes.

Thus, if the homeowner can demonstrate any sort of hardship, the agent can encourage them to discuss a short sale with their lender, while remaining current on mortgage payments.

Short sales under Fannie Mae and Freddie Mac

Homeowners with mortgages held by **Fannie Mae** or **Freddie Mac** are eligible for a short sale without defaulting if they meet hardship criteria, which include:

- death of a borrower or co-borrower;
- divorce;
- unemployment;
- disability; or

Form 124

Authorization To Release Confidential Information

AUTHORIZATION TO RELEASE CONFIDENTIAL INFORMATION

NOTE: This form is used by an agent when negotiating a short sale payoff or loan modification to obtain written consent from an owner authorizing their lender to release information and discuss with the agent any aspect related to the owner's mortgage.

DATE: ____________, 20_____, Prepared by ____________________

TO LENDER:	**PROPERTY OWNER/BORROWER:**
Name ____________	Name ____________
ATTN ____________	Phone ____________
Address ____________	Cell ____________
____________	Work ____________
Phone ________ Cell ________	Email ____________
Email ____________	

1. Mortgage information:

1.1 Loan number ____________________.

1.2 Name of original Borrower ____________________.

1.3 Address of the mortgaged property ____________________

____________________.

1.4 Type of property:

☐ single family residence, ☐condo unit, ☐ two-to-four residential units, ☐ commercial property,

☐ ____________________.

2. Lender is authorized to release any information related to this mortgage and discuss any aspect of this mortgage with:

Agent's name ____________________ CalBRE#: ____________

Broker's name ____________________ CalBRE#: ____________

Address ____________________

Phone ____________________ Cell Phone ____________________

Email ____________________

3. This authorization is effective until revoked by any Borrwer on written notice received by Lender.

I agree to the terms stated above.

☐ See Signature Page Addendum. [**RPI** Form 251]

Date: ____________, 20_____

Owner/Borrower: ____________	Owner/Borrower: ____________
Signature: ____________	Signature: ____________
Owner/Borrower: ____________	Owner/Borrower: ____________
Signature: ____________	Signature: ____________

FORM 124 09-11

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.

- relocation for a job.

However, a homeowner who enters into a short sale, even without a delinquency, still incurs a *FICO* score hit, since short sales are still reported by lenders as debt "not paid as agreed."

Tax aspects of the short payoff

Tax wise, the two most significant consequences of the short sale of a **nonrecourse** loan (which includes an owner-occupied one-to-four unit residential property encumbered by a purchase-assist loan, improvement loan or *refinance* on a purchase-assist loan) are:

- the short sale does not trigger tax reporting of ordinary income for the discounted and discharged portion of the loan if the home is sold on or before January 1, 2018; and
- the discount on a short payoff produces a capital loss that may not be used to reduce taxable income.

Editor's note: The Mortgage Forgiveness Debt Relief Act was most recently renewed in 2018. Had the Act not been renewed, it's expiration would not hamper Californians with nonrecourse loans. A property owner is not personally liable for a nonrecourse loan.[1]

For holders of non-purchase money loans (refinances, equity loans/ HELOCs), it's a slightly different story. California's anti-deficiency protections cover ***discharge-of-indebtedness income*** *from a first trust deed on a short sale — for both purchase money and non-purchase money loans, i.e. refi's.*

California's anti-deficiency protections also include discharge of indebtedness income from any lien on a short sale, provided a short sale agreement exists between the homeowner and all participating lenders.

No discharge -of- indebtedness income

The discount on a short payoff is not to be reported by the seller as *discharge-of-indebtedness income*. Instead, the discount produces a personal loss (capital loss) on the sale that may not be written off. However, the lender will file a 1099C indicating the discount occurred. This action reports the discount as debt relief that is taxable personal income, except for the negative equity home sales rule.[2]

This strategic default requires no out-of-pocket cash from the homeowner nor can the lender collect any deficiency in the property value from the homeowner.

A second trust deed complicates the liability analysis. Seconds are generally **recourse** paper, unless the second trust deed lender gives written consent to a short sale.

recourse
On default on a debt secured by real estate, a lender may pursue a homeowner for a loss due to a deficiency in the value of the secured property if the lender forecloses judicially.

The only way to avoid FICO score damage is to come to an agreement with your lender as part of the shortpay consent to report the short sale as "paid as agreed." This rarely occurs but is possible for the very determined, or the homeowner willing to hold the threat of foreclosure over the lender's head.

1 26 Code of Federal Regulations §1.1001-2(a)
2 Internal Revenue Code §108(e)

Chapter 14 Summary

When a homeowner seeking a short sale has more than one lien encumbering their property, all lien holders need to consent to the short payoff.

A government program provided cash incentives to the homeowner, lender and agent to complete a short sale called the Home Affordable Foreclosure Alternatives (HAFA).

Seller's agents need to keep an eye on short sale buyers, as if a frustrated buyer walks away from the deal, the approval process starts all over again.

A short sale and a foreclosure have the same effect on a homeowner's credit score. A homeowner can avoid the full credit score hit by not defaulting on payments and by negotiating with the lender to report the short sale as "paid as agreed."

Chapter 14 Key Terms

Chapter 15

Other amounts due under three-day notices

Learning Objectives

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

- perform the steps a landlord takes to properly manage late charge provisions; and
- identify the proper use of an unlawful detainer action for the collection of unpaid late charges.

Key Terms

late charge notice
late payment clause
public policy

Know what the judge will allow

A lease agreement between a landlord and their tenant contains a clause calling for the accrual of interest on delinquent rent. This is a type of **late payment clause**.

late payment clause
A provision in a lease agreement specifying late charges paid by the tenant on delinquent rent.

The tenant fails to pay rent before it becomes delinquent. The landlord then prepares a three-day notice to pay or quit and serves the notice on the tenant. [See **RPI** Form 575-1 and Form 575]

The three-day notice itemizes the amounts of delinquent rent and daily interest accrued that are due and unpaid on the date the notice is prepared. The tenant fails to pay or quit during the three-day period. The landlord files an *unlawful detainer (UD)* action to evict the tenant.

At the UD hearing, the tenant claims the landlord cannot terminate the tenant's right to possess the premises under the three-day notice. The notice demands payment of an amount greater than the rent due under the lease agreement. It is defective as the demand includes other amounts due the landlord.

May the three-day notice include amounts due under the lease agreement in addition to the rent itself?

Yes! A three-day notice to pay or quit is not limited to the scheduled amount of periodic rent which is delinquent. While the notice to pay may not be served until rent is delinquent, the notice may include all sums of money which are properly due and unpaid under the rental or lease agreement at the time the notice is served, including the delinquent rent.[1]

Examples of amounts of money due periodically under a rental or lease agreement, in addition to scheduled rent, include:

- *common area maintenance charges (CAMs)*;
- association charges;
- pro rata insurance premiums, property taxes and assessments;
- late payment and bad check charges;
- expenses incurred by the landlord to cure *waste* or failure to maintain the property; and
- other amounts of money properly due as compensation or reimbursement of expenses arising out of the occupancy.

A three-day notice to pay or quit form provides for the itemization of rent and other amounts due which are unpaid and delinquent. [See **RPI** Form 575]

Lump sum late charges

Under a commercial lease agreement entered into by a tenant, rent is typically due and payable on the first day of each month, called the *due date*. The lease agreement contains a late charge provision stating the tenant agrees to pay a charge in the amount of $150 if the rent is not received by the landlord on or before the fifth day of each month, called a **grace period**. [See **RPI** Form 552 §4.7]

The rent payment is *delinquent* the day after the grace period runs, the sixth day of the month. The delinquency triggers the landlord's right to demand payment of the agreed-to late charge, or do nothing and waive it.

The lease agreement also requires the tenant to pay $25 for each rent check returned for insufficient funds. [See **RPI** Form 552 §4.9]

One month, the landlord receives the rent after the grace period expires. The landlord (as they need to) accepts the rent since the tenant's right of possession has not been terminated by a declaration of forfeiture provision in a three-day notice or expiration of the lease. The landlord then notifies the tenant in writing that they are imposing a late charge, payable with the following month's rent, as called for in the lease agreement. [See **RPI** Form 569]

The following month the landlord receives the regularly scheduled rent within the grace period. However, the tenant does not also tender the late charge the landlord demanded based on the delinquency of the prior month's delinquent payment.

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1 **Canal-Randolph Anaheim, Inc.** v. **Wilkoski** (1978) 78 CA3d 477

Landlord's options for collection

The landlord's options to enforce payment, viable or not, include:

- returning the rent check to the tenant as insufficient payment for the total amount due;
- serving the tenant with a three-day notice to pay or quit;
- deducting the additional charge from the security deposit on written notice to the tenant; or
- filing an action against the tenant in small claims court to collect the late charge.

Returning the rent check to the tenant will result in one of the following scenarios:

- the tenant will submit another check which includes rent and payment of the late charge (which payment will be delinquent and arguably incur another late charge); or
- the tenant will retain the rent check as having been properly tendered and therefore legally paid, and do nothing more until they send a check for the following month's rent.

A tenant who fails to pay rent or otherwise materially breaches the lease agreement, may be served with the appropriate three-day notice. The three-day notice based on a material breach properly includes a demand for late charges and any other monetary amounts past due.[2]

If the tenant fails to cure the breach within three days following service of the notice and remains in possession, the landlord may file a UD action to regain possession.[3]

Failure to pay

However, a landlord will not succeed in a UD action when the landlord's refusal to accept the tenant's timely tender of a rent check is based solely on the tenant's refusal to pay late charges. Failure to pay the agreed late charge after notice is a **minor breach**.[4]

A late charge is properly sought when pursuing delinquent rent. But alone, a late charge (or bounced check charge) is a *minor breach* and will not independently support a UD action.[5]

Thus, the landlord has two viable options for the collection of unpaid late charges from the tenant:

- accept the rent check, deduct the amount of the unpaid late charge from the security deposit then or later, and advise the tenant of the deduction; or
- accept the rent check and file a money action for the unpaid late charge amounts.

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2 Canal-Randolph Anaheim, Inc., *supra*

3 Calif. Code of Civil Procedure §1161

4 Canal-Randolph Anaheim, Inc., *supra*

5 **Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818

The financially practical action is for the landlord to accept the rent and deduct the demanded late charge from the tenant's security deposit.

Late charges to compensate for costs

To be enforceable, late charges need to be reasonably related to:

- the actual costs of collecting the delinquent rent (the time and effort involved); and
- the delay in its receipt (loss of use, such as interest).

A lump sum late charge becomes a liquidated damages provision if the amount of the late charge is significantly greater than the actual out-of-pocket losses. As liquidated damages, the charge is a penalty and is unenforceable.[6]

Editor's note — Some may argue any lump sum late charge on residential property is void as a liquidated damage since out-of-pocket money losses due to a late payment are readily ascertainable, especially in real estate transactions.

A liquidated damages provision in any agreement is void unless:

- the loss covered is impracticable or nearly impossible to calculate (rarely the case); or
- the amount of the charge is a reasonable estimate of the landlord's out-of-pocket expenses for the collection effort.[7]

When setting the amount of a late charge, a landlord needs to consider charging an amount equivalent to the late charge allowed on delinquent residential loan payments by the state legislature as public policy. The late mortgage payment late charge formula amount is a good indicator of what is deemed reasonable for a late charge on a monthly rent payment.

The late charge amount allowed for a delinquent payment on a loan secured by residential property is controlled by statute. This is not the case for late charges on rent, which is determined by case law.

For example, the lump sum late charge allowed on a loan secured by an owner-occupied, single-family residence cannot exceed 6% of the delinquent payment (principal and interest only).[8]

Rent is the economic equivalent of interest. For purposes of late charges, rent payments should be treated no differently than interest payments.

Late charges as liquidated damages

A late charge provision calling for interest to accrue at a predetermined annual percentage rate on delinquent rent is not a liquidated damages provision. Therefore, it is fully enforceable unless the rate of interest is unconscionable.[9]

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6 **Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731

7 Calif. Civil Code §1671(d)

8 CC §2954.4(a)

9 Canal-Randolph Anaheim, Inc., *supra*

Form 575-1

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 $0.00
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: ________________________ DRE# ______________
Signature: ____
Address: ____
Phone: ________________________ Cell: ______________________

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However, some landlords wrongfully view late charges as a means for coercing tenants to pay rent on time. Thus, landlords set the late charge at an amount exceeding their actual losses. This constitutes a penalty assessment and, as such, is unenforceable.

A late charge provision calling for a specific dollar amount, or lump sum is a liquidated damages provision. The charge is a one-time, predetermined fixed amount. It is intended by its nature to reimburse the landlord for the delay in receipt of the rent money and the costs and effort spent to collect the delinquent amount.[10]

10 CC §1951.5

Thus, a lump sum late charge provision in a commercial lease agreement is valid unless the tenant can show the amount of the late charge is an unreasonable reimbursement for the delay in receipt of the rent and costs of collection efforts.[11]

A late charge is unenforceable if the charge is so great in comparison to actual losses that it imposes a penalty on the tenant for their late rent payment.[12]

In a lease agreement for single-user property encumbered by a loan, an appropriate late charge for the tenant is equal to the amount of the late charge imposed on the landlord from their mortgage lender. The landlord is simply "passing through" the loss incurred by late receipt of the tenant's rent payment.

However, in a residential lease agreement, a late charge provision setting a fixed amount is void unless the losses suffered by the landlord due to late payment are impracticable to calculate.[13]

Editor's note — Determining money losses suffered due to late payments in any real estate transaction, especially in a residential lease, is not impracticable. A landlord may calculate this by accounting for known costs incurred due to collection efforts and lost use of the funds until received.

Imposing the late charge

A late charge is not automatically due and payable by the tenant when the landlord fails to receive the rent payment within the grace period.

The landlord needs to first make a written demand on the tenant for payment of the late charge. The demand needs to include the amount due and the date for its payment before the late charge collection can be enforced.

late charge notice
A written notice demanding payment of a late charge by a set date.

Thus, a written billing demanding payment of the late charge with the next month's rent is delivered to the tenant to ensure the late charge agreed to is imposed. This is called a **late charge notice**. [See **RPI** Form 568]

The *late charge notice* advises the tenant the landlord is entitled to enforce collection of the unpaid late charge by:

- deducting the unpaid late charge amount from the tenant's security deposit; or
- filing a small claims or municipal court action for unpaid late charge amounts.

Too late to collect

Recall that a landlord has only one year from the date of the delinquency to serve a three-day notice to collect delinquent rent due and unpaid.[14]

As an alternative to seeking a recovery of money in a UD action with its one-year limitation, the landlord can file a separate money action within four years of the breach to collect unpaid late charges, returned check handling charges and any other amounts due under the lease agreement.[15]

11 CC §1671(b)
12 Garrett, *supra*
13 CC §1671(d)
14 CCP §1161(2)
15 CCP §337

Ultimately, the landlord may deduct properly demanded late charges from the tenant's security deposit as payment of unpaid amounts due the landlord under the rental or lease agreement.[16]

The UD court problem

In *Canal-Randolph Anaheim, Inc.,* the court clarified a landlord may include any sums due and unpaid under the lease as an amount due in the three-day notice.

Also, existing statutes do not forbid (or limit) the collection of a late charge in a rental or lease agreement. However, cases do limit the charge to an amount reasonably calculated to cover the losses inflicted by late payment.[17]

Despite the holding of *Canal-Randolph Anaheim, Inc.*, some trial judges declare late charges are not rent in residential agreements. Thus the delinquency of a late charge payment previously demanded is not properly included as an amount due the landlord to be collected by use of a three-day notice to pay or quit.[18]

These judges hold a late charge or bad check charge cannot be included in the three-day notice as part of the amount due. If included, the demand would bar an eviction before those judges.

Varying approaches

Before a landlord or a property manager includes any late charge (or other amounts due besides technical rent) in a three-day notice as part of the total amount due, the wise landlord will determine if the judge presiding over UD actions in the jurisdiction will allow a demand for late charges.

Judges in UD actions on residential rental or lease agreements vary in their approach to late charges:

- some allow masked late charges built into the monthly rent and cloaked as a forgiveness of 6% to 10% of the scheduled rent, if paid before the rent (including the masked late charge) is considered delinquent;
- some allow a late charge of up to 6% of the delinquent rent as a reasonable amount;
- some disallow fixed-sum late charges as an unenforceable penalty for being delinquent;
- some disallow late charges as a forfeiture of money (since the amount exceeds the costs of collection); and
- some just disallow late charges altogether as an exercise of their discretion.

Information on the treatment given by the local trial court judge can be obtained from an attorney or other landlords who have experience appearing in front of the judge in question.

16 CC §§1950.5(b)(1); 1950.7(c)
17 Garrett, *supra*
18 CCP §1161(2)

If the judge will not allow the late charge as part of the amount due from the tenant, the landlord is best served leaving it out of the three-day notice. Instead, the landlord's best practice is to either deduct the late charge they have demanded from the security deposit (if any remains when refunded), or pursue collection in a separate action for money. Both of these remedies avoid the issue of demands placed in the three-day notice.

The landlord needs to inquire into the local judge's behavior first to eliminate the risk of getting an erroneous judicial determination that late charges or other amounts due were improperly included in the three-day notice. Such a judgment will result in a denial of the eviction, requiring an appeal or renewal of the three-day notice and UD process without the late charge.

public policy
A system of laws upheld by local, state or federal government.

*Editor's note — An obvious solution to the inconsistent rules applied to late charges is **public policy** legislation defining the nature of late charges and acceptable limits on time and amounts for recovery of the cost of collecting delinquent rent. This would provide guidance for all involved in the UD process.*

Late charges for rent should be treated like late charges on mortgages. Both serve the same economic function — recovery of costs incurred due to the delayed receipt of funds and resulting collection efforts. The number of homeowners with mortgage payments is almost equal to the number of renters with rental payments in California. Both mortgage payments and rental payments are part of the cost of occupancy and entitled to equivalent legislative controls.

Chapter 15 Summary

The landlord needs to first make a written demand on the tenant for payment of the late charge and include the date when the charge is payable before the collection can be enforced. If the amount of the late charge is significantly greater than the landlord's actual out-of-pocket losses it is unenforceable.

A late charge is properly sought when pursuing delinquent rent. But alone, a late charge (or bounced check charge) is a minor breach and will not independently support a UD action. However, a three-day notice to pay or quit may include all sums of money which are due and unpaid under the rental or lease agreement at the time the notice is served, including any delinquent rent.

Chapter 15 Key Terms

Chapter 16

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 those responsibilities.

Key Terms

commingling	**start-up fee**
property profile	**trust account**
prudent investor standard	**trust funds**

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 an interest in 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.

Recall that in California, an individual who acts as a property manager on behalf of another for a fee needs to hold a valid California Department of Real Estate (DRE) broker license. Any licensed agent or broker associate involved acts on behalf of their broker.[1]

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

1 Calif. Business and Professions Code §§10130, 10131(b)

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]

Requisite competence to manage

To be successful in the property management field, a broker needs to first acquire the minimum knowledge and experience required to adequately perform their tasks.

A broker acquires property management expertise through:

- courses required to qualify for and maintain a real estate license;[3]
- on-the-job training as an agent;
- experience as a landlord;
- practical experience in the business management field; and/or
- exposure to related or similar management activities.

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
A bank account used to hold trust funds.

- 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;

2 Bus & P C §§10177(g), 10177(h)
3 Bus & P C §§10153.2, 10170.5

- advertising for prospective tenants;
- showing the property and qualifying tenants;
- 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.

In addition to these tasks, the property manager needs to also:

- 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.

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**.

prudent investor standard
A property management standard exemplified by investor standards requiring the efficient and effective management of rental income and expenses.

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, whether or not the landlord is familiar with it.

In contrast, the standards of resident and commercial owners may not necessarily be based on obtaining the maximum rental income or incurring only those minimal expenses needed to maintain the long-term income flow of rents from tenants.

Resident owners are more apt to maintain property in a condition which they find personally satisfying, not necessarily in accord with sound economic principles. They are not often concerned about the effect of the marketplace on their property's value until it is time to sell or refinance.

Likewise, the landlord may not have the knowledge or expertise to effectively manage the property. Most owners of rental income property pursue unrelated occupations which leave them very little time to concentrate on the management of their properties.

However, property managers are employed to manage property as the primary occupation in which they have developed some level of expertise. A landlord's primary reason for hiring a property manager is to have the property manager maintain the condition of the property at the least cost necessary and keep the rental income stable and as high as the market permits at sound vacancy rates.

Thus, the property manager bases decisions on the need to generate a reasonable income from the property and incur expenses necessary to preserve the safety, security and habitability of the property.

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.

The competition in the marketplace includes the manager's ability to locate tenants willing and able to pay the desired rent rate.

For example, if there are more tenants seeking space than units available to rent, the property manager can increase the rent (excluding units covered by rent control ordinances) and still maintain occupancy levels.

Conversely, if the number of rental units or spaces available exceeds the quantity of tenants available to occupy them, a property manager has less pricing power. Special programs to better retain tenants and attract new, long-term ones may be necessary to keep the units at optimum levels of occupancy.

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. The analytical property manager works up a cost-benefits analysis and reviews it with the landlord to consider what will or will not be done.

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.

Liens affect commercial tenants

Along with the condition of the property, a property manager operating commercial property needs to take a close look at provisions and the status of the trust deed liens on the landlord's property. Both the property manager and the tenants are ultimately affected by the burden existing financing places on the landlord's cash flow, and possibly the landlord's ability to retain ownership.

A property manager cannot perform economic miracles for a landlord when payments on the financing encumbering the property are inconsistent with the property's capacity to generate a positive cash flow. Worse yet, in some cases loan payments may consume such a high percentage of rents as to obstruct payment of maintenance or property management fees.

Also, a thoughtful property manager will apprise the landlord when the opportunity arises to refinance the property with more advantageously structured loans. The property manager can charge an additional fee for soliciting or arranging financing. [See **RPI** Form 104]

The tenant's right to possess the property is usually subject to an existing lender's right to foreclose and terminate the tenancy. A commercial tenant's move-in costs and tenant improvements are at risk of loss if the pre-existing lender forecloses.

Title profile analysis avoids surprises

It is good practice, and in the property manager's best interest, 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.

When the property manager cannot timely perform or complete the management tasks undertaken, they need to delegate some of this work load to administrative employees or resident managers. However, the property manager needs to maintain constant oversight as their supervisor and employer.

Handling UD actions in small claims

A property manager may file a small claims action on behalf of the landlord to recover amounts due and unpaid under a lease or rental agreement if:

- the landlord has retained the property manager under a property management agreement ;
- the agreement was not entered into solely to represent the landlord in small claims court; and
- the claim relates to the rental property managed.[4]

A property manager may also file small claims actions to collect money on behalf of a *homeowners' association (HOA)* created to manage a *common interest development (CID)*.[5]

However, in order for the property manager to represent the landlord in a small claims action, property managers are required to file a declaration in the action stating the property manager:

- is authorized by the landlord to appear on the landlord's behalf under a property management agreement; and
- is not employed solely to represent the landlord in small claims court. [6]

Consider a licensed real estate broker who operates a property management business as a sole proprietorship under an individual license. The broker manages an apartment complex for a landlord under a property management agreement.

4 Calif. Code of Civil Procedure §116.540(h)

5 CCP §116.540(i)

6 CCP §116.540(j)

The property management agreement gives the broker all care and management responsibilities for the complex, including the authority to:

- enter into leases and rental agreements as the landlord;
- file UD actions; and
- hire an attorney to handle evictions, if necessary.

The broker signs all lease and rental agreements in their own name as the lessor under the authority given them in the management contract. The landlord's name does not appear on any lease or rental agreement.

A tenant of the complex fails to pay rent under a rental agreement entered into with the broker. The broker serves a three-day notice to pay rent or quit the premise on the tenant. [See **RPI** Form 575]

The tenant does not pay the delinquent rent within three days and remains on the premises. The broker files a UD action to recover possession by an eviction of the tenant, appearing as the plaintiff on the UD complaint.

The tenant defends against the eviction by claiming the broker cannot maintain a UD action to evict the tenant since the broker is not the true landlord of the real estate or the landlord's attorney.

Can the broker file and maintain a UD action against the tenant in their own name?

Yes! The broker may file the UD action even though they are not the true landlord (owner). The broker entered into the lease agreement and delivered possession as the lessor, and is now recovering possession from the tenant in their own name as the lessor.[7]

As the lessor under the lease, the property manager has the greater right of possession of the premises than the tenant, even though the owner is known to be the true landlord.

Thus, as the lessor named on the lease, the property manager can maintain the UD action against the tenant and recover possession of the premises.

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.

7 **Allen** v. **Dailey** (1928) 92 CA 308

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." Conditions which might endanger the health and safety of tenants and their guests cannot 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.

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.

The amount of rental income receipts is directly related to the property manager's evaluation of the rents charged and implementation of any changes. A re-evaluation of rents includes the consideration of factors which influence the amount to charge for rent. These factors include:

- market changes, such as a decrease or increase in the number of tenants competing for a greater or lesser availability of units;
- the physical condition and appearance of the property; and
- the property's location, such as its proximity to employment, shopping, transportation, schools, financial centers, etc.

A property manager's duty includes keeping abreast of market changes which affect the property's future rental rates. With this information, they are able to make the necessary changes when negotiating leases and rental agreements. The more curious and perceptive the property manager is about future trends, the more protection the landlord's investment will likely receive against loss of potential income.

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 needed 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.

Different types of property require different degrees of maintenance and upkeep. For instance, a commercial or industrial tenant who occupies the entire (commercial) property may agree in their lease to perform all maintenance and upkeep of the property.

The broker, as the property manager, then has a greatly reduced role in the care and maintenance of the property. The property manager simply oversees the tenant to confirm they are caring for the property and otherwise fully performing under the terms of the lease agreement.

On the other hand, consider an HOA requirement that maintains common areas for the benefit of the homeowners within a CID. The HOA hires a property manager to undertake these duties. A property manager acting on behalf of an HOA exercises a high degree of control over the maintenance and upkeep of the property and the security of the occupants.

Usually, landlords set a ceiling on the dollar amount of repairs and maintenance the property manager has authority to incur on behalf of the landlord. The property manager does not exceed this dollar ceiling without the landlord's consent even though the landlord receives a benefit from the expenditure.

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.

Thus, the property manager prepares a repair and maintenance disclosure addendum and attaches it to the property management agreement. This addendum needs to cover information such as:

- the types of repairs and maintenance the manager's staff will perform;
- hourly charges for jobs performed;
- costs of workers' compensation and method for charging the landlord;
- any service or handling charges for purchasing parts, materials or supplies (usually a percentage of the cost);
- whether the staff will perform work when they are available and qualified, in lieu of contracting the work out (i.e., no bids will be taken); and

- to what extent repairs and maintenance will generate net revenue for the management company, constituting additional income to the property manager.

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 **RPI** Form 119]

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.[8]

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 is maintained, and hopefully increased, 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.

A prudent property manager makes recommendations to the landlord about maintaining the property to eliminate any accumulated wear and tear, deterioration or obsolescence. Thus, they help enhance the property's "curb appeal."

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.[9]

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.

8 Jerry v. Bender (1956) 143 CA2d 198

9 10 Calif. Code of Regulations §2830

start-up fee
A flat, one-time fee charged by a property manager for the time and effort taken to become familiar with the operations of the property to be managed.

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 loan payments exceed income. Security deposits are additional to the client's cash reserves.

The property manager needs to insist all security deposits previously collected from existing tenants are deposited into the property manager's trust account.

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 need 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.[10]

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.[11]

Separate ledger for each landlord

All accounts need to be maintained in accordance with standard accounting procedures. These standards are best met by using computer software designed for property management.[12]

Also, withdrawals from the trust fund account cannot be made by the landlord, only by the property manager.

However, a property manager can give written consent to allow a licensed employee or an unlicensed employee who is bonded to make withdrawals from the trust account.[13]

No matter who the property manager authorizes to make the withdrawal, the property manager alone is responsible for the accurate daily maintenance of the trust account.[14]

The property manager's bookkeeping records for each trust account maintained at a bank or thrift need to include entries of:

- the amount, date of receipt and source of all trust funds deposited;

10 Calif. Civil Code §1950.5(g)(1); 1950.7(c)(1)
11 Bus & P C §10145(a); Department of Real Estate Regulations §2832
12 DRE Reg. §2831
13 DRE Reg. §2834(a)
14 DRE Reg. §2834(c)

- the date the trust funds were deposited in the trust account;
- the date and check number for disbursements of trust funds previously deposited in the trust account; and
- the daily balance of the trust account.[15]

Entries in the general ledger for the overall trust account need to be in chronological order and in a column format. Ledgers may be maintained in a written journal or one generated by a computer software program.[16]

In addition to the general ledger of the entire trust account, the property manager needs to maintain a separate subaccount ledger for each landlord they represent. Each subaccount ledger needs to account for all trust funds deposited into or disbursed from a separate landlord's trust account.

Each separate, individual subaccount ledger needs to identify the parties to each entry and include:

- the date and amount of trust funds deposited;
- the date, check number and amount of each related disbursement from the trust account;
- the date and amount of any interest earned on funds in the trust fund account; and
- the total amount of trust funds remaining after each deposit or disbursement from the trust account.[17]

Like the general ledger for the entire trust account, entries in each client's subaccount record need to also be in chronological order, columnized and on a written or computer journal/ledger.[18]

Manager's trust account supervision

If a property manager or their employees delay the proper maintenance of a trust account, the property manager is in violation of their duty to the landlord to maintain the trust account. This violation places the broker's license at risk of loss or suspension.

To avoid jeopardizing the status of the property manager's license due to a mishandling of the trust account, the property manager needs to:

- deposit the funds received, whether in cash, check or other form of payment, within three business days;[19]
- keep trust fund account records for three years after the transaction;[20]
- keep a separate ledger or record of deposits and expenditures itemized by each transaction and for each landlord;[21] and
- keep accurate trust account records for all receipts and disbursements.[22]

15 DRE Reg. §2831(a)
16 DRE Reg. §2831(c)
17 DRE Reg. §2831.1
18 DRE Reg. §2831.1(b)
19 DRE Reg. §2832
20 Bus & P C §10148
21 DRE Reg. §2831.1
22 DRE Reg. §2831

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;
- 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.

Although the property manager is required to account to the landlord no less than once each calendar quarter, best practices call for a monthly accounting. They may then rightly collect their fee at the end of each month after they have fully performed and their fee is due. In this way, the property manager can avoid the receipt of advance fees. Accounting for the collection of advance fees requires a DRE-approved form.[23]

Handling of trust account funds

When a property manager places funds into a *trust account,* they need to diligently manage the account to avoid claims of mishandling, misappropriation or **commingling** the landlord's funds with the property manager's personal funds.

commingling
The mixing of personal funds with client or other third-party funds required to be held in trust.

Consider a landlord who hires a broker to act as a property manager. In addition to paying for expenses and costs incurred, the property manager is instructed and authorized to pay the monthly mortgage payments.

The property manager locates a tenant and collects the initial rent and security deposit. After depositing the funds in the property manager's trust account, but prior to disbursing the loan payment, the property manager withdraws:

- the leasing fee for locating the tenant; and

23 Bus & P C §10146

- the monthly property manager's fee.

Both fees are due the property manager for work completed under the property management contract.

However, the withdrawal of the property manager's fees leaves insufficient funds in the trust account to make the authorized loan payment. The property manager then issues a check on funds held in one of the property manager's personal accounts to make the landlord's mortgage payment. However, this account also has insufficient funds.

Meanwhile, the lender sends the landlord a late payment notice for the loan delinquency. The landlord immediately contacts the property manager regarding the delinquent payment. The property manager says they will cover it and does so.

More than three months later, the landlord terminates the property management agreement.

Failure to account for funds

Continuing the previous example, the property manager sends a closing statement on the account containing some erroneous deductions. The closing statement is the only accounting the property manager ever prepared for the landlord.

After discussion with the landlord, the property manager corrects the errors in the closing statement, issues the landlord a check for the remaining balance, closes the account and destroys the landlord's file.

Later, the landlord files a complaint with the DRE regarding the property manager.

The DRE investigates and concludes the property manager breached their agency duties. The property manager issued a check for a loan payment from an account other than the trust account, an activity that automatically constitutes *commingling* of the property manager's personal funds with trust funds.

Also, the property manager knew they had insufficient funds when they issued the check. This constituted a dishonest act.

In addition, the property manager failed to accurately account for funds taken in or expended on behalf of the landlord. Worse, the property manager neglected their duty to provide an accounting at least every quarter.

Finally, the property manager destroyed the records prior to the expiration of the three-year minimum record keeping requirement. Based on these many violations, the DRE properly revokes the property manager's real estate broker license.[24]

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

Management conflicts with sales operations

A broker who operates a real estate sales office, in conjunction with a property management operation, has a potential conflict of interest that may need to be disclosed to their clients.

For example, a creditworthy prospective tenant responding to a rental advertisement might be swayed by the broker's sales staff to purchase a residence instead of renting. Sales fees are typically greater than leasing fees for the time spent. Conversely, sales fees are one-shot fees, not continuously recurring fees.

Any active attempt to convert a prospective tenant to a buyer when the prospect has responded to a rental advertisement paid for by a landlord or provided as part of the property management services, suggests improper conduct. The broker's conduct may range from "bait and switch" techniques with prospective tenants to diverting the landlord's existing tenants through efforts purportedly expended on the landlord's behalf or interfering with the landlord's best interests.

A property manager needs to be careful to keep their sales and management operations sufficiently separate from one another. They need to diligently pursue rental or lease agreements with creditworthy tenants who apply to rent. The conflict of interest arising when a client seeks the same or different purposes does not bar a broker from conflicting activities so long as the conflict has been timely and properly disclosed. [See **RPI** Form 527]

The landlord comes first. The broker's concern for greater fees comes second.

Chapter 16 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 needs to diligently manage all accounts to avoid claims of mishandling, misappropriation or commingling of funds. The property manager is also responsible for providing a statement of account to the landlord.

Chapter 16 Key Terms

Chapter 17

Security deposits and pre-expiration inspections

Learning Objectives

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

- apply security deposit rules controlling residential and commercial landlords; and
- manage the residential tenant's right to a pre-expiration inspection.

Key Terms

final inspection	**rent**
itemized statement of deductions	**security deposit**
joint pre-expiration inspection	**statement of deficiencies**

Cover for a tenant's non-performance

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** Forms 550 and 552]

The **security deposit** provides a source of recovery for money losses incurred due to a default on obligations agreed to in the rental or lease agreement. Tenant monetary obligations include:

- 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.

security deposit
Security against the 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 law. Further, the amount of any security deposit is greatly influenced by the current condition of the local residential and commercial market. If competition is tight, a landlord may be forced to lower the security deposit amount required 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.

Rent is paid in advance

Any monies handed to a residential landlord by a tenant on entering into a rental or lease agreement is characterized as one of the following:

- *rent*;
- a *security deposit*;
- a *waterbed administrative fee*; or
- a *tenant screening fee* for processing an application.[1]

rent
Compensation received by a landlord in exchange for the tenant's use, possession and enjoyment of the property.

Rent is compensation, usually paid periodically, received by a landlord in exchange for the tenant's use, possession and enjoyment of the property.[2]

Editor's note — Rent by agreement also includes amounts due from a tenant in payment of late charges on delinquent rent, and bounced check charges. [3]

Residential security deposits: not rents, not fees

Residential tenants, unlike commercial tenants, lack sufficient bargaining power when negotiating a rental or lease agreement. To prevent residential tenants from abuse, California public policy and laws limit 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.[4]

However, the landlord may collect a security deposit equal to two months' rent when the landlord:

- is a **natural person** or a limited liability company (LLC) consisting solely of natural persons; and
- owns no more than two residential rental properties consisting of no more than four rental units total.[5]

The exception: when the tenant is a **service member**, landlords (including **mom-and-pop landlords**) may not charge the tenant for a security deposit amounting to more than one month's rent for an unfurnished unit, or two months' rent for a furnished unit.[6]

Further, the landlord may not refuse to rent a unit to a service member due to this restriction on security deposits.[7]

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1 Calif. Civil Code §§1940.5(g); 1950.5(b); 1950.6(b)
2 **Telegraph Ave. Corporation** v. **Raentsch** (1928) 205 C 93
3 **Canal-Randolph Anaheim, Inc.** v. **Wilkoski** (1978) 78 CA3d 477
4 Calif. Civil Code §1950.5(c)
5 CC §1950.5(c)(4)
6 CC §1950.5(c)(2)
7 CC §1950.5(c)(2)

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. [8]

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.[9]

Any funds received and recharacterized as a security deposit are refundable when the tenant vacates, less permissible deductions.

The amount of a residential security deposit demanded of tenants need to be uniform based on either the amount of the rent charged or the tenant's creditworthiness.

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. [10]

Further, a landlord cannot require higher security deposits for tenants with children than for tenants without children as this is a prohibited discriminatory act. Any increase in a security deposit for larger versus smaller families is also a prohibited discriminatory practice.[11]

The additional waterbed deposit

An additional security deposit may be demanded and collected when a tenant maintains a waterbed in an unfurnished rental unit.

This waterbed deposit cannot exceed an amount equal to one-half month's rent. This waterbed deposit is in addition to the first month's rent and the maximum permissible security deposit.

The landlord may also charge a reasonable fee to cover administrative costs of processing the waterbed arrangements.[12]

Commercial security deposits

A commercial landlord has the discretion to set security deposit amounts under a rental or lease agreement. 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.

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8 CC §§1940.5; 1950.5(b), (c); 1950.6

9 CC §1950.5(c)

10 24 Code of Federal Regulations §100.60(b)(4)

11 Calif. Government Code §12955(a); 24 CFR §100.65

12 CC §1940.5(g)

Case in point

To defer the first month's rent

Consider a residential landlord who locates a creditworthy tenant. In addition to the advance payment of the first month's rent, the landlord requires a security deposit equal to one month's rent.

The tenant asks the landlord if they can pay half the security deposit in advance and the other half with the second month's rent. The tenant is unable to pay the security deposit in full until they receive their security deposit refund from their current landlord.

The landlord wants this applicant as a tenant and is willing to extend the credit.

To be cautious, the landlord structures receipt of the tenant's funds as payment of the entire security deposit and half of the first month's rent. The tenant will pay the remaining half of the first month's rent with payment of the second month's rent.

Thus, if the tenant fails to pay the second month's rent and the remainder of the first month's rent when due, the landlord may serve the tenant with a three-day notice to pay rent or quit. Then, if the tenant vacates, the landlord may deduct all rents accrued and due from the security deposit. The reason: an unpaid portion of the security deposit cannot be collected while unpaid rent can be collected by deduction from the security deposit.

Conversely, consider a landlord who allows a tenant to allocate their initial payment on the lease to one full month's rent paid in advance, with payment of the balance due on the security deposit spread over two or more months.

Here, if the tenant fails to pay the promised installments of the security deposit, the default is not considered a material breach of the lease or rental agreement. A material breach is necessary before an unlawful detainer (UD) action based on service of a three-day notice to perform can proceed to an eviction. A security deposit is not rent, although it is an amount "owed" to the landlord.

The landlord is protected by classifying the initial advance payment as fully prepaying the security deposit. The security deposit then covers any default in the promise to pay deferred rent.

A tenant's breach needs to be material and relate to the economics of the rental agreement or lease, such as a failure to pay rent, before the landlord can justify service of a three-day notice. However, while they are considered "rent", a failure to pay late charges, returned check charges and deferred security deposit is considered a minor breach. Thus, failure to pay these amounts does not justify the serving of a three-day notice to quit.

Failure to deliver rent and other amounts regularly paid to the landlord, such as CAMs on commercial leases, is a material breach supporting forfeiture of the tenant's leasehold and right of possession of the property. [Baypoint Mortgage v. Crest Premium Real Estate Investments Retirement Trust (1985) 168 CA3d 818]

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.

Editor's note — A photography studio tenant, laundry facility or other users of chemicals needs to be required to provide insurance coverage for losses due to toxic conditions created on the property.

Like all other terms in a commercial lease, the amount of the security deposit is negotiable between the commercial landlord and the tenant prior to entering into the lease.

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.[13]

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.

Now consider a residential tenant who pays the first month's rent and a security deposit equal to one month's rent.

When the last month's rent becomes due, the tenant does not pay it. The tenant knows the defaulted payment of rent will be deducted from his security deposit. This is a permissible use of the security deposit by the landlord. The landlord does not attempt to have the tenant evicted since the tenant will vacate before an eviction under an unlawful detainer (UD) action is processed.

On expiration of the lease, the tenant vacates the unit. Due to excess wear and tear on the unit inflicted by the tenant, repairs and replacements are required before the unit can be re-rented.

However, after deducting the unpaid last month's rent from the security deposit, no money remains to reimburse the landlord for the cost of the repairs.

The recovery of the repair costs is limited to a demand on the tenant for payment. If unpaid, a small claims court action may be used to enforce collection.

If the landlord requires advance payment on the first and last month's rent but no security deposit, a similar demand is made on the tenant for payment of repair costs.

13 CC §1950.5(c)

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

Landlord 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.[14]

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.[15]

14 CC §§1950.5(d); 1950.7(b)

15 **Korens** v. **R.W. Zukin Corporation** (1989) 212 CA3d 1054

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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 ____

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Form 567-1

Notice of Right to Request a Joint Pre-Expiration Inspection

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However, some local rent control ordinances require residential landlords to pay interest at or below bank savings account rates to tenants on their security deposits.

Joint pre-expiration inspections and the deposit

joint pre-expiration inspection
An inspection conducted by a residential landlord to advise a tenant of the repairs the tenant needs to perform to avoid deductions from the security 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.

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 unlawfully 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

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

- a 30-day notice to vacate initiated by either the landlord or the tenant.[16] [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 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.

16 CC §1950.5(f)(1)

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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: ____

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Form 567-3

Statement of Deficiencies on Joint Pre-Expiration Inspection

Page 2 of 2

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.

If the landlord and tenant cannot agree to the date and time of the inspection, the landlord may set the time. However, if a mutually acceptable time for the inspection is within 48 hours, a written waiver of the notice of entry is to be signed by both the landlord and tenant.

When the waiver is signed, the landlord may proceed with the inspection.[17] [See **RPI** Form 567-2]

Following service on the tenant of the 48-hour notice, 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.

statement of deficiencies
A document the landlord presents to the tenant specifying 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]

17 CC §1950.5(f)(1)

Form 585

Security Deposit Disposition on Vacating Residential Premises

SECURITY DEPOSIT DISPOSITION
ON VACATING RESIDENTIAL PREMISES

NOTE: This form is used by a residential property manager or landlord when a tenant has vacated a premises and the landlord holds the tenant's security deposit, to provide the tenant with an itemized statement within 21 days of vacating of the security deposit's disposition and documentation of charges deducted.

DATE: ___________________, 20______, at ____, California.
TO TENANT:
Items left blank or unchecked are not applicable.
FACTS:
1. This is notice to Tenant of any Landlord deductions from the security deposit under the following agreement:
☐ Residential lease agreement ☐ Occupancy agreement
☐ Reseidential rental agreement ☐ ____
1.1 dated __________________, 20_____, at ____, California,
1.2 entered into by ____, as the Landlord,
1.3 and ____, as the Tenant,
1.4 regarding residential premises referred to as ____.
DISPOSITION OF DEPOSIT:
2. Under the above referenced agreement, Tenant handed Landlord a security deposit in the amount of . . . .$_______________
3. The following deductions have been made by Landlord from the security deposit:
3.1 Repair of damages — Cost
a. ____ $_____________
b. ____ $_____________
3.2 Necessary cleaning of the premises — Cost
a. ____ $_____________
b. ____ $_____________
3.3 Delinquent or holdover rent — Amount
a. From ____________________ To ______________________ $_____________
3.4 Replacement/repair of lost or damaged furnishings — Cost
a. ____ $_____________
3.5 **TOTAL** deductions from security deposit (line 2 less line 3.4) . . . . (-)$_______________
4. BALANCE DUE TENANT:
4.1 Balance of security deposit remaining after deductions (line 2 less line 3.4) . . . .$_______________
4.2 Interest on the security deposit from ____________________ to ________________
at _________ % per annum . . . .(+)$_______________
4.3 Balance due Tenant is refunded in the amount of (line 4.1 plus line 4.2) . . . . $_______________
by Landlord / Agent's check #_____________.
5. AMOUNT DUE LANDLORD:
5.1 The amount due Landlord after deductions (line 2 less line 3.5) . . . . $_______________
5.2 Less interest on the security deposit from _________________ to ________________
at ______ % per annum . . . . (-)$_______________
5.3 Tenant to hand or mail Landlord/Agent the balance due of (line 5.1 less line 5.2) . . . .$_______________

This statement is true and correct.
Date: ______________, 20_______
Landlord/Agent: __________________ CalBRE #:____________________

Signature: ____
Address: ____
____
Phone: __________________ Cell: ___________________________
Email: ____

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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.[18]

18 CC §1950.5(f)(2)

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]

Editor's note — The completion of a pre-expiration inspection statement by the landlord does not bar the landlord from deducting other costs from the security deposit for:

- *any damages noted in the joint pre-expiration inspection statement which are not cured;*
- *any damages which occurred between the pre-expiration inspection and termination of the tenancy; or*
- *any damages not identified during the pre-expiration inspection due to the tenant's possessions being in the way.*[19]

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.[20] [See Form 585 accompanying this chapter]

final inspection
An inspection of the premises conducted by the landlord within 21 days after a residential tenant vacates the property.

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.[21]

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.[22]

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.[23]

No receipt or invoice copies

It is not necessary for the landlord to provide copies of receipts, bills or invoices for repair work or cleaning to the tenant if:

- the total deduction from the security deposit to cover the costs of repairs and cleaning is equal to or less than $125; or

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19 CC §1950.5(f)
20 CC §1950.5(g)
21 CC §1950.5(g)(2)
22 CC §1950.5(g)(3)
23 CC §1950(g)(3)

- the tenant signs a waiver of their right to receive bills when or after notice to terminate their tenancy is given.[24]

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.[25]

Editor's note — Residential security deposit 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.[26]

Reasonable deductions from the security 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
- costs to replace or restore furnishings provided by the landlord if agreed to in the lease.[27]

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 claims of pre-existing defects, a joint inspection of the unit and written documentation of any defects is completed before possession is given to the tenant. [See **RPI** Form 560] [28]

itemized statement of deductions
A document accounting for the tenant's security deposit, delivered by the landlord to a residential tenant after the tenant vacates.

As previously discussed, when a residential tenant vacates, the landlord provides the tenant with a security deposit refund accounting. If local rent control ordinances (or state law) require the landlord to pay interest on security deposits, the landlord uses this **itemized statement of deductions** to account for interest accrued on the security deposit. [See Form 585 §4.2]

A residential landlord who, in bad faith, fails to comply with security deposit refund requirements is subject to statutory penalties of up to twice the amount of the security deposit. Additionally, the landlord is liable to the tenant for actual money losses the tenant incurs for the wrongful retention of security deposits.[29]

As an aside, on the landlord's sale of a residential or commercial property, the landlord is to deliver an itemized statement to tenants stating:

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24 CC §1950.5(g)(4)
25 CC §1950.5(g)(5)
26 CC §1950.5
27 CC §§1950.5(b); 1950.7(c)
28 CC §1950.5(e)
29 CC §1950.5(l)

- the amount of the tenant's security deposit;
- any deductions made from the security deposit; and
- the name, address and telephone number of the buyer.

The notice, important for the seller, shifts liability to the buyer of the property for the future return of the security deposit to the tenant.[30] [See **RPI** Form 586]

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 through 552-4]

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.

Occasionally, the security deposit exceeds two months' rent and the only deduction from the deposit is for delinquent rent. Here, the commercial landlord is to return any remaining amount in excess of one month's rent within two weeks after the transfer of possession of the property to the landlord. The remaining amount of the security deposit is to be returned to the tenant or accounted for within 30 days after the transfer of possession.[31]

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.[32]

Unlike the residential landlord, the commercial landlord is not required to provide tenants with an itemized statement of deductions when the security 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.[33]

30 CC §§1950.5(h); 1950.7(d)
31 CC §1950.7(c)
32 CC §1950.8(b)
33 CC §1950.7(f)

Chapter 17 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 codes. 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 17 Key Terms

Chapter 18

Accepting partial rent

Learning Objectives

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

- apply in practice the landlord's right to receive partial rent; and
- distinguish the rights of residential tenants from commercial tenants when paying partial rent; and
- determine when a landlord has the right to file an unlawful detainer action after receipt of partial rent.

Key Terms

nonwaiver of rights provision **reservation of rights**
partial payment agreement

Residential and commercial landlord rights

A commercial tenant, also called a commercial or industrial tenant, experiences cash flow difficulties due to a business downturn. As a result, the tenant becomes delinquent in the payment of rent.

Discussions between the landlord and tenant follow. To enforce collection of the rent, the landlord eventually serves the tenant with a three-day notice to pay rent or quit the premises. [See **RPI** Form 575]

Prior to the filing of an unlawful detainer (UD) action, the tenant offers to make a partial payment of the delinquent rent, if the landlord will accept it. Further, the commercial tenant offers to pay the balance of the delinquent rent by a specific date if the landlord agrees not to file of a UD action. This is called a **partial payment agreement**. [See Form 558 accompanying this chapter]

partial payment agreement
An agreement by a landlord and a tenant which acknowledges receipt of the partial rent paid, and specifies the amount of deferred rent remaining due and unpaid and the date by which it is to be paid.

The *partial payment agreement* states:

- the amount received as partial rent;
- the amount of deferred rent remaining unpaid;

- a promise to pay the deferred rent;
- the date the payment is due; and
- the consequences of nonpayment.

If the deferred rent is not paid as scheduled, the nonresidential landlord may file a UD action to evict the tenant without serving another three-day notice.

Here, the partial payment agreement only temporarily delays the commercial landlord's eviction process which commenced with service of the three-day notice on the tenant.

The tenant fails to pay the deferred balance of the delinquent rent on the date scheduled for payment. Without further notice to the tenant, the landlord files a UD action.

The commercial tenant seeks to prevent the landlord from proceeding with the UD action. The tenant claims the landlord's acceptance of the partial rent payment invalidated the three-day notice since the notice now states an amount of rent which is no longer due.

Can the commercial landlord accept a payment of partial rent after serving a three-day notice and later file a UD action against the tenant without serving another three-day notice for the amount remaining due and now delinquent?

Yes! A commercial landlord can accept a partial payment of rent after serving a three-day notice and before eviction. Without further notice to the tenant, the commercial landlord can proceed with a UD action and evict the tenant.[1]

Reservation of rights

Further, on accepting a partial payment of delinquent rent, a commercial landlord does not need to agree to a due date for the remaining rent. They also do not need to enter into any agreement regarding acceptance of the partial payment, as long as the tenant has been provided with a notice stating acceptance of late rent does not waive the landlord's right to enforce any remaining breach of the lease. This statement is called a **reservation of rights clause**.

reservation of rights clause
A clause in the nonwaiver of rights provision in commercial rental and lease agreements stating acceptance of late rent does not waive the landlord's right to enforce remedies for any remaining breach of the lease agreement by the tenant.

The *reservation of rights clause* is found in the *nonwaiver of rights provision* in commercial lease agreements as well as in *acceptance of partial rent agreements*. [See Figure 1, excerpt from **RPI** Form 552 §20.2]

However, the commercial landlord who memorializes their acceptance of the partial rent payment and the due date for payment of the remaining balance eliminates conflicting claims the tenant may make in a UD action.

The impact of serving a three-day notice, then accepting partial rent from a commercial tenant is vastly different from the protection a residential tenant is provided in partial rent situations.

1 Calif. Code of Civil Procedure §1161.1(b)

Form 558

Partial Payment Agreement: Commercial

PARTIAL PAYMENT AGREEMENT
Commercial

NOTE: This form is used by a commercial landlord or their agent when accepting partial payment of delinquent rent and temporarily deferring any eviction activity, to document the terms for payment of the remainder of the delinquent rent and preserve the right to continue any eviction process underway if the tenant defaults.

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

FACTS:

1. This partial payment agreement pertains to the collection of past due rent under a commercial 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 the premises referred to as ____.

AGREEMENT:

2. Tenant has not paid delinquent rent for the period(s) of _____________________________________.
3. Landlord hereby accepts partial payment on delinquent rent in the amount of . . . . $______________
4. The balance of the delinquent rent owed is . . . . $______________
4.1 Plus late charges for delinquency(ies) of . . . . $______________
4.2 Plus deferred rent processing charges of . . . .$______________
4.3 **TOTAL deferred rent** due, including additional charges, is the sum of . . . . $______________
5. Tenant to pay the total deferred rent on or before ___________, 20_____.
5.1 Rent to be paid by ☐ cash, ☐ check, or ☐ cashier's check, made payable to Landlord.
5.2 Rent may be tendered by ☐ mail, or ☐ personal delivery, to:
____ (Name)
____ (Address)
____ (Phone)
a. Personal delivery of rent will be accepted during the hours of _______ to ___________ on the following days:
____.
5.3 Rent may also be paid by deposit into account number ____________________________________ at:
____ (Financial Institution)
____ (Address)
5.4 No grace period for payment of the deferred rent is granted to Tenant.
5.5 Delinquent payment of the deferred rent incurs a late charge of $_______________.
6. If deferred rent is paid when due, any outstanding three-day notice to pay rent or quit is no longer valid.
7. If the deferred rent is not paid when due, Landlord reserves the right to:
(**Check one box only**)
7.1 ☐ Serve Tenant with a three-day notice to pay the remaining balance of the rent due or quit the premises.
(Check if a three-day notice has not been served)
7.2 ☐ Commence, without further notice, an unlawful detainer action to evict Tenant from the premises.
(Check if a three-day notice has been served)
7.3 ☐ Continue with the unlawful detainer action on file to evict Tenant from the premises.
(Check if unlawful detainer action has been filed)
8. No provision of the rental or lease agreement is affected in this agreement.
9. ____

I agree to the terms stated above. ☐ See attached Signature Page addendum. [**RPI** Form 251] Date: ___________, 20_____ Landlord: ______________________________ Agent: ______________ CalBRE #:____________ Signature: ______________________________ Phone: ____________ Cell: _________________ Email: _________________________________	**I agree to the terms stated above.** ☐ See attached Signature Page addendum. [**RPI** Form 251] Date: ___________, 20_____ Tenant: _________________________________ Signature: ______________________________ Tenant: _________________________________ Signature: ______________________________ Phone: _________________ Cell: ____________ Email: _________________________________

FORM 558 03-11

A residential landlord who accepts any amount of rent from a tenant after serving a three-day notice waives their right to use that notice as the basis for a UD action.

After receiving partial rent, a residential landlord needs to serve the tenant with another three-day notice for the amount now remaining unpaid.[2]

2 **EDC Associates, Ltd.** v. **Gutierrez** (1984) 153 CA3d 167

Residential vs. commercial landlords

Acceptance of a partial payment toward delinquent rent is within the discretion of the landlord. A landlord might agree to accept partial payments when:

- the partial payment is at least equal to the rent accrued at the time the tenant offers the payment;
- the tenant is creditworthy;
- the tenant has an adequate payment history; and
- the tenant is one the landlord wants to retain.

Both residential and commercial landlords may accept a partial payment of delinquent rent. Then, unless they have agreed to the contrary, immediately serve the tenant with a three-day notice demanding payment of the balance due or quit. Of course, a landlord may agree in a partial payment agreement not to serve a three-day notice after receipt of the partial payment of rent on the condition the balance is received on or before a specified date. [See Forms 558 and 559 accompanying this chapter]

Residential rent paid after notice

If a residential landlord files a UD action and, prior to eviction, accepts a partial payment of rent, the acceptance of rent nullifies the UD action and the landlord cannot proceed to eviction. The reason the UD action cannot proceed lies in the difference between:

- the amount of rent demanded in the notice to pay supporting the UD action; and
- the amount actually remaining unpaid at the time of the UD hearing.

In residential UD actions, the amounts in the three-day notice and the amount owed by the tenant need to be the same. Once the residential landlord accepts a partial payment of delinquent rent, the three-day notice served on the tenant no longer states the correct amount the tenant is to pay to avoid losing the right of possession. This rule does not apply to commercial tenancies.

Any three-day notice served on a residential tenant overstating the amount of delinquent rent due at the time of trial on the UD action is invalid. The UD action in a residential eviction based on an overstated amount in the three-day notice fails.[3]

Commercial nonwaiver requirements

A commercial landlord serves their tenant with a three-day notice to pay rent or quit. Later, the landlord accepts a partial payment of rent under an agreement with the tenant containing a **nonwaiver of rights provision**. This provision states the acceptance of rent does not waive the landlord's right to enforce a breach of the lease. If the nonwaiver notice is not given, the commercial landlord needs to serve the tenant with another three-day notice for payment of the sums remaining due and unpaid. [See Figure 1, excerpt from **RPI** Form 552]

3 **Jayasinghe** v. **Lee** (1993) 13 CA4th Supp. 33

The *nonwaiver of rights provision* also exists in the commercial lease agreement entered into by the tenant. When the tenant has received a nonwaiver of rights notice on or before the landlord's acceptance of partial rent, the landlord may take the money and file or continue with an already filed UD action to recover possession of the premises.[4]

nonwaiver of rights provision
A commercial lease or rental agreement provision containing the landlord's reservation of rights.

No waiver of rights

Now consider a commercial tenant who defaults on a rent payment called for in a lease agreement which contains a nonwaiver of rights provision. The tenant is served with a three-day notice to pay or quit. The tenant fails to pay the rent before it expires, causing the tenancy to be terminated. The three-day notice to pay does not contain a provision for nonwaiver of rights on acceptance of partial rent.

The landlord then accepts a partial payment of rent without entering into any agreements, except to acknowledge receipt of the amount paid as rent. The commercial landlord files a UD action for the amount remaining due and unpaid.

The tenant claims the landlord cannot proceed with a UD hearing since neither the three-day notice nor the landlord's receipt of the partial rent payment include a nonwaiver of rights provision.

Here, the commercial landlord may proceed with the UD action after receipt of partial rent. The nonwaiver provision in the lease agreement puts the tenant on notice, allowing the landlord to accept rent without waiving enforcement rights. One such right is the right to proceed with a UD action.[5]

A nonwaiver of rights provision in a three-day notice or partial payment agreement provides the landlord with the same right to proceed with the UD action as though the provision existed in the lease agreement.

On accepting a partial payment of rent after a UD action has been filed, the commercial landlord amends the UD complaint to reflect the partial payment received and the amount due and unpaid by the tenant.[6]

Get it in writing

Without a written partial payment agreement, tenants might claim the landlord who accepted partial rent:

- treated acceptance of partial rent as satisfaction of all the rent due;
- waived their right to continue eviction proceedings; or
- permanently modified the lease agreement, establishing a semi-monthly rent payment schedule.

When a residential or commercial landlord accepts a partial payment of rent, the evidence provided by a signed partial payment agreement overcomes tenant claims that the landlord waived UD enforcement rights by accepting rent.

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4 CCP §1161.1(c)

5 **Woodman Partners** v. **Sofa U Love** (2001) 94 CA4th 766

6 CCP §1161.1(c)

Form 559

Partial Payment Agreement: Residential

PARTIAL PAYMENT AGREEMENT
Residential

NOTE: This form is used by a residential landlord or their agent when accepting partial payment of delinquent rent and temporarily deferring any eviction activity, to document the terms for payment of the remainder of the delinquent rent and preserve the right to continue any eviction process underway if the tenant defaults.

DATE: ______________, 20______, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This partial payment agreement pertains to the collection of past due rent under a residential 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 the premises referred to as ____
____.

AGREEMENT:

2. Tenant has not paid the full rent due for the month(s) of ____.

3. Landlord hereby accepts partial payment on the past due rent in the amount of . . . .$____________

4. The balance of the unpaid rent owed by Tenant is . . . . $____________
- 4.1 Plus late charges for delinquency of. . . . . $____________
- 4.2 Plus deferred rent processing charge of . . . .$____________
- 4.3 **TOTAL deferred rent** due, including additional charge, is the sum of . . . . $____________

5. Tenant to pay the total deferred rent on or before _______________, 20____.
- 5.1 Rent to be paid by ☐ personal check, or ☐ ____.
- 5.2 Rent may be tendered by ☐ mail, or ☐ personal delivery, to:
  - ____ (Name)
  - ____ (Address)
  - ____
  - ____ (Phone)
  - a. Personal delivery of rent will be accepted during the hours of _______ to _________ on the following days: __________________________.
- 5.3 Rent may also be paid by deposit into account number _________________at:
  - ____ (Financial Institution)
  - ____ (Address)
  - ____
  - ____ (Phone)
- 5.4 No grace period for payment of the deferred rent is granted to Tenant.
- 5.5 Delinquent payment of the deferred rent incurs a late charge of $________________

6. If the deferred rent is not paid when due, a three-day notice to pay rent or quit may be served at any time. [See **RPI** Form 575 and 575-1]

7. No provision of the rental or lease agreement is affected by this agreement.

8. ____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: ____________, 20_____	Date: ____________, 20_____
Landlord: ______________________	Tenant: ______________________
Agent: ______________________	Signature: ______________________
	Tenant: ______________________
Signature: ______________________	Signature: ______________________
Address: ______________________	Address: ______________________
______________________	______________________
Phone: ____________ Cell: ____________	Phone: ____________ Cell: ____________
Fax: ______________________	

FORM 559 03-11

Residential partial payment agreement

The *partial payment agreement* entered into by a tenant and a landlord accepting partial rent memorializes:

- the landlord's receipt of partial rent;
- the amount owed on the deferred portion of the delinquent rent;
- the tenant's promise to pay the remaining rent owed on or before a specific date; and
- notification of the landlord's right to serve a three-day notice on failure to pay the remaining balance. [See Form 559]

20. WAIVER:

20.1 Waiver of a breach of any provision in this lease agreement does not constitute a waiver of any subsequent breach.

20.2 Landlord's receipt of rent with knowledge of Tenant's breach does not waive Landlord's right to enforce the breach.

PAGE 4 OF 5 — FORM 552

Figure 1

Except From Form 552

Commercial Lease Agreement

Consider a residential tenant who informs the landlord they are unable to pay the full monthly rent before the payment becomes delinquent. The tenant offers to pay part of the rent prior to delinquency and the remainder ten days later.

Since the tenant is creditworthy, has not been seriously delinquent in the past and the landlord wishes to retain the tenant, the residential landlord agrees to accept the partial payment.

However, to avoid disputes regarding the amount of rent remaining due and when it is to be paid, the residential landlord prepares and the landlord and tenant sign a partial payment agreement formalizing their understanding.

Now consider a residential landlord who serves a three-day notice and then accepts a partial payment of rent before completing the eviction process started by the notice. By accepting a partial payment, the residential landlord understands the three-day notice had been rendered invalid and no longer supports a UD action and eviction.

Thus, when the residential landlord accepts payment of partial rent it is on the condition the tenant enters into a partial payment agreement stating the date the balance owed is due. The partial payment agreement prevents disputes with the tenant about when the balance is due or a three-day notice may be served if the balance is not paid.

Chapter 18 Summary

Acceptance of a partial payment toward delinquent rent is within the discretion of the landlord.

Both residential and commercial landlords may accept a partial payment of delinquent rent. Different rules apply for commercial and residential partial rent payments.

A commercial landlord can accept a partial payment of rent after serving a three-day notice and before eviction. Without further notice to the tenant, the commercial landlord can proceed with a UD action and evict the tenant.

However, a residential landlord who accepts any amount of rent from a tenant after serving a three-day notice waives their right to use the notice as the basis for a UD action. After receiving partial rent, a residential landlord needs to serve the tenant with another three-day notice for the amount now remaining unpaid.

Chapter 18 Key Terms

Chapter 19

Changing terms on a month-to-month tenancy

Learning Objectives

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

- apply the rules a landlord needs to adhere 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

pro rata rent

Landlord's notice to tenant

A landlord and tenant enter into a month-to-month tenancy under a rental agreement which grants an option to purchase the property. The option expires on termination of the tenancy.

Later, the landlord serves the tenant with a 30-day notice of a change in rental terms. The notice states the option to purchase expires in 30 days, unless exercised by the tenant. [See Form 570 accompanying this chapter]

After the 30-day notice expires, the tenant, who is still in possession, attempts to exercise the option. In response, the landlord refuses to sell the property under the option. The landlord claims the tenant's right to exercise the purchase option expired due to the change of rental terms in the 30-day notice.

The tenant claims the option to purchase is binding until the tenancy is terminated, and the month-to-month rental agreement and occupancy have not been terminated.

Can the tenant enforce the option to purchase?

No! The option expired, unexercised. The option to purchase was part of the terms of the rental agreement. Thus, on expiration of the 30-day notice terminating the option, the option to purchase was eliminated.

Like any other provision contained or referenced in a month-to-month rental agreement, the option to purchase is part of the tenant's rights and obligations comprising the month-to-month tenancy. Thus, the option was subject to change on 30 days' written notice from the landlord.[1]

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%. The 60-day notice will be discussed in a later subhead.[2]

notice of change in rental terms
Written notice provided by the landlord of any changes in the conditions of a month-to-month rental agreement.

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 Form 570]

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. However, only the landlord may unilaterally change the terms in a rental agreement.[3]

A month-to-month tenant has no ability to alter the terms of the rental agreement, other than to terminate the tenancy and vacate.[4]

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.[5]

However, the new rental terms stated in the notice do not take effect until expiration of the 30-day notice.

1 **Wilcox** v. **Anderson** (1978) 84 CA3d 593
2 Calif. Civil Code §827
3 CC §827
4 CC §1946
5 CC §827

Form 570

30-Day Notice of Change in Rental Terms

30-DAY NOTICE OF CHANGE IN RENTAL TERMS

NOTE: This form is used by a property manager or landlord when a residential or commercial property manager or landlord is increasing rent, shifting property operating expenses onto the tenant or adding or altering provisions in a rental or lease agreement, excluding residential rent increases exceeding 10%, to notify the tenant more than 30 days in advance of a change in rental or lease agreement terms.

Date: ____________________, 20_____, at ____, California.
To Tenant: ____
Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental agreement 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:

Thirty (30) days after service of this notice on you, the terms of your tenancy on the real estate are hereby changed as indicated below:

2. Rent will be $________________ payable ☐ monthly, or ☐ ____, in advance, and due on the ___________________ day of the month.
2.1 Rent to be paid by ☐ personal check, or ☐ ____.
2.2 Rent may be tendered by ☐ mail, or ☐ personal delivery,
to ____ (Name)
____ (Address)
____ (Phone, Fax, Email)
a. Personal delivery of rent will be accepted during the hours of _______ to _______ on the following days:
____.
2.3 Rent may also be paid by deposit into account number ____,
at ____ (Financial Institution)
____ (Address)

3. The common area maintenance charge will be $________________ per month, payable with each payment of rent.
4. Utilities now paid by Landlord to be paid by Tenant as checked:
☐ Gas ☐ Electricity ☐ Sewage and Rubbish ☐ Water ☐ Cable TV
5. ☐ Tenant to maintain and properly care for the lawns, gardens, trees, shrubs and watering system.
6. An additional security deposit of $_______________ is payable with the next rent payment.
7. ____
____
8. This notice affects no other terms of your tenancy.

Date: _______________, 20______
Landlord/Agent: ________________________ CalBRE#:_______________

Signature: ____
Address: ____
____
Phone: ____________________ Cell: ______________________________
Fax: ____
Email: ____

FORM 570 12-17 ©2017 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

For example, a property manager prepares a 30-day notice of change in rental terms to be served on a month-to-month tenant to increase the rent. The due date for the payment of rent is the first day of each month.

The tenant is properly served with the 30-day notice on the 10th of June. The tenant intends to remain in possession at the new rent rate.

Form 572

30-Day Notice to Vacate: From Tenant

30-DAY NOTICE TO VACATE
From Tenant

NOTE: This form is used by a tenant when the tenant occupies the property under a month-to-month rental agreement or occupancy with rent paid under an expired lease agreement, and is vacating the premises, to notify the property manager or landlord the tenant will vacate within 30 days.

Date: ____________________, 20_____, at ____, California.
To Landlord: ____
Items left blank or unchecked are not applicable.

FACTS:

1. I am a Tenant under a rental agreement or expired elase agreement
- 1.1 dated __________________, at ____, California,
- 1.2 entered into by ____, as the Tenant, and ____, as the Landlord,
- 1.3 regarding real estate referred to as ____ ____.

NOTICE:

2. Within thirty (30) days after service of this notice, I will vacate and deliver possession of the premises to Landlord or ____.

3. This notice is intended as a 30-day Notice to terminate my month-to-month tenancy.

4. I understand:
- 4.1 I will owe pro rated daily rent for any days in the 30-day period I have not prepaid rent.
- 4.2 I have previously given Landlord a security deposit of $___________________.
  - a. I acknowledge, if I am a residential tenant, that I have the right to request and be present for an inspection of the premises to be conducted within two weeks of expiration of this notice to vacate for the purposes of Landlord providing me with an itemized statement of deductible charges for repairs and cleaning to allow me the opportunity to remedy these deficiencies and avoid a deduction from my security deposit. [Calif. Civil Code §1950.5(f)(1)]
  - b. Within 21 days after I vacate, Landlord will furnish me a written statement and explanation of any deductions from the deposit, and a refund of the remaining amount. [Calif. Civil Code §1950.5(g)(1)]
- 4.3 Landlord may deduct only those amounts necessary to:
  - a. reimburse for Tenant defaults in rental payments;
  - b. repair damages to the premises caused by Tenant (ordinary wear and tear excluded);
  - c. clean the premises, if necessary;
  - d. reimburse for loss, damage or excessive wear and tear on furnishings provided to Tenant.
- 4.4 Landlord may show the premises to prospective tenants during normal business hours by first giving you written notice at least 24 hours in advance of entry. The notice will be given to you in person, by leaving a copy with an occupant of suitable age and discretion, or by leaving the notice on or under your entry door.

5. The reason for termination is ____.

6. I have served this notice on Landlord or Manager ☐ personally, or ☐ by certified or registered mail.

This statement is true and correct.	For Landlord/Agent's use:
Date: ______________, 20______	Date Received: _______________________________.
Tenant: ____	
Signature: ______________________________________	
Forwarding Address:______________________________ ____	
Phone: ___________________ Cell: _________________	
Fax: ____	
Email: ____	

FORM 572 03-11

Since June 11th is the first day of the 30-day notice period, the rent will not begin to accrue at the increased rate until July 11th — the day after the 30-day notice expires. However, rent for all of July is payable in advance on the first of the month, including the number of days affected by the rent increase.

To calculate the advance rent due and payable on the first day of July, the rent is prorated as follows:

- the old daily rate of rent for the first ten days of the month; and
- the new daily rate of rent for the remaining days in the month of July.

pro rata rent
Rental payment amounts which vary based on the portion of the rental period for which a change has been made.

Pro rata rent due on the first is determined based on the number of days in the calendar month, unless the rental agreement contains a provision prorating rent on a 30-day month.[6]

Notice periods for increasing rent

If a residential 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 needs to compare 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.[7]

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 needs to serve 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 landlord currently seeks to increase the rent by an additional $100. The requested increase of $100 is compared to lowest amount of rent paid during the last 12 months — the $950. Since the total increase in rent is now 10.5%, the landlord needs to serve the tenant with a 60-day notice of a change in rental terms in order to increase the rent by the additional $100.

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; 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.

6 CC §14
7 CC §827

Consider the tenant who receives the landlord's notice but does not wish to comply with changes in the rental terms. Accordingly, the tenant serves the landlord with a 30-day notice of intent to vacate. [See Form 572 accompanying this chapter]

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 (single family residences/condos) may establish their own rent rates, within limitations, if they are subject to rent control ordinances established prior to 1995.

Chapter 19 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 landlord or property manager may serve a notice of change in rental terms on any day during the rental period. The new rental terms stated in the notice do not take effect until expiration of the notice. The notice period for most changes is 30 days. For residential rent increases greater than 10%, a 60-day notice period is required.

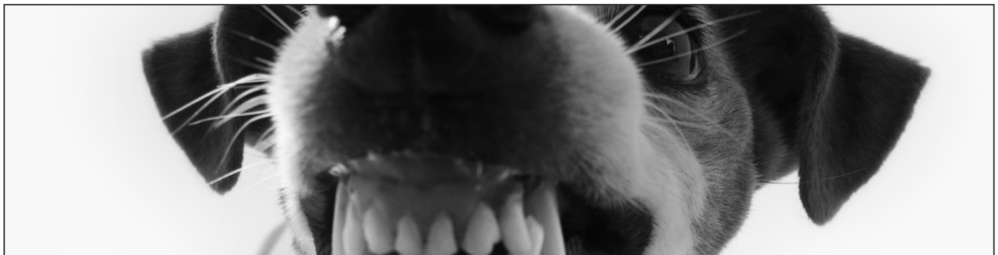
Chapter 19 Key Terms

notice of change in rental terms .... **pg. 182**

notice of intent to vacate .... **pg. 185**

pro rata rent .... **pg. 185**

Chapter 20



Dangerous on-site and off-site activities

Learning Objectives

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

- identify the duty of care a landlord has to inspect the leased premises; and
- understand how a landlord is to properly address dangerous conditions existing on the premises.

Key Term

comparative negligence

Duty to all to remove on-site dangers

A landlord, by their exercise of reasonable care in the management of their property, needs to prevent foreseeable injury to all who enter the leased premises.[1]

If a person is injured due to the landlord's breach of their duty of care to remove or correct a known dangerous on-site condition, the landlord is liable for the person's money losses incurred due to the injury. The person can be a tenant, guest, invitee or trespasser.[2]

The duty of care for others owed by the landlord applies to all persons on the property whether they enter the premises with or without permission, unless the person is committing a felony on the property.

Conditions imposing responsibility

Before liability can be imposed on a landlord for an injury suffered by any person on the leased premises, several factors need to be considered:

- the foreseeability of the type of injury suffered by the individual;
- the closeness of the connection between the landlord's conduct and the injury suffered;

1 **Rowland** v. **Christian** (1968) 69 C2d 108; Calif. Civil Code §1714

2 CC §1714

- the moral blame attached to the landlord's conduct;
- the public policy of preventing future harm;
- the extent of the burden on the landlord and the consequences to the community of imposing a duty to exercise care to prevent the injury suffered; and
- the availability, cost, and prevalence of insurance for the risk involved.[3]

For example, the landlord with knowledge of a dangerous situation created by the presence of a tenant's dog is liable for injuries inflicted on others by the dog based on many of these factors. The landlord's failure to remove the dangerous condition from their property is closely connected to injuries inflicted by the dog.

The landlord is sufficiently aware of the dangerous condition created by the presence of the dog to reasonably foresee the possibility of injury to others. Also, the landlord has the ability to eliminate or reduce the dangerous condition and prevent future harm by serving on the tenant a three-day notice to remove the dog or vacate.[4]

Landlord's duty to inspect

To prevent harm, the property needs to be inspected by the landlord whenever entry is available to the landlord.

Each time a landlord enters into, renews or extends a rental or lease agreement, a reasonable inspection of the leased premises for dangerous conditions is completed as part of their duty of care. If the landlord fails to inspect when the opportunity exists, the landlord is still charged with knowledge of any dangerous condition discoverable by an inspection.

Consider a landlord and tenant who enter into a commercial lease agreement.

The lease agreement allows the landlord to enter the premises for yearly inspections. Also, the tenant is required to obtain the landlord's approval before making any improvements.

With the landlord's consent, the tenant builds a roadside marketing structure and operates a retail produce business. The structure's concrete floor is improperly constructed and unfinished. Produce is often littered on the floor.

More than a year after construction, a customer slips and falls on produce littered on the floor, causing the customer to be injured. The customer claims the landlord is liable for their losses due to the injuries since the landlord's right to inspect the property puts them on notice of the dangerous condition.

The landlord claims they are not liable for the customer's injuries since they had no actual notice of the dangerous condition created by the temporary deposit of produce on the floor.

---

3 Rowland, *supra*

4 **Uccello** v. **Laudenslayer** (1975) 44 CA3d 504

However, the landlord is liable for the customer's injuries if the construction of the concrete floor:

- is a dangerous condition; or
- poses a dangerous condition when littered with produce from a permitted use.[5]

Inspection reveals condition

A landlord is required to conduct an inspection of the leased premises for the purpose of making the premises safe from dangerous conditions when:

- a lease is executed, extended or renewed; and
- the landlord exercises any periodic right to re-enter or any other control over the property, such as an approval of construction.[6]

Here, the landlord would have observed the condition of the floor had they conducted the yearly inspection of the premises called for in the lease agreement. The landlord is liable for slip and fall injuries when the condition of the floor is determined to be dangerous.[7]

A reasonable inspection on any entry

A landlord has a duty to inspect the leased premises when they enter the premises for any single purpose. This includes maintenance, water damage or some other exigency causing them to make an emergency visit.

A landlord who enters the premises during a lease term is not required to make a thorough inspection of the entire leased premises. However, the landlord who enters will be charged with the knowledge of a dangerous condition if the condition would have been observed by a reasonable person.[8]

A landlord of a leased premises containing areas open to the public will be liable for injuries caused by a dangerous condition in the public area if the condition would be discovered during a landlord inspection.

However, if the landlord is not responsible under the lease agreement for repair and maintenance of nonpublic areas, the landlord will not be liable for failing to discover a dangerous condition. The landlord is not required to expend extraordinary amounts of time and money constantly conducting extensive searches for possible dangerous conditions.[9]

For example, a triple-net, management-free lease agreement usually transfers all responsibility for maintaining and repairing the property to the tenant.

Under a triple-net lease agreement, the landlord will not be liable for injuries to persons caused by a dangerous condition on the leased premises if:

- the dangerous condition came about after the tenant takes possession; and
- the landlord has no actual knowledge of the dangerous condition.

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5 **Lopez** v. **Superior Court** (1996) 45 CA4th 705
6 **Mora** v. **Baker Commodities, Inc.** (1989) 210 CA3d 771
7 Lopez, *supra*
8 Mora, *supra*
9 Mora, *supra*

Editor's note — Landlords concerned about tenant maintenance of a leased premises will often reserve the right to enter the premises every six or twelve months. However, frequent inspections of a leased premises create a greater potential of liability for the landlord.

Landlords often reserve the right to conduct frequent inspections to assure that the tenant is not damaging or wasting the premises and reducing its market value. The right to enter brings with it the obligation to inspect for dangerous conditions. Also, the landlord may erroneously tend to overlook possible dangerous conditions they can control that are connected to the tenant's use, rather than maintenance of the property. [See Sidebar, "The agency duties of property managers"]

Knowledge of dangerous conditions

Consider a landlord and tenant who enter into a residential rental agreement giving the tenant permission to keep a German Shepherd dog on the premises.

After the tenant takes possession of the property, the landlord never visits the premises. Later, an employee from a utility company enters the yard and suffers injuries when they are attacked by the tenant's dog.

The utility company employee seeks to recover money from the landlord as compensation for the injuries inflicted on them by the tenant's dog. The employee claims the landlord should have known the dog was dangerous since German Shepherds are a breed with the propensity for viciousness.

Is the landlord liable for the employee's injuries?

No! The landlord did not have knowledge the tenant's dog was vicious and presented a danger to others.[10]

A landlord's obligation to prevent harm to others arises only when the landlord is aware of or should have known about the dangerous condition and failed to take preemptive action.

For example, the landlord receiving complaints from neighbors about the behavior of a tenant's dog may deduce the dog creates a dangerous condition, even if the dog has not yet injured anyone.

Editor's note — The landlord's duty to protect others from an injury inflicted by a dog does not yet include asking the tenant if their dog is dangerous. However, it is feasible the legislature could enact a law or the courts could impose a duty of inquiry on landlords when authorizing the tenant to keep a dog on the premises.

The pet authorization provision in the rental or lease agreement could include a declaration that the authorized pet is not dangerous. Further, the owner of a dog is neither civilly nor criminally liable for a dog bite suffered by a person who enters the dog owner's property, lawfully or otherwise, unless the person is invited onto the property by the owner of the dog, is an employee of a utility company, a police officer or a U.S. mail carrier.[11]

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10 **Lundy** v. **California Realty** (1985) 170 CA3d 813

11 *CC §3342(a)*

Often, landlords employ real estate licensees to act as their property managers.

When acting as an agent for the landlord, the licensed property manager has a duty to notify the landlord of the property manager's activities and observations regarding the maintenance and management of the landlord's property. [Calif. Civil Code §2020]

However, the landlord is considered to have the same knowledge about the condition of the landlord's property as the property manager. [CC §2332]

Further, since the property manager is the landlord's representative, the landlord will be liable for the property manager's actions performed in the scope of their representation. [CC §2330]

However, the landlord is entitled to indemnity from the property manager if the landlord is held liable for the property manager's failure to perform their duties and keep the landlord informed. The licensed property manager will be liable to the landlord for breach of their agency duty, called indemnity. [CC §2333]

The agency duties of property managers

Landlord should have known

Now consider a landlord who leases commercial property to a tenant who operates a retail sales business on the property. The tenant keeps a dog on the premises and posts a "Beware of Dog" sign. A newspaper article written about the dog's vicious temperament is also posted on the premises. The landlord visits the leased premises several times a year and knows the dog is kept in the public area of the premises.

After the lease is renewed, a delivery man is attacked and injured by the dog. The delivery man claims the landlord needs to compensate them for their injuries.

The landlord claims they are not liable since they were personally unaware the dog was dangerous.

Is the landlord liable for the delivery man's injuries?

Yes! The landlord owes a duty to the delivery man as a member of the public to:

- exercise reasonable care in the inspection of their property to discover dangerous conditions; and
- remove or otherwise eliminate the dangerous condition that may be created by the presence of a vicious dog.

The injured person can recover when the landlord is personally unaware of the dog's vicious propensities since a reasonable inspection of the premises on renewal of the lease would have revealed to the landlord the newspaper article and the "Beware of Dog" sign.[12]

Also, it is foreseeable that a guard dog kept on a premises during business hours could injure someone.

12 **Portillo** v. **Aiassa** (1994) 27 CA4th 1128

Further, the landlord's failure to require the tenant to remove the dog from the premises on discovery that the dog constitutes a dangerous condition is closely connected to the delivery man's injuries.

The landlord had control over the condition. They could serve a three-day notice on the tenant, requiring the tenant to either remove the dog from the premises during business hours or vacate the premises.

A landlord can often remove a dangerous condition by merely exercising their responsibility to make repairs that will eliminate the condition. However, a dangerous condition caused by a tenant's activity may require a three-day notice ordering the tenant to correct or remove the dangerous condition, or vacate the premises. [See **RPI** Form 576]

On-site danger leads to off-site injury

Now consider a landlord and tenant who enter into a rental agreement for a residential dwelling. The agreement allows the tenant to keep dogs on the premises.

After the tenant occupies the residence, the landlord visits the premises monthly to collect the rent payments. During their visits, the landlord observes the dogs. The landlord is aware of the dogs' vicious nature.

One day, a neighbor and their dog are attacked and injured by the tenant's dogs two blocks away from the leased premises. The neighbor demands the landlord pay for losses resulting from the injuries. The neighbor claims the landlord owes them a duty of care to prevent injuries arising from dangerous animals the tenant keeps on the landlord's premises.

The landlord claims they are not liable since the injuries occurred off the leased premises.

Here, the landlord is liable for the off-site injuries since the landlord:

- was aware of the vicious propensities of dogs housed on their premises; and
- had the ability to remove the dangerous condition by serving a three-day notice on the tenant to remove the dogs or vacate the premises.[13]

The landlord's liability for injuries inflicted by a tenant's dog off the premises is the same as their liability for injuries inflicted by the dog that occur on the premises.

While the landlord did not have control over the property where the injury occurred, the landlord did have control over the tenant's right to keep and maintain a known dangerous condition.

The landlord's failure to have dangerous dogs removed from the premises caused the injuries suffered by the neighbor. The injury would not have occurred if the landlord had not allowed the dogs, which they knew to be vicious, to remain on the premises they controlled.[14]

13 **Donchin** v. **Guerrero** (1995) 34 CA4th 1832

14 Donchin, *supra*

Tenant's dangerous on-site activity

Consider a landlord who is aware the tenant of their single-family rental unit occasionally discharges a firearm in the backyard. One day, a bullet fired by the tenant enters the backyard of the neighboring residence and kills the neighbor.

The neighbor's spouse makes a demand on the landlord for the financial loss resulting from the neighbor's death. The spouse claims the landlord breached their duty to individuals on the neighboring property by failing to exercise care in the management of their property.

Is the landlord liable for the neighbor's death?

Yes! Even though the injury occurred off the leased premises, the landlord is liable since the landlord:

- knew of the dangerous on-site activity carried on by the tenant who inflicted the injury; and
- had the ability to eliminate the dangerous condition by serving a three-day notice on the tenant to refrain from discharging the gun or quit the premises.[15]

The landlord had a duty to prevent the tenant from continuing to fire the gun on the premises. Once again, a landlord is liable for any injury resulting from a *known dangerous condition* or *activity occurring on their property* that they have the ability to remove. This is the case even if the actual injury is suffered off the leased premises.

However, had the tenant left the landlord's premises with their gun and then shot and killed an individual, the landlord would not be liable.[16]

Failure to avoid obvious dangers

Some dangerous conditions are obvious to persons entering or using the premises. Obviously dangerous conditions impose a duty of care on each person to avoid injury to themselves.

For example, a person wearing cleats walks on a concrete path. Alongside the concrete path is a rubber walkway used to prevent slip and fall injuries. The person wearing cleated shoes walks on the concrete path and slips, becoming injured in the fall. A sign does not exist explaining the danger of the person's activity.

Here, a landlord has no duty to warn or guard others against a dangerous condition that is obvious.[17]

While a landlord needs to compensate others for injuries caused by their failure to use skill and ordinary care in the management of their property, the liability has its limits.

15 **Rosales** v. **Stewart** (1980) 113 CA3d 130
16 **Medina** v. **Hillshore Partners** (1995) 40 CA4th 477
17 **Beauchamp** v. **Los Gatos Golf Course** (1969) 273 CA2d 20

A person, who willfully or by their own lack of ordinary care injures themselves, exonerates the landlord, wholly or in part, from liability.[18]

A person has a duty of care to themselves to be sufficiently observant and keep themselves out of harm's way.

comparative negligence
An injured person's share of the negligence causing their injury when the injured person's lack of care for themselves contributes to the injury.

When the injured person's lack of care for themselves contributes to their injury, the money losses recoverable by the injured person will be diminished in proportion to the percent of negligence attributable to the injured person. This injured person's share of the negligence causing their injury is called **comparative negligence**.[19]

Consider a trespasser who illegally enters a property and fails to conduct themselves with care to avoid harm.

When the trespasser is negligent in exercising care to prevent harm to themselves, any losses recoverable by the injured trespasser will be reduced by the percentage amount of their negligence which caused the injury.[20]

The landlord's liability will be further limited if the trespasser was in the process of committing a felony on the property when they were injured.[21]

Not a dangerous condition

Now consider a person who enters leased commercial property and wants to look inside the building.

Next to the building, below a window, stands a vat of acid maintained by the business authorized to operate on the leased premises. The vat is covered with plywood for the purpose of keeping out dirt and dust.

In order to see through the window, the person climbs up and steps onto the plywood cover which immediately collapses. The person falls into the vat, suffering injuries.

The injured person attempts to recover money from the landlord for losses resulting from their injury.

Here, the landlord is not liable for the person's injuries since the vat is not a dangerous condition that presents a risk of harm. The vat of acid is an integral part of the business run on the leased premises and is not a danger to any person who conducts themselves with care around the vat.

The injured person undertook the risk of harm to themselves by climbing on top of the vat and creating the dangerous situation leading to their injuries.[22]

Now consider a landlord of an apartment complex used by gang members as a base for planning their off-site criminal offenses. One of the gang members is a named tenant on a rental agreement.

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18 CC §1714
19 **Li** v. **Yellow Cab Company of California** (1975) 13 C3d 804
20 **Beard** v. **Atchison, Topeka and Santa Fe Railway Co.** (1970) 4 CA3d 129
21 CC §847
22 **Bisetti** v. **United Refrigeration Corp.** (1985) 174 CA3d 643

The tenants and law enforcement officials complain to the landlord about the gang. However, the gang members do not harm or pose a threat of danger to the tenants.

Later, a pedestrian walking past the complex in the public right of way is chased by the gang members. One of the gang members, who is not the tenant, shoots and kills the pedestrian on a street adjacent to the complex.

The spouse of the pedestrian claims the landlord is liable for the death since they failed to remove the presence of gang members from their premises.

However, the landlord does not have a duty to protect members of the public using adjacent public streets from assaults by gang members who congregate on the leased premises.[23]

The congregation of gang members on the leased premises is not itself a dangerous condition. Thus, the landlord's failure to take steps to prevent the gang members from congregating on the leased premises is not the cause of the off-site shooting of a pedestrian by one of the gang members.

Again, the landlord is not liable for injuries that occur off the leased premises, since the landlord has no control over the activities of individuals or tenants while they are on public property, only when they are on their property.[24]

Dangerous off-site conditions

Now consider a landlord who leases a residence to a tenant. The residents of the neighboring property own a dog the landlord knows to be vicious. The neighbor brings their leashed dog onto the leased premises. The neighbor invites the tenant's child to pet the dog.

The dog breaks free from the leash and attacks the child, causing injuries. The tenant claims the landlord is liable for their child's injuries since the landlord failed to warn them of the dangerous condition created by the neighbor's vicious dog.

Is the landlord liable for injuries inflicted on-site by the neighbor's dog, which they knew was vicious?

No! The dangerous condition was not maintained on the leased premises. The landlord has no control or authority to remove the dangerous condition from the neighbor's property.[25]

While a landlord owes a duty to others to remove a dog from their property that they know to be dangerous, they do not have a duty to warn their tenants of the presence of vicious animals located on *other properties* in the neighborhood.

23 Medina, *supra*
24 Medina, *supra*
25 **Wylie** v. **Gresch** (1987) 191 CA3d 412

The landlord's failure to warn the tenant about the neighbor's dog did not create a dangerous condition on the leased premises that caused the tenant to be injured. A landlord's duty to correct or prevent injury from dangerous conditions does not extend off the premises.[26]

While the landlord has a duty to make the leased premises safe, they are not required to ensure the tenant's safety from off-site hazards.[27]

Off-site injuries under landlord control

The public right of way for a street fronting a leased premises includes part of the front lawn, located between the street curb and the property line. The landlord maintains the entire lawn up to the curb.

A water meter is located on the lawn in the street right of way. Several tenants inform the landlord the water meter box is broken and needs repair.

A tenant trips on the broken water meter box and suffers injuries. The tenant makes a demand on the landlord for losses caused by their injuries, claiming the landlord has a duty to eliminate dangerous conditions located in the public right of way within the lawn maintained by the landlord.

The landlord claims they are not liable since the water meter box is not located on their property and the landlord does not own or control the meter box.

However, the landlord is liable for the injuries suffered by the tenant. While the broken water meter box is located in a public right of way, the surrounding lawn is maintained by the landlord.[28]

Also, a landlord or other property owner who installs trees adjacent to or in the lawn area between the public sidewalk and the street-side curb owes a duty of care to prevent the trees from causing injury.

For example, trees planted and maintained by the property owner grow and eventually produce roots that crack and lift the sidewalk. The owner is aware of the hazard created by the tree roots but undertakes no steps to have the hazardous condition repaired or replaced.

Here, the owner has *taken control* over the off-site area containing the public sidewalk since the roots of the trees on their property have damaged the sidewalk. Thus, the owner will be liable to any pedestrian who is injured by the cracked sidewalk.[29]

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26 Wylie, *supra*

27 **7735 Hollywood Boulevard Venture** v. **Superior Court** (1981) 116 CA3d 901

28 **Alcaraz** v. **Vece** (1997) 14 C4th 1149

29 **Alpert** v. **Villa Romano Homeowners Association** (2000) 81 CA4th 1320

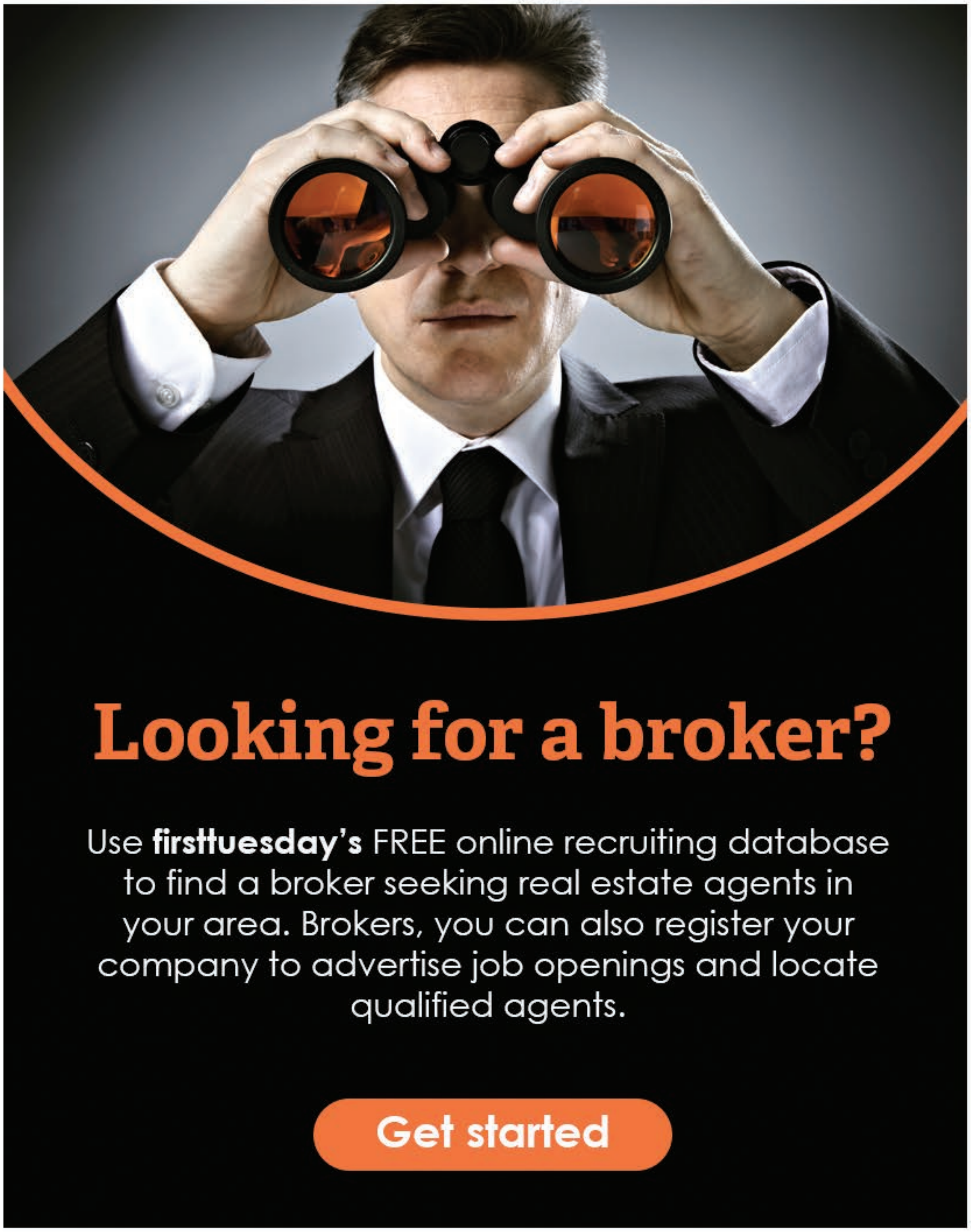
Chapter 20 Summary

Each time a landlord enters into, renews or extends a rental or lease agreement, a reasonable inspection of the leased premises for dangerous conditions needs to be completed as part of their duty of care. A landlord who enters the premises during a lease term is not required to make a thorough inspection of the entire leased premises. However, the landlord who enters will be charged with the knowledge of a dangerous condition if the condition would have been observed by a reasonable person.

A landlord is liable for any injury resulting from a known dangerous condition or activity occurring on their property that they have the ability to remove. This is the case even if the actual injury is suffered off the leased premises. However, a landlord's duty to correct or prevent injury from dangerous conditions does not extend to conditions that exist off the premises.

Chapter 20 Key Term

comparative negligence .... pg. 194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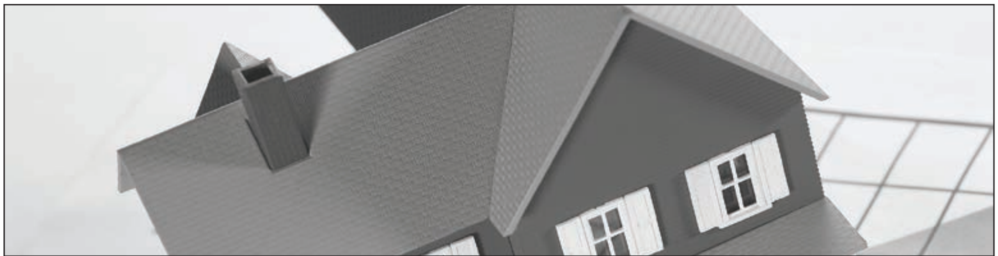


Chapter 21

Rates affecting real estate

Learning Objectives

After reading this chapter, you will understand:

- the most crucial interest rates commonly used in California real estate transactions; and
- how the Federal Reserve controls certain interest rates.

Key Terms

1-year Treasury Bill	**discount rate**
applicable federal rates	**federal funds**
Cost of Funds Index	**prime rate**

The influence of Federal Reserve policies

Minimum reserve requirements have been imposed on banks to prevent a crisis of liquidity ever since the Great Depression. As an additional measure to ensure the supply of money from banks to the public, the *Federal Reserve (the Fed)* makes loans to banks to fulfill its role as lender of last resort.

The discount rate is the interest rate the Fed charges banks and thrifts who borrow funds directly from the Fed to maintain reserve requirements.

The **discount rate** is important to private money lenders, when they:

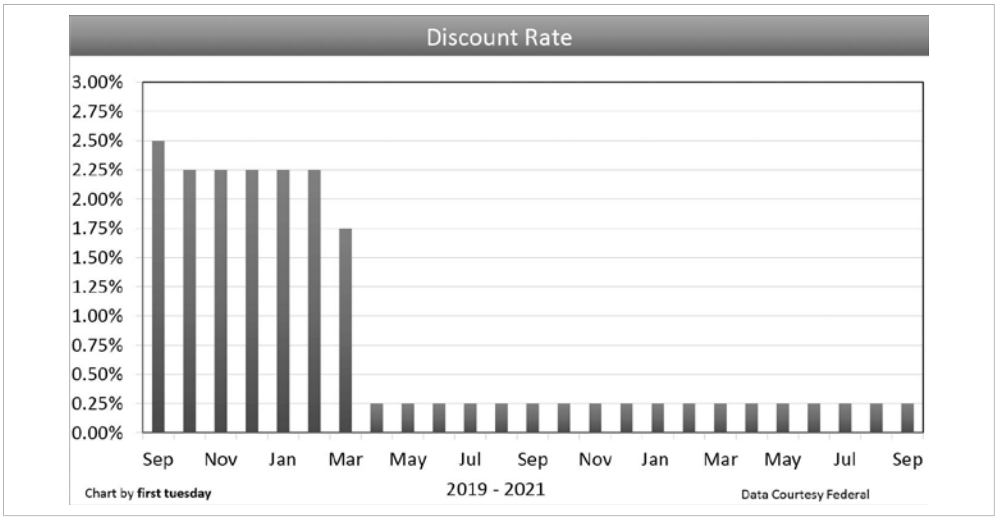
- are not licensed real estate brokers; and
- do not arrange their mortgages through real estate brokers.

Nonetheless, an understanding of discount rates is beneficial to real estate brokers and agents. Most importantly, the discount rate is a component of the interest rate limits imposed by *usury laws* on non-brokered, private money mortgages, since they are not exempt (as are all broker-made or broker-arranged mortgages).

discount rate
The interest rate the Federal Reserve charges banks and thrifts who borrow funds directly from the Fed to maintain reserve requirements.

Figure 1

Discount Rate



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The discount rate component for usury limits is set each month based on the Federal Reserve Bank of San Francisco (FRBSF) discount rate effective on the 25th day of the month previous to the month the loan is agreed to by the lender. The discount rate is set for the life of the non-exempt mortgage.

The maximum annual interest rate on non-exempt mortgages is the greater of:

- 10% per annum; or
- the discount rate plus 5%. [See Figure 1; California Constitution, Article XV §1]

Federal funds

federal funds
Overnight funds lent to banks with insufficient reserves by the Federal Reserve and other banks with excess reserves.

Depending upon current rates, banks often prefer to borrow from one another rather than the Fed. **Federal funds** are overnight funds lent by other banks with excess reserves and the Fed in the open market to banks with insufficient reserves.

The Fed influences the movement of the federal funds rate by buying or selling government securities, typically 1-year Treasury bills (T-Bills). This raises or lowers the supply of bank reserves available in sympathy with the Fed buying and selling securities.

When the Fed wants to tighten monetary policy to reduce the rate of inflation, it will sell government securities. This withdraws funds held by investors and thus reduces bank reserves. This results in an increase in the federal funds rate.

An increase in the federal funds rate directly causes rate increases in other short-term money instruments such as T-bills, certificates of deposits (CDs) and repurchase agreements (RPs). In the real estate market, movement in the federal funds rate influences movements in adjustable rate mortgage (ARM) indices. In turn, this triggers adjustments in the note rate and payment schedules for ARMs.

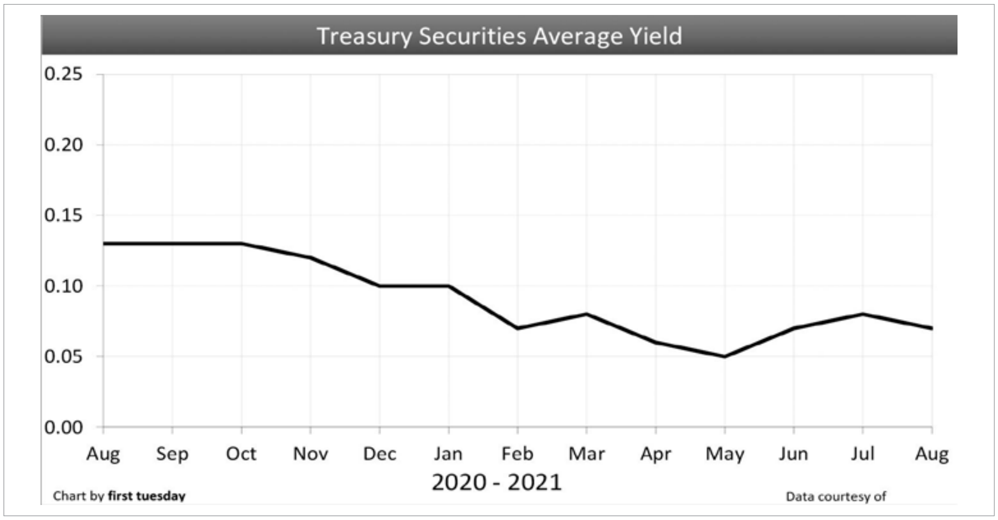

Figure 2

Treasury Securities Average Yield

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Fixed-rate mortgages (FRMs) are not affected by the federal funds rate since they are tied to 10-year Treasury notes.

The Fed uses the *discount rate* and the *federal funds rate* to control short-term interest rates. Increases in short-term rates are spurred by the Fed's perception that higher consumer price inflation looms in the future due to an excessive demand for goods and services.

By increasing the short-term rates, the Fed raises the cost of borrowing, limiting the availability of credit. This slows the economy down, decreasing the level of price inflation.

Cost of Funds Index
One of several indices referenced by lenders in adjustable rate mortgage notes to adjust the note's interest rate. This index is one of the steadiest.

Treasury Securities average yield

This index is one of several indices used by lenders as referenced in their ARM note to periodically adjust the note's interest rate. The ARM interest rate equals the T-Bill yield, plus the lender's profit margin which is also set forth in the note. The index is an average of T-Bill yields with maturities adjusted to one year. [See Figure 2]

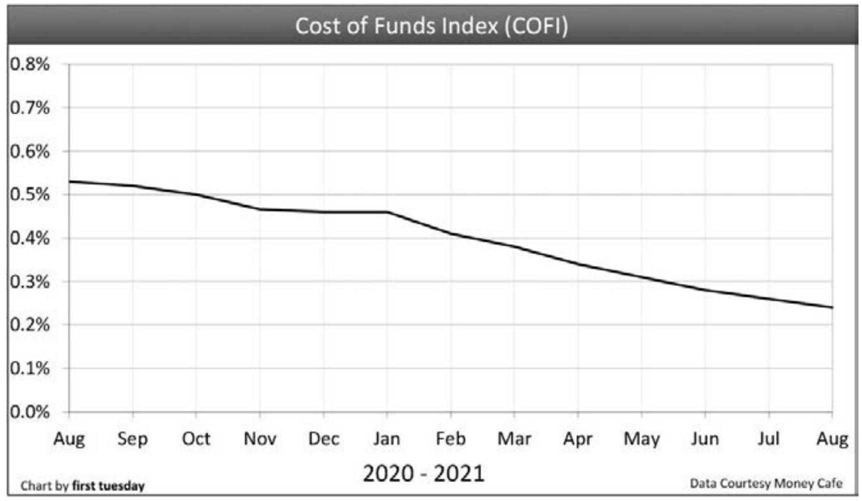
11th district Cost of Funds Index (for the Federal Home Loan Bank of San Francisco)

This index is another one of several indices referenced by lenders in their ARM note to periodically adjust the note's interest rate. The ARM interest rate equals the **Cost-of-Funds Index**, plus the lender's profit margin. [See Figure 3]

The figures for 1-year T-bill indices (Figure 2) are based on the sale of T-bills through the money market. In contrast, the *11th District Cost of Funds Index* (Figure 3) is the average interest rate paid by thrift institutions that borrow money in the 11th Home Loan Bank District, which includes California and surrounding states. Both the 1-year T-bills and the 11th District Cost of Funds Index are used to periodically set ARM rates. [See Figure 3]

Figure 3

Cost of Funds Index



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1-year Treasury Bill
One of several indices referenced by lenders to adjust the rate of an adjustable rate mortgage. This index is one of the most volatile.

Rates on **1-year T-bills** are more volatile and rise and fall faster than the steadier 11th District Cost of Funds. Remember that banks are able to borrow from the Fed at rates designed to protect their solvency during recessionary times and fight inflation during boom times.

As a result, *1-year T-Bill* based indices and rates (and thus ARM rates) are prone to fluctuate wildly as the economy cycles. Although ARMs set to the comparatively stable Cost of Funds rate (which are few today) can evince less movement, the volatility of both indices makes the ARM a very risky loan for wage earners.

When entering periods of increasing rates, such as 2005 to 2007, lenders retaining the mortgages they originate prefer the faster upward movement of the 1-year T-bill indices for increasing their yield, maintaining portfolio value and remaining solvent.

Prime rate

prime rate
A base rate used by banks to price short-term business loans, set 3% above the federal funds rate.

The **prime rate** index is one of several referenced by lenders in their ARM note by adding a margin of 2% or 3% for monthly adjustments in interest charges. The *prime rate* is set in unison by U.S. banks, and is adjusted as frequently as the Fed adjusts the federal funds rate. [See Figure 4]

Borrowers with high credit scores may have their interest set to a lower rate, such as the London Inter-Bank Offered Rate (LIBOR).

As of October 2021, the prime rate is 3.25%.

The *prime rate* is a base rate used by banks to price short-term business loans, and is set at 3% above the federal funds rate. As short-term interest rates increase, so does the prime rate. In addition to ARMs, home equity lines of credit, credit card rates and some private student loans are commonly indexed to the prime rate.

CPI, rents and resale pricing

The long-term interest rates reported in this chapter are:

- the average 30-year conventional commitment rate for the Western region as reported by Freddie Mac; and

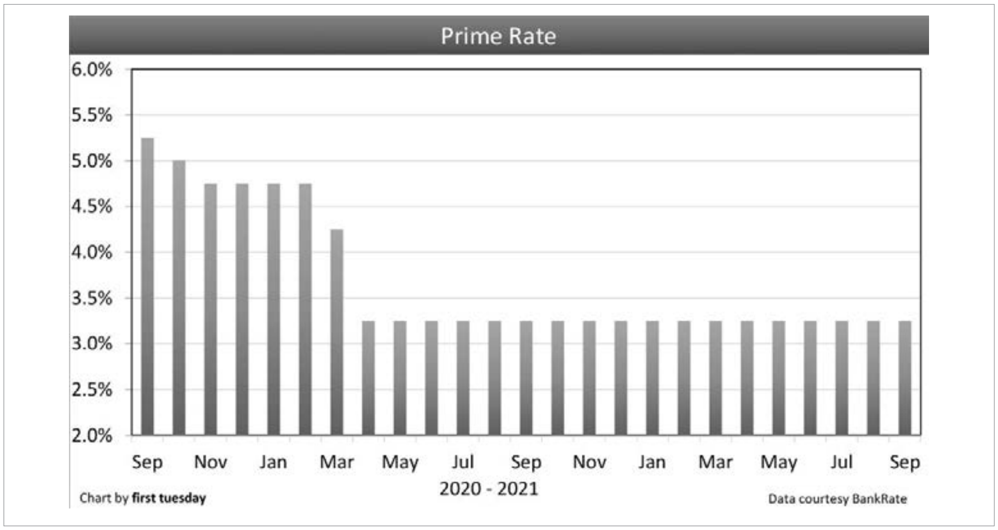

Figure 4

Prime Rate

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- 10-year T-bills.

The Fed infrequently takes direct control over long-term interest rates. The Fed did so during 2009 and 2010, and again in 2011-2012 due to the jobless recovery following the 2008 recession.

However, the Fed controls inflation primarily through its monetary policy. By moving the short-term rates the Fed influence the expected future inflation rates. The bond market's expected rate of inflation going forward is reflected in its long-term interest rates.

For example, the Fed began to increase short-term interest rates in mid-2004 and continued through 2005. The Fed did this to fight perceived inflationary pressures in the economy brought about by demand and pricing (and the recovery of foreign markets, weakening dollar, etc.).

Due to a general view within the bond market that inflationary pressures existed in the national economy, and controversy over whether the Fed had the desire or tenacity to control the perceived inflationary pressures, long-term interest rates began to rise.

Applicable federal rates

Applicable federal rates (AFRs) determine the minimum interest yield reportable on carryback financing, called **imputed interest** since it is the obligation of the taxpayer to impute principal in the note to interest income. The AFR category is determined by the carryback due date. Listed rates are for monthly payments. [See Figure 5]

applicable federal rate (AFR)
A rate set monthly by the Internal Revenue Service determining the minimum interest yield reportable on carryback financing.

Imputed interest reporting applies the *AFR* to debt carried back by a seller on an installment sale. An interest rate on a carryback note negotiated at a note rate below the AFR triggers imputed interest reporting to the Internal Revenue Service (IRS). Thus, profit in the form of principal on the note is shifted to interest income.

Figure 5

Applicable Federal Rates

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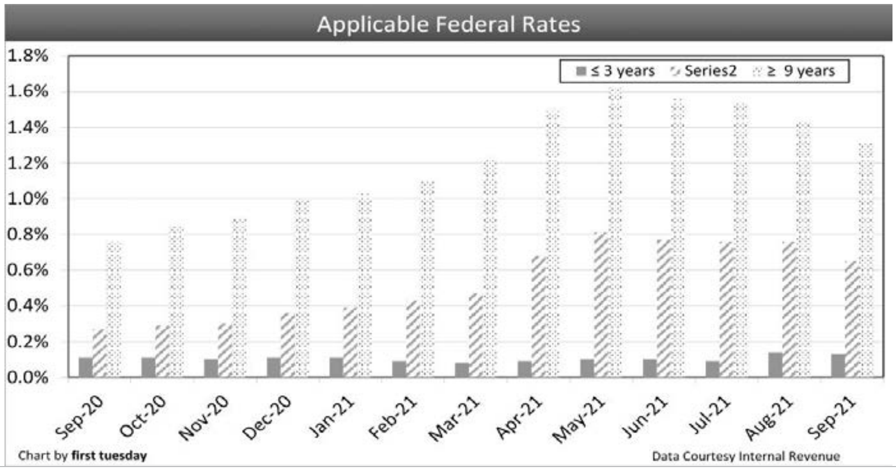

The imputed rate is the lesser of the AFR for the month the purchase agreement is entered into, or 9%.

Twelve AFRs are set monthly by the IRS. The due date of the note and the periodic payment schedule determine the note's minimum reporting rate. For example, notes due in three or less years, payable quarterly, fall into the short-term AFR category at its quarterly rate.

Assorted market rates

See Figures 6-8 for other critical market rates which affect California real estate.

Figure 6

3-Month Treasury Bill

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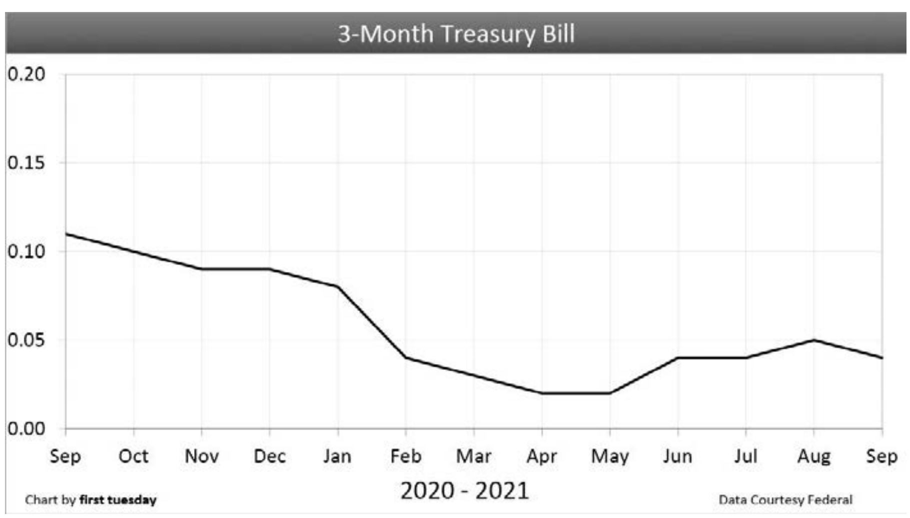
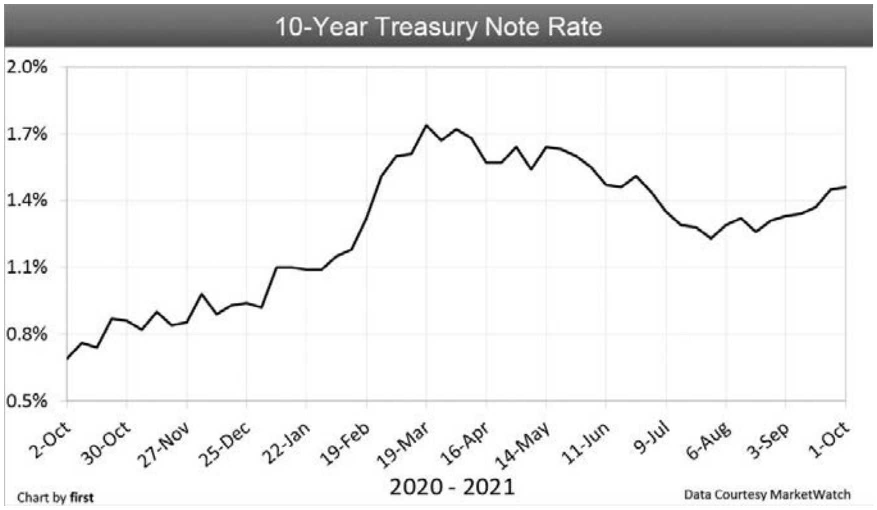


The 3-Month Treasury Bill is the rate managed by the Fed through the federal funds rate as the base price of borrowing money in the short-term. It is also used in determining the yield spread, which predicts the likelihood of a recession or rise in the economy one year forward.



The 10-year Treasury Note rate is a leading indicator of the direction of future Fannie Mae and Freddie Mac rates, which historically run around 1.4% higher than the 10-year yield during a stable money market. The rate is comprised of the level of worldwide demand for the dollar and anticipated future domestic inflation.

Figure 7

10-Year Treasury Note Rate

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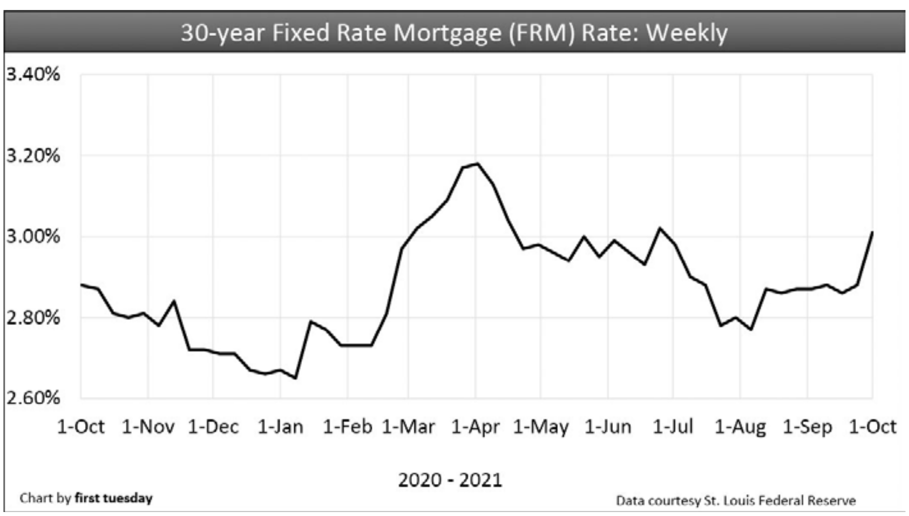

The average 30-year commitment rate is the rate at which a lender commits to lend mortgage money in the U.S.-West as reported by Freddie Mac. This rate is published on a weekly basis.

Figure 8

Average 30-Year FRM Rate for the Western Region

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Chapter 21 Summary

The Federal Reserve (the Fed) is the lender of last resort, ensuring a sufficient money supply during economic crises.
The Fed combats inflation by using the discount rate and the federal funds rate to control short-term interest rates. Occasionally the Fed will take control over long-term rates.

Lenders use several established indices to control how ARM interest rates fluctuate. Some of these indices are the Cost of Funds Index, the 1-Year Treasury-Bill index, and the prime rate.

Chapter 21 Key Terms

Chapter 22

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;
- understand the conditionality of a written mortgage commitment or rate lock; 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 **rate lock**

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 loan 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 loans and credit sales arrangements to acquire equipment and improvements.

The loan 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, which are *put options,* 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 — again, without liability if they refuse to fund.

Enforceable agreement to grant a permanent modification

Now consider a lender who signed a **Servicer Participation Agreement** with the U.S. Department of Treasury under the Home Affordable Modification Program (HAMP). The lender agrees to follow the Treasury's guidelines and procedures in modifying mortgages.

A distressed-homeowner applies to the lender for a modification of their mortgage. The lender prepares a written *Trial Period Plan (TPP)* which states the homeowner will receive a **permanent mortgage modification** if they make trial modification payments and submit qualifying documents.

The borrower signs the TPP and returns it, makes all trial modification payments and submits the required documentation to confirm eligibility for the permanent modification.

The lender never agrees to give the homeowner a modification nor do they notify the borrower of any failure to qualify. However, under HAMP, the lender is obligated to the government to enter into a mortgage modification

1 **Kruse** v. **Bank of America** (1988) 202 CA3d 38

when the homeowner meets all the requirements under the TPP. The homeowner seeks to compel the lender to agree to a permanent modification since the owner followed all the terms of the written TPP.

Is the lender compelled to grant a permanent modification?

Yes! The borrower followed all the terms of the *written* TPP. Thus, the lender is compelled to grant the permanent modification since they entered into the *Servicer Participation Agreement* under HAMP.[2]

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).**

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. Unless you believe in the fantastical tooth fairy, lending is an **asymmetrical power relationship**, not one of a willing lender and a willing borrower sharing a common goal and rooted in mutual consent. Until the lender literally delivers funds and a closing has occurred, the lender can back out of its oral or unsigned written commitment at any time, without liability.

As a result, the balance of power is entirely with the lenders. The rigged lending-game requires borrowers to rely solely on the lenders' *verbal assurances* and proposals to get a mortgage. Conversely, the lender bears no burden and suffers no consequences for failure to follow through on any of their oral or unsigned written promises.

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 in the mortgage application process. Again, the relationship between lender and borrower is inherently adversarial. Thus, the informed buyer is best able to anticipate and defend themselves when confronted with unscrupulous eleventh-hour lender tactics.

2 **Corvello** v. **Wells Fargo Bank** (9th Cir. 2013) 728 F3d 878

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 California Department of Real Estate (DRE).

To assist the buyer with the task of comparing the products of two or more lenders, entities such as the California Department of Financial Protection and Innovation (DFPI) publish **Mortgage Shopping Worksheets.** These *Mortgage Shopping Worksheets* contain a list of mortgage variables occurring on origination and during the life of the mortgage. Once the Worksheet has been filled in for multiple lenders, the buyer may compare the terms offered by the competing lenders and close with the lender providing the best rates and terms.

The DFPI Mortgage Shopping Worksheet can be obtained through their website at *https://dfpi.ca.gov*.

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.

Rate locks: tin shields or the real deal?

rate lock
A lender's conditional, unsigned commitment to fund a mortgage at a quoted interest rate, origination fee and fixed number of points, regardless of whether interest rates rise or fall prior to funding the mortgage.

A **rate lock** is similar to a lender's mortgage commitment. A *rate lock* is a lender's conditional commitment to fund a mortgage at a quoted interest rate, origination fee and fixed number of points, regardless of whether interest rates rise or fall prior to funding the mortgage.

At first glance, rate locks seem like a brilliant idea; a personal favor from a lender to a homebuyer, if you will. However, mortgage lending is not a charity. It's business.

A rate lock as issued by lenders in the mortgage process is NOT a commitment to lend your buyer money. A mortgage commitment needs to be in writing, signed and given in exchange for consideration (read: money).[3]

To be enforceable, the lender needs to receive money paid in consideration for the mortgage commitment. Even then, no lender guarantees a mortgage until it is funded and closed.

A rate lock is not a guarantee your buyer will receive the rate stated on the rate lock statement. It is not certain. Why? It is always **contingent** upon all other lender requirements being met at time of funding.

A long list of contingencies to the rate lock provides the lender with an equal number of opportunities to escape from the rate lock agreement even if it were binding. Your buyer's interests are best served by expediting the mortgage process as much as possible, lock or no lock.

To close the mortgage as quickly as possible, direct your buyer to collect the following information before asking for a lock on the rate and points quoted:

- bank account numbers;

3 Calif. Civil Code §2922

- latest bank statement;
- latest pay stubs;
- W2 and tax forms;
- tax returns for the past two years;
- mortgage and credit card account numbers;
- names and addresses of creditors;
- name and contact information for their new homeowners insurance company; and
- evidence of mortgage or rent payments.

However, even if your buyer gets the agreed-to rate at closing, rate locks are a *gamble* — your buyer has to ante up just to get a chance at keeping a lower rate in a rising market.

By their nature, a rate lock is never a guarantee your buyer will receive the most advantageous mortgage terms available at the time of funding. Thus, prudent buyers and their agents submit mortgage applications to a minimum of two lenders to guard against last-minute surprises.

Chapter 22 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.

Similarly, a rate lock is a lender's conditional commitment to fund a mortgage at a quoted interest rate, origination fee and fixed number of points, regardless of whether interest rates rise or fall prior to funding the mortgage. However, a rate lock is always contingent upon all other lender requirements being met at time of funding, providing the lender with a number of opportunities to escape from the rate lock agreement.

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 22 Key Terms

Chapter 23

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 lenders;
- apply the exemptions barring lenders from due-on enforcement; and
- negotiate a limitation or waiver of a lender's due-on rights.

Key Terms

acceleration	**inter vivos trust**
due-on clause	**waiver agreement**

Rising rates bring lender interference

During times of upward sales volume, expanding mortgage origination and increasing absorption rates for space available to rent, the marketplace functions at full throttle. This is known economically as a **virtuous cycle**.

Responsibility for this frenzy lies with the gatekeepers to real estate ownership — brokers, builders and lenders – and government regulation of conduct in the real estate and mortgage markets.

During the good times of rising prosperity, buyers put up with the onerous threshold of entry procedures maintained by the gatekeepers. In the rush to do deals, all the numerous steps to ownership seem justified for the buyers. There is plenty of money for everyone, or so it seems.

However, when mortgage rates and short-term interest rates rise to dampen excess inflation, lending standards suddenly tighten. At this point, buyers become unwilling to further cope with the regime of higher rates, increased credit standards, seller price demands, and excessive documentation requirements. This change in expectations triggers a **vicious cycle** which begins quickly but takes years to unwind after it bottoms.

due-on clause
A clause in a trust deed, triggered by the transfer of any interest in the real estate, which allows the lender to call the loan.

Enter **due-on-sale** restrictions.

When the boom turns to bust, and stagnation

A burden on the use and mobility of ownership is created by the existence of the *due-on clause* buried within all trust deeds held by lenders.

During boom years and long-term episodes of declining interest rates, the due-on clause is not an issue. The decades of the 80s, 90s and 2000s are examples of periods when buyers could easily qualify for a new loan at ever decreasing interest rates to cash out the seller. Further, sellers are relatively unconcerned about the size of any prepayment penalty on the payoff of their mortgages during these good times.

As the boom turns to bust and buyers are induced to purchase property as prices fall, the most effective arrangement for financing the purchase price is for the buyer to take over the seller's mortgage – if it has an interest rate lower than the current rates charged by lenders.

However, lenders in the past have refused to consent to any type of loan takeover or assumption. The reason: they prefer to receive a prepayment penalty and re-lend the money at the higher current rate.

Thus, though the due-on clause was not a burden during the boom, it becomes a noose around the seller's neck when the market stagnates. The combination of generally rising interest rates (following the 2009-2015 zero lower bound interest rates) and the due-on clause in existing mortgages ties the seller to their property. Thus, the seller is fettered to their home (and title) without a financially suitable way out.

As an alternative, the seller lowers their sales price to offset the buyer's lesser mortgage amount brought on by increasing mortgage rates. New expectations about pricing during rising interest rate periods will develop.

Lender interference is federal policy

Generally, lenders are allowed to enforce due-on sale clauses in trust deeds on most transfers of any interest in any type of real estate.[1]

Thus, federal mortgage law deprives Californians of their state law right to convey real estate subject to trust deed liens without the lender interfering with the transfer of ownership for additional profit. To interfere with sale of the secured property under state law, the lender needs to demonstrate the buyer lacks creditworthiness or is wasteful of property in their management

1 12 United States Code §1701j-3, Garn-St. Germain Depository Institutions Act of 1982 (Garn)

– essentially, that the buyer is an *insolvent arsonist*. However, the federal legislative process called **pre-emption** bars application of state law since it is to the contrary.

The occurrence of an event triggering due-on enforcement automatically allows the lender to:

- **call the loan**, demanding the full amount remaining due to be paid immediately, also known as **acceleration**; or
- **recast** the loan, requiring a modification of the loan's terms as a condition for the lender's consent to a transfer, called a *waiver by consent*.

acceleration
When a lender or carryback seller makes a demand for immediate payment of the amounts remaining due on a loan or extension of credit. Also known as "calling the loan."

The federal **Garn Act** itself encourages lenders to allow buyers to assume real estate loans at existing rates, but provides lenders no incentives for doing so. The congressional intent in 1982 when passing the *Garn Act* was to pre-empt state law restrictions of due-on enforcement solely to allow lenders to increase their profits on an old mortgage whenever the owner sells, leases or further encumbers the secured property.

Excessive lender interference

However, the enforcement of the due-on clause by lenders was not intended to occur at the expense of permitting excessive lender interference with real estate transactions.[2]

Yet, when the Federal Home Loan Bank Board (now the *Office of Thrift Supervision (OTS)*) issued due-on regulations to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights. The following 30 years saw mortgage rates drop, and no seller or buyer was interested in keeping or taking over existing mortgages at higher than current rates. Thus, the leniency issue was, well, never an issue.

The regulations allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few family-related, owner-occupied single family residence (SFR) exceptions. No encouragement or guidelines were established in the regulations for lender consent to loan assumptions or to limit interference in commonplace transactions. This regulatory encouragement will be needed to avoid the interference that is going to result as buyers attempt to take over the seller's low-rate mortgages when the seller will not lower their price.

Economic recessions and recoveries

In times of stable or falling interest rates, lenders usually permit assumptions of loans at the existing note rate, unless a *prepayment penalty clause* exists. Lenders have no financial incentive to recast loans, or call and re-lend the funds at a lower rate when interest rates are dropping.

However, in times of steadily rising rates, lenders 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,

2 USC §1701j-3(b)(3)

the lender requires the loan 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 interference was an obscure issue during the 30-year period (1982-2012) after *Garn* became law. During this period, fixed mortgage rates declined from 15% to 3.25% and mortgage money became more plentiful. All that downward rate movement was reversed in 2008 with zero lower bound interest rates and mortgages at historically low note rates in 2012.

Due-on-sale

Due-on clauses are most commonly known as *due-on-sale* clauses. However, "due-on clause" is a more accurate term. A sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the lender's due-on clause is a sale of property which is subject to the lender's trust deed lien.

The due-on clause is triggered not only by a transfer using a grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, recorded or not. Examples include a:

- land sales contract;
- lease-option sale; or
- other wraparound carryback devices, such as an *all-inclusive trust deed (AITD)*.

For example, a land sales contract does not involve a conveyance of real estate to the buyer by grant deed until the price is fully paid by the buyer. The seller retains title as security for the carryback debt owed by the buyer. However, the buyer under a land sales contract becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession is transferred. This sales arrangement triggers the due-on clause in any existing trust deed.[3]

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.[4]

This interference addresses owners or 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

3 **Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629

4 12 Code of Federal Regulations §591.2(b)

occupancy under a lease agreement. Otherwise, the lender can call the loan if the initial period is more than three years, or when exercised the extension of the lease term is for more than three years.

Due-on-further encumbrance

Consider an owner-occupant of a SFR subject to a first trust deed. The owner applies for an *equity loan* to be secured by a second trust deed on their property. The first trust deed contains a due-on clause.

The loan broker tells the owner they are concerned about due-on enforcement by the senior lender. The broker is aware encumbering the property with a second trust deed lien triggers the existing lender's due on clause, unless the activity is exempt. On inquiry, the owner informs the broker they will continue to occupy the property as their residence.

The broker assures the owner the second trust deed encumbrance will not trigger the senior lender's due-on clause, as long as the owner continues to occupy the residence. Due-on enforcement based on a further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted.[5]

However, on real estate other than an owner-occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing lender's consent and waiver of its due-on clause triggers the due-on clause.

Thus, junior financing without a waiver of the senior lender's due-on clause becomes a risky enterprise for trust deed investors in times of rising interest rates. Increasing market rates give trust deed lenders an incentive to call loans on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

Due-on-foreclosure

Consider a parcel of real estate subject to a first trust deed lien and a second trust deed lien which the first trust deed lender previously consented to. The property owner defaults on the first trust deed. The junior trust deed holder reinstates the first trust deed and forecloses on the second, acquiring the property at the trustee's sale. At all times, the second trust deed holder keeps the first trust deed current and advised of the foreclosure proceedings.

On acquiring title at foreclosure, the junior trust deed holder advises the lender they are now the owner. The senior lender informs the junior lender, now the new owner of the property, that it is calling its loan due, based on the transfer of the property by trustee's deed – unless they are to receive points for an assumption of the loan and a modification of the note rate and payments to current market rates.

Can the senior lender call its loan due based on the completion of foreclosure by the second trust deed holder?

Yes! A senior lender may call a loan due on completion of the **foreclosure sale** by a junior lender or carryback seller on any type of real estate. A *trustee's*

5 12 CFR §591.5(b)(1)(i)

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.[6]

Federal regulations allow due-on enforcement on **any transfer** of real estate which secures the lien, whether the transfer is voluntary or involuntary.[7]

The risk of a senior lender enforcing its due-on clause on a trustee's sale by the junior lender has a **debilitating effect** on the availability of junior trust deed loans and carryback sales. Prudent lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt should they be forced to foreclose on the real estate.[8]

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, 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.[9]

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 loan was originated. Conversely, occupancy is not required for a surviving joint tenant who qualifies for the joint tenancy exception.[10]

In all other transfers, the death of a vested owner, joint tenant or other co-owner triggers the lender's due-on clause.

Thus, due-on enforcement is triggered on death by:

- a transfer of the deceased's residence to a non-relative, by will or by trust, following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which was not originally occupied by any of the surviving joint tenants;
- the death of a co-owner of any type of property other than one-to-four residential units; and

6 **Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423 (Disclosure: the legal editor of this publication was an attorney in this case.)

7 12 CFR §591.2(b)

8 **Pas** v. **Hill** (1978) 87 CA3d 521

9 12 CFR §591.5(b)(1)(v)(A)]

10 12 CFR §591.5(b)(1)(iii)

Trust deed called or recast at lender's option

Events triggering the due-on clause

Sale:

- *transfer of legal title (grant or quitclaim deed);*
- *land sales contract or holding escrow;*
- *court-ordered conveyance; or*
- *death.*

Lease:

- *lease for more than three years; or*
- *lease with an option to buy.*

Further encumbrance:

- *creation or refinance of a junior lien; or*
- *foreclosure by junior lienholder.*

Transfers not triggering due-on enforcement (owner-occupied, four-or-less residential)

- *creation of junior lien where owner continues to occupy;*
- *transfers to spouse or child who occupies;*
- *transfer into inter vivos trust (owner obtains lender's consent*
- *and continues to occupy);*
- *death of a joint tenant; or*
- *transfer on death to a relative who occupies.*

It has recently come to our attention

- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

Divorce and inter-family transfers

Consider a married couple that occupies a residence vested in the name of the husband and owned as his separate property. The residence is subject to a trust deed containing a due-on clause.

The couple separates and the residence is transferred to the wife as part of the property settlement to dissolve the marriage. The wife continues to occupy the residence.

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the lender?

No! Federal due-on regulations bar due-on enforcement on the transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property.[11]

11 12 CFR §591.5(b)(1)(v)(C)

However, if the acquiring spouse chooses to lease the residential property for any period of time rather than occupy it, the lender may call or recast the loan.

Inter-family exception

The due-on clause is not triggered by an owner's transfer of their one-to-four unit residential property to a **spouse or child** who occupies the property.[12]

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.

inter vivos trust
A property owner's title holding arrangement designed for probate avoidance on death. Also known as a "living trust."

Consider an owner-occupant of one-to-four unit residential property who transfers the property into an **inter vivos trust**, naming themselves as beneficiary. The owner continues to occupy the property after transferring title into the living trust.

The owner notifies the lender prior to transfer. The owner agrees to give the lender notice of any later transfer of their beneficial interest in the trust or change in occupancy of the property as requested by the lender.

Does this transfer into a living trust trigger the due-on clause in a trust deed encumbering the owner's residence?

No! The owner met the federal regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an *inter vivos trust*.[13]

To meet regulations, the owner needs to provide means acceptable to the lender by which the lender is given notice of any later transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the lender's approval of the notice provision, the lender may call the loan due.

Thus, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the lender can call or recast the loan.

Waiver by negotiation and by conduct

An owner wishing to enter into a transaction to sell, lease or further encumber their real estate without lender interference needs to first negotiate a **limitation or waiver** of the lender's due-on rights.

Waiver agreements are trade-offs. In return for waiving or agreeing to limit the exercise of its due-on rights in the future, the lender demands consideration such as:

- additional points if an origination;
- additional security;
- principal reduction;
- increased interest;

12 12 CFR §591.5(b)(1)(v)(B)
13 CFR §591.5(b)(1)(vi)

- a shorter due date; or
- an assumption fee.

waiver agreement
An agreement in which a lender consents to the owner's present or future transfer of an interest in the secured property as a waiver of the lender's due-on rights. Also known as an "assumption agreement."

Consider a buyer who applies for a loan to purchase a residence they intend to occupy for only a few years. The buyer is concerned due-on enforcement will later make it more difficult to resell.

The buyer and lender negotiate the conditions on which a qualified buyer in a later sale of the property will be able to assume the buyer's loan without a call by the lender. In exchange, the buyer agrees to pay increased points or a higher interest rate.

The lender's waiver of its due-on rights under an *assumption agreement* applies only to the present transfer to the buyer. Unless additionally agreed to, any **later transfer** of an interest in the property will trigger the due-on clause, allowing the lender to call or recast the loan again.

In addition to a waiver agreement, waiver of the lender's due-on rights may occur *by conduct* when the lender fails to promptly enforce them.

For example, a buyer purchases real estate subject to a loan secured by a trust deed containing a due-on clause. The lender is informed or discovers the transfer and immediately calls the loan. However, the lender then accepts payments from the buyer for over 12 months. The lender later (after interest rates further increase) seeks to enforce its prior call by refusing further payments.

Here, the lender waived the right to enforce its due-on clause by its conduct.[14]

14 **Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292

Chapter 23 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 lender to call or recast the loan. In times of rising rates, lenders 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 lender 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.

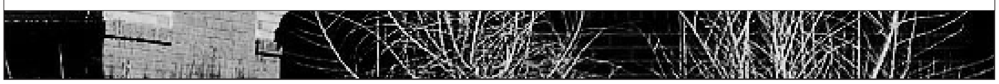
Exceptions to due-on enforcement exist. Due-on enforcement based on the further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted. Similarly, the due-on clause is not triggered by an owner's transfer of property to a spouse or child who then occupies the property, 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 lender interference needs to first negotiate a limitation or waiver of the lender's due-on rights. Waiver of the lender's due-on rights may also occur by conduct when the lender fails to promptly enforce them.

Chapter 23 Key Terms

Chapter 24

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 lender 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**
bad-faith waste	**short pay-off**

Protected: nonrecourse mortgage debt

The public policy objective behind **anti-deficiency** legislation is to provide protection to mortgaged property owners who will otherwise lose their property and be subjected to a money judgment on foreclosure. By way of the protection, the "debtor's prison" aura surrounding defaulting homeowners is near totally dissipated.

anti-deficiency
A limitation placed on a mortgage lender's ability to recover losses on a default when the secured property's value is insufficient to satisfy the 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**.

Nonrecourse debt is created by statute covering mortgages in two sets of facts:

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.

- **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
- **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 lender 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**.

bad-faith waste
Reckless or malicious injury to property causing a drop in its fair market value.

A few notable exceptions exist: anti-deficiency protections aside, a lender who underbids at the trustee's sale may pursue an owner for those mortgage losses caused by the owner's **bad-faith waste** of the property. *Bad-faith waste* is the reckless or malicious injury to the property, such as pouring concrete down toilets, stripping cabinets or deliberately destroying landscaping.[2]

Additionally, while the lender may not pursue a homeowner for a deficiency in the value of the property to satisfy a purchase-money mortgage, the **Federal Housing Administration (FHA)** or **Department of Veterans Affairs (VA)** have recourse against the homebuyer who signed an *FHA* or *VA* guarantee agreement for losses under their *mortgage default insurance programs (MIPs)*. Practically speaking however, the FHA and the VA rarely pursue deficiency judgments though they have the legal right to do so.[3]

Unprotected: recourse mortgage debt

Recourse debt is any mortgage other than mortgages classified as nonrecourse debt. A lender 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.[4]

Refinanced purchase-money debt: recourse or not?

Refinanced purchase-money debt only retains its purchase-money nonrecourse status if:

- the lender of the original purchase-money debt is the refinancing lender[5];
- the refinanced debt is substantially the same debt as the original purchase-money debt[6]; and

1 Calif. Code of Civil Procedure §580b
2 **Cornelison** v. **Kornbluth** (1975) 15 CA3d 590
3 **Carter** v. **Derwinski** (9th Cir. 1993) 987 F2d 611
4 CCP §580a
5 **Union Bank** v. **Wendland** (1976) 54 CA3d 393
6 **DeBerard Properties, Ltd.** v. **Lim** (1999) 20 C4th 649

- the refinanced debt is secured by the same property as the original purchase-money debt.[7]

In absence of any of the three conditions, the refinanced debt is considered *recourse debt* subject to a lender'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.[8]

The extension of nonrecourse status to the lender'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 lender may not require a homeowner to *waive* their anti-deficiency protection as a condition of granting a mortgage modification when the mortgage remains secured by the same property. The result would simply be a magic trick performed by the lender to flip nonrecourse into recourse status on a default — an unenforceable departure from the legislative intent of anti-deficiency statutes.[9]

Special rules for shortsales

Anti-deficiency protection has also been extended to homeowners who negotiate **short payoffs (shortpays)** with their lender*s* and close a short sale to dispose of their homes.

short payoff
A sale in which the lender accepts the net proceeds at closing in full satisfaction by discounting the mortgage debt.

Regardless of the recourse or nonrecourse status of the mortgage, a lender 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.[10]

*Editor's note – In **Coker** v. **JP Morgan Chase Bank, N.A.**, the California Supreme Court holds a homeowner is not liable for a short sale deficiency since the homeowner cannot waive their statutory anti-deficiency protections which fully apply to short sales.*

7 **Goodyear** v. **Mack** (1984) 159 CA3d 654
8 DeBerard, *supra*
9 **Palm** v. **Schilling** (1988) 199 CA3d 63
10 CCP §580e

Lender's choice of recovery

A homeowner with a recourse mortgage is not necessarily destined to be hounded by the lender's debt collectors forever. One last anti-deficiency protection lies in the lender's choice of mortgage debt recovery on a default.

In response to a homeowner's default, a lender is required to first foreclose on the property to satisfy the debt. Until a foreclosure sale is held, the lender may make no attempt at collecting the debt. This condition is part of its grand bargain under the **power of sale provision** and **put option** contained in the trust deed.[11]

And then on foreclosure, a mortgage lender may only pursue a money judgment for a deficiency if it completes a **judicial foreclosure sale** (as opposed to a nonjudicial foreclosure, also called a **trustee's sale**).

Further, a lender foreclosing judicially may only seek a deficiency after foreclosure if:

- the mortgage is recourse paper; and
- the property value and the high bid are each less than the amount of the mortgage at the time of the judicial foreclosure sale.[12]

Further, the borrower has the **right to redeem** the property – recover title – within one year after the judicial foreclosure sale by paying the amount of the high bid (plus interest). The money judgment for any deficiency in the property value is awarded to the lender as a separate debt, unconnected to the *right to redeem* the property for the price bid at the foreclosure sale.[13]

Costly (and timely) for lenders

Judicial foreclosures are lengthy and expensive for lenders. They also risk:

- a further decline in a property's value during litigation and the one-year redemption period after the foreclosure sale; and
- being unable to recover on a collection attempt under the money award for the deficiency.

If the lender chooses instead to complete a nonjudicial foreclosure via a **trustee's sale**, it loses its right to pursue any loss on the mortgage. Lenders trade the right to complete a judicial foreclosure for a cheaper, faster trustee's sale. Additionally, the homeowner's right to redeem the property by payment of the debt in full is terminated on completion of the trustee's sale.[14]

11 CCP §726(a); **Walker** v. **Community Bank** (1974) 10 C3d 729

12 CCP §580c, 580a

13 CCP §729.030

14 CCP §580d

Chapter 24 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 lender 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 lender of the original purchase-money debt is the refinancing lender;
- 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.

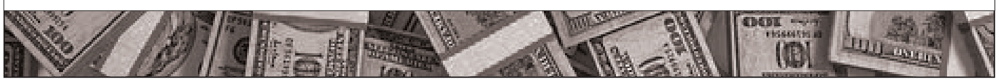
Alternatively, recourse debt is any debt not classified as nonrecourse debt. A lender may only pursue an owner for a loss due to a deficiency in the fair market value (FMV) of the secured property through judicial foreclosure, and only then if:

- 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.

Regardless of the recourse or nonrecourse status of the mortgage, a lender 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 24 Key Terms

Carryback financing in lieu of cash



Chapter 25

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;
- advise on the various forms of documentation used to structure seller 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

Seller financing supports the price

When mortgage money is plentiful and accessible, lenders are eager to make loans to nearly every buyer — no matter the type of property sought, its location or the buyer's creditworthiness.

However, when the availability of real estate loans tightens, the definition of a "qualified" buyer becomes more restrictive and approvals more elusive. As Californians trek through our current washboard recovery, lenders have greatly tightened their lending guidelines.

In these economic conditions, a seller hoping to locate a buyer amenable to the seller's asking price needs to consider **seller financing**.

seller financing
A note 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.

Basics of carryback financing

Seller financing is also known as:

- an installment sale;
- a credit sale;
- carryback financing; or
- an owner-will-carry (OWC) sale.

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 license. A residential mortgage loan 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.

Seller's agents use these circumstances to inform their sellers about pricing arrangements in hyper-competitive buyer's markets as speculator acquisitions drop.

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 loans. 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.

Mortgage lenders mechanically require a minimum down payment of around 20% if the buyer is to avoid **private mortgage insurance (PMI)**.

> **private mortgage insurance (PMI)**
> Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios higher than 80%.

In a carryback sale, the amount of the down payment is negotiable between the buyer and seller without the outside influences a traditional mortgage loan 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.

The seller can have one or the other, but not both, if the buyer or their broker is knowledgeable and everyone involved is at least somewhat rational. In today's interest rate environment, imputed interest reporting is not an issue.

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.

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**. This is the case regardless of the fact the property sold was in another income category (passive/business/personal).

> **portfolio category income**
> Unearned income from interest on investments in bonds, savings and trust deeds notes; dividends on stocks; profits on the resale of these investments and land held for profit; and income from management-free long-term income property ownership.

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.

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]

Regular or all-inclusive

The note and trust deed can be structured in *regular* or *all-inclusive* terms to meet the financial needs of the buyer and seller.

For instance, if the real estate is encumbered by a first trust deed which a qualified buyer can **assume** with the lender, the seller can carry back a regular note secured by a second trust deed. The note will be for the balance of the seller's equity which remains unpaid after deducting the buyer's down payment.

However, if the lender or servicing agent for the existing loan will not allow the loan to be assumed, the buyer may arrange a new first trust deed loan to pay off the existing financing. Here, the lender will need to approve of the seller carryback of a second trust deed.

Often the seller's borrowing power is greater than the buyer's. Here the seller might refinance the existing loan on the property themselves and withdraw a portion of their equity by placing new conventional financing on the property.

The buyer assumes the new loan and the seller carries back a regular note and second trust deed for the remainder of their unpaid equity in the property.

1 Calif. Civil Code §2956

The wraparound security device

An alternative reduces the seller's risk of loss and defers more profit taxes than a regular second trust deed note. It is the **all-inclusive trust deed (AITD)** note, called a **wraparound security device**.

In an AITD carryback arrangement, the amount owed to the seller on the carryback note is always secured by a junior trust deed (AITD) lien on the property. However, the note secured by the AITD is for a dollar amount equal to the balance of the entire purchase price remaining unpaid after the down payment. A regular note is limited in its dollar amount to the amount of equity remaining unpaid after the down payment.

Thus, the AITD *"wraps"* the senior financing by including the dollar amount of the first trust deed in the principal amount of the AITD note. The buyer makes payments to the seller on the AITD note. In turn, the seller continues to remain responsible for making payments on the senior loan from payments received on the AITD.

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.

Being a secured creditor is a fundamental real estate concept the seller's agent needs to understand when advising their seller on the nature and consequences of carrying a trust deed note. Most sellers of homes are wage earners aware of debt obligations. However, few are aware of the management required of an owner whose income is derived from assets (the note), rather than gainful employment.

all-inclusive trust deed (AITD)
A note executed by the buyer in favor of the seller for payment of the amount remaining due on the purchase price after deducting the down payment, the seller remaining responsible for payment on one or more underlying trust deed obligations. It is also referred to as a "wraparound" or "overriding" note.

Above all, the seller's agent needs to confirm the seller appreciates why they are receiving a **trust deed** as a lien on the property sold. 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 – the vicious part of the business cycle – poses serious consequences for the seller when the buyer defaults on the payment of taxes, assessments, insurance premiums or maintenance of the property.

Thus, costs incurred to foreclose and resell property can quickly turn a sale from a low-down payment, high-interest-rate note into a cash drain for the seller. This is a potential condition any seller's agent needs to advise their seller on, prior to the seller agreeing to carry back a note.

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

Concerns about the buyer's default

On a default by the buyer, the carryback seller may suddenly find themselves returned to their original position — owning property they do not want to own. Financially, they will own it subject to a senior trust deed. In the end, the seller will incur out-of-pocket costs for:

- foreclosure;
- carrying the property (taxes, insurance, maintenance and senior mortgage payments);

- any reduction in property value;
- reassessment to current value triggered by both the sale and foreclosure;
- a modified (higher) interest rate on the old loan (foreclosure also triggers the due-on clause); and
- profit taxes on any previously untaxed principal received from the down payment and in amortized monthly payments. [See Form 303 accompanying this chapter]

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]

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.

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.

2 Calif. Code of Civil Procedure §580b

Chapter 25 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 loan 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.

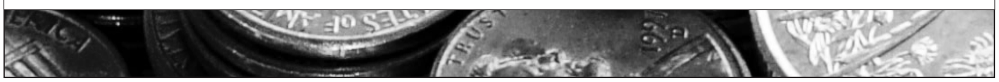
Seller financing is documented in a variety of ways, including land sales contracts, lease-option sales, sale-leasebacks and trust deed notes. The most universally understood carryback documentation consists of a promissory note executed by the buyer in favor of the seller as evidence that a portion of the price remains to be paid, coupled with a trust deed lien on the property to secure the debt owed by the buyer.

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 25 Key Terms

Chapter 26

Usury and the private lender



Learning Objectives

After reading this chapter, you will be able to:

- appreciate the origins, evolution and remaining purpose of California usury laws;
- 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 debts	**restricted real estate loans**
excluded debts	**treble damages**
non-exempt private lenders	**usury**

Broker arranged loans avoid usury

When a loan 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]

usury
A limit on the interest rate charged on non-exempt real estate loans.

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 (read: a rate that is exorbitant). These loans are categorized as *usurious*.[2]

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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 loan market.[3]

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 loan companies;
- credit unions;
- pawnbrokers;
- agricultural cooperatives;
- corporate insurance companies; and
- personal property brokers.[4]

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 loan, 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 loan become part of the lender's yield on the loan—*interest*.[5]

Thus, interest includes the value of all compensation a lender receives for lending money, whatever its form, excluding reimbursement or payment for loan origination costs incurred and services rendered by the lender.[6]

However, it is common for **non-exempt private lenders** to attempt to evade the usury law restrictions by including bogus charges or claiming fees for making the loan.

3 Cal. Const. Art. XV
4 Cal. Const. Art. XV
5 CC §1916-2
6 CC §1915

A lender may charge the borrower a loan fee or discount. However, charges and receipts are recharacterized as interest when they do not compensate the lender for services rendered in the process of originating the loan.

Charges unrelated to loan origination services are added to the interest stated in the note to determine the aggregate yield on the principal. The average annual yield over the life of the loan may not exceed the *threshold rate* which triggers application of the usury laws — unless the loan transaction is exempt.[7]

As long as the service performed or the expense incurred was necessary to the origination of the loan, the charges do not add to the lender's yield and is not considered interest.[8]

Examples of services and expenses not included in the *interest yield* include:

- appraisal, escrow and recording fees;[9]
- negotiation and brokerage fees paid to a third party;[10]
- administrative costs, such as foreclosing on a loan in default;[11]
- attorney fees for legal services relating to the loan;[12] and
- late charges due on loan default or prepayment penalties.[13]

Setting the interest rate

If the use of the proceeds of a loan is earmarked primarily for **personal, family, or household use** by the borrower, the maximum annual interest rate is 10% per annum.[14]

Loans 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%. [See Chapter 21]

Usury law and real estate loans

Two basic classifications of private loan transactions exist relating to interest rates private lenders may charge on real estate loans:

- **brokered** real estate loans; and
- **restricted** or **non-brokered** real estate loans.

non-exempt private lenders
A lender subject to usury limitations when making a loan.

7 **Haines** v. **Commercial Mortgage Co.** (1927) 200 C 609
8 **Klett** v. **Security Acceptance Co.** (1952) 38 C2d 770
9 **Ex Parte Fuller** (1940) 15 C2d 425
10 Ex Parte Fuller, *supra*
11 **Penziner** v. **West American Finance Company** (1937) 10 C2d 160
12 **Murphy** v. **Wilson** (1957) 153 CA2d 132
13 **First American Title Insurance & Trust Co.** v. **Cook** (1970) 12 CA3d 592
14 Calif. Const. Art. XV §1(1)

Brokered real estate loans are exempt from usury restrictions and fall into one of two categories:

- loans **made** by a licensed real estate broker **acting as a principal** for their own account as the private lender who funds the loan; or
- loans **arranged** with private lenders by a licensed real estate broker acting **as an agent** in the loan transaction for compensation.

restricted real estate loans
All loans made by private party lenders which are neither made nor arranged by a real estate broker.

Restricted real estate loans are all loans 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 loan* involves private party lenders, unlicensed and unassisted by brokers, who make secured or unsecured loans.

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 loan or a forbearance on a loan and are broker-made or arranged; and
- **excluded debts,** being *debts* which do not involve a loan.

exempt debts
Private party transactions involving the origination of a loan that is made or arranged by a real estate broker.

excluded debts
Extensions of credit by sellers of real estate creating a debt obligation in sales transactions.

The most familiar of the excluded "non-loan" type debts is **seller carryback financing**. [See Chapter 25]

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 loan. 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 loan. Thus, the lender is only entitled to a return of the principal advanced on the loan. All payments made by the borrower are applied entirely to principal reduction, with nothing applied to interest.[15]

The lender may also have to pay a usury penalty of **treble damages**.[16]

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 loan.

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.

15 **Bayne** v. **Jolley** (1964) 227 CA2d 630
16 CC §1916-3

An award of treble damages is typically reserved for a lender the court believes took *grossly unfair advantage* of an unwary borrower.[17]

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.

Pay to play

If a borrower plans to obtain financing in the form of a brokered loan, they best be prepared to perform on their commitments in the note and trust deed.

Courts rarely invalidate contracts or their provisions which are entered into in good faith between competent persons. If the lender charged an outrageously excessive interest rate or committed fraud on the borrower, playing off of a borrower's naivety and qualifying as predatory lending, legal remedies are available to protect the borrower.

More often than not, cases involving claims of usury are the result of a borrower who knowingly bit off more than they can chew. These borrowers simply want to escape from enforcement of their agreements and grasp at any legal foothold within reach.

But courts abhor usury. The defense to payment of an agreed rate of interest sets a chaotic precedent, one where mutually agreed to contract provisions can be reneged by one of the parties on a judicially disfavored technicality.

Already, usury is being phased out of the law, as evidenced by the growing collection of broad usury exemptions already in place. It is likely to continue to fade in influence, following the logical path it is already on. One day, it is likely all mortgages will be exempt from claims of avoidance of the payment of any interest by the law of usury. However, for the time being, if a borrower signs on the dotted line agreeing to a loan arranged by a broker, the borrower cannot exit from the obligation by claims of usurious interest rates.

Usury has more to do with theological concepts dating back prior to Renaissance Italy than with the secular lending practices of today. Usury is a restatement of theology, which has no place in secular lending fundamentals.

In continuing with the separation of church and state and the stripping of usury's reach, expect to see fewer borrowers like the one above getting off the interest enforcement hook on claims the mortgage is usurious.

17 **White** v. **Seitzman** (1964) 230 CA2d 756

Chapter 26 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. Usury laws were put in place with the goal of preventing lenders from charging interest at a rate higher than the threshold set by law.

Brokered real estate loans include loans made (read: funded) by a licensed California real estate broker acting as the private lender and loans arranged by a broker acting as an agent in the loan transaction. As mortgages made or arranged by a California real estate broker, they are exempt from usury restrictions.

Non-exempt private lenders attempt to evade usury law restrictions on interest by including charges or claiming fees or points for their making the loan. Charges or other compensation are permissible so long as they cover a mortgage origination expense or service—otherwise, they are considered receipts by the lender of additional interest.

Loans 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.

Sales transactions involving the extension of credit by a seller are not subject to usury laws, such as seller carryback financing.

Penalties for violating usury law include the forfeiture of all interest on a usurious loan. Lenders who are found to have taken grossly unfair advantage can also be penalized with treble damages, computed at three times the total interest paid by the borrower during the one year period immediately preceding their filing of a suit and the period of litigation until judgment.

Chapter 26 Key Terms

Chapter 27

Employment: a prerequisite to renting or owning

Learning Objectives

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

- apply employment trends to your local real estate industry; and
- anticipate real estate sales volume and price movement in the months ahead.

Key Term

real demand

Income for the necessities of life

Of all the factors affecting California real estate, **employment** has the most impact. This is true in good economic times, and times of economic recession and financial crisis.

Without jobs, wage earners have *insufficient financial ability* to make rent or mortgage payments. Thus, the unemployed are forced to move in with relatives or friends, negatively impacting the housing market.

High unemployment stems from businesses' inability to provide work. When the economy is slow, businesses have no need to occupy and use retail space, office suites, warehouses for inventory and distribution, industrial buildings for production or land for development. Thus, commercial real estate experiences high vacancy rates, and much rented space goes unused.

Demand (**real demand**, as opposed to artificial demand) rises for all types of real estate when local jobs increase, as during periods of economic development. Additions to the local labor force tend to drive up rents and

real demand
The demand of end-user buyer-occupants in the real estate market.

Figure 1

California Payroll Employment

Figure 1 and Figure 2 track the number of people employed in California. These charts show total employment numbers statewide (Figure 1) and for California's five most populous counties (Figure 2). The gray bars indicate periods of recession in the United States (as tracked by the National Bureau of Economic Research).

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.

property prices in the vicinity when the point of optimal occupancy has been reached. On the other hand, a decline in the number of local jobs reduces the need for all types of real estate, as during a recession. [See Chapter 28 and 32]

Jobs set the trend

The current trend in the number of individuals employed in a region sets the direction for:

- the *volume* of rentals and sales during the following 12 to 18 months; and
- the *price movement* of rents and prices paid for the use and occupancy of real estate during the following 24 to 30 months.

Jobs issues which affect the level of rents and prices paid for property include:

- the *quantity* of employed individuals;
- the *quality* of existing jobs; and
- the *type* of jobs existing and developing in the local market.

Quantity of employed individuals

Historically, California jobs create homeowners and tenants on an approximate 50:50 basis, with half of all households owning the residence they occupy and the other half renting it. This number leaned toward more homeowners and fewer tenants during the Millennium Boom. However, the homeownership rate has rapidly declined in recent years.

The appreciation or depreciation of property values is triggered by increases or decreases in local population density and the economics (numbers and pay levels) of local jobs.

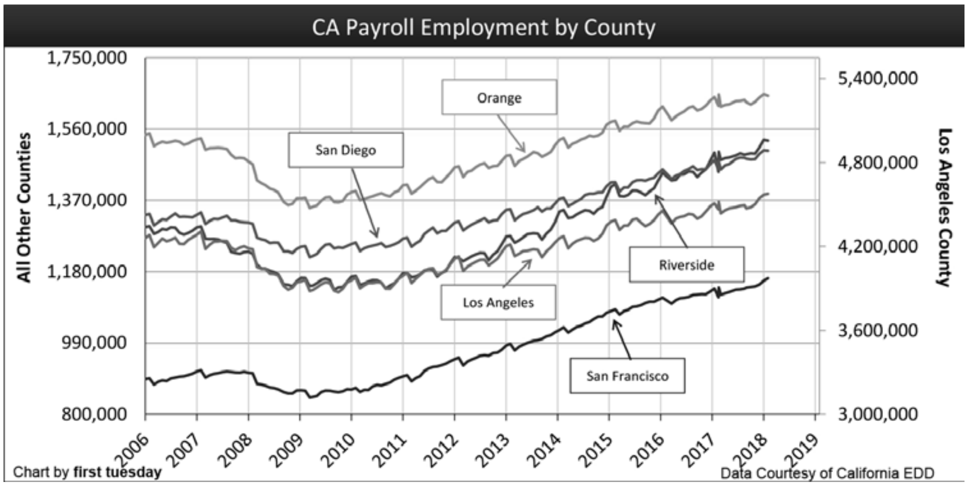

Figure 2

CA Payroll Employment by County

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.

Of California's largest counties, *San Francisco* has experienced the quickest job growth since the 2008 recession, surpassing their pre-recession levels. This is largely due to the area's prospering technology industry. All other populous counties have yet to return to pre-recession employment levels.

The unemployed and underemployed are of little to no concern to the present real estate market. Unemployment numbers tell us only who *cannot participate* in the real estate industry. Individuals first need a full-time job before they can buy or rent. [See Figure 3]

See Figures 1 and 2 for historical and current projections of the number of people employed in California, and in its most populous counties.

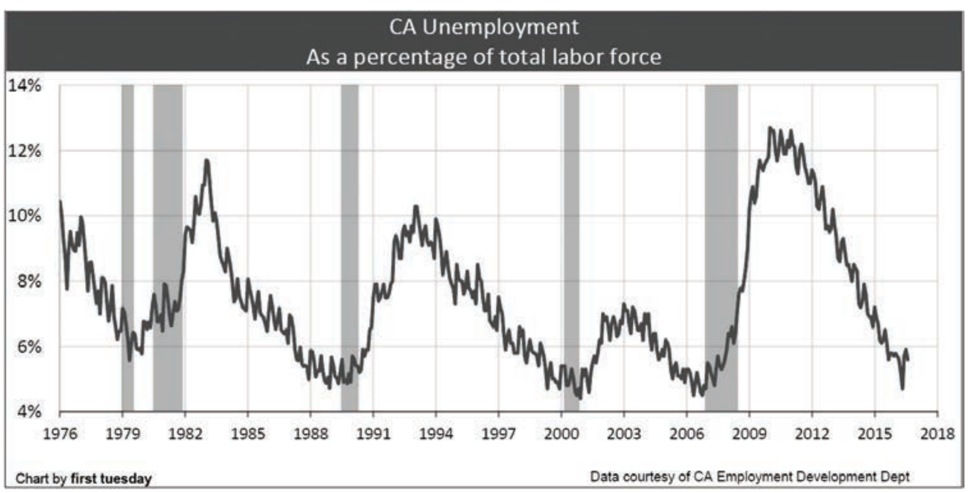

Figure 3 depicts joblessness – those receiving unemployment benefits – in California over the past 30+ years as a percentage of the state's total labor force. The figures do not include those who have dropped out of the job market or are voluntarily unemployed. The chart encompasses several run-of-the-mill recessions. Unemployment today is a higher percentage of the labor force, rising faster during 2008 and 2009 than at any time since just after WWII. We suspect our recovery will be correspondingly longer than any recession during the past 55 years, and more like the years after WWII.

Figure 3

CA Unemployment

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.

Chapter 27 Summary

Employment is the single most important factor in determining the future vigor of the real estate market.

The number of employed individuals and the rate of job creation sets the trend for sales and rental volume 12 to 18 months forward. The employment numbers set price movement 24 to 30 months forward.

Chapter 27 Key Term

Chapter 28

It's the demand, stupid!

Learning Objectives

After reading this chapter, you will be able to:

- understand how supply and demand dictate the direction of the real estate market in different phases of the interest rate cycle;
- differentiate between the roles of speculators and end users in determining demand for housing; and
- identify key indicators of organic demand in the market.

Key Terms

buyer occupant	**long-term investor**
demand	**seller's market**
end user	**speculator**
flipper	**supply**

"If you build or list it they will come"

To those vociferous quibblers who proclaim the elixir to the real estate market's ills is **supply**, listen up! When a *flat sales volume* is propped up by speculators temporarily snatching inventory as quickly as it is listed, the situation is but a **mini-boom** in reported sales prices.

supply
The available inventory a local real estate market is able to offer.

MLS inventory and days on the market no longer paint a picture of real estate sales volume or pricing realities one year hence. The extended ride on this *bumpy plateau recovery* from the real estate crash of 2008 continued through 2019. This recovery period is referred to by economists as **secular stagnation** and has not been experienced since the decade prior to 1947 — the *Great Depression* recovery period.

A change in the availability of real estate inventory, known as *supply* and typically stated in terms of months of supply, inversely affects the price of

demand
The amount of housing inventory desired by buyer occupants.

property. In the 2010s era of recovery with **zero lower-bound interest rates**, it is critical to acknowledge that the market is not driven by supply – it's driven by **demand**.

Editor's note — In this period, most classes of assets in the U.S. were enjoying high prices due to speculative demand. The reason: ready access by the wealthier to bountiful cheap money (their own or borrowed) and few long-term investment opportunities.

During the period from 1980 to 2007, real estate sales of all types of property operated under **supply side paradigm** behavior. The *supply side paradigm* was a boon to the construction industry, sellers and seller's agents. Their task of moving inventory was made easier by the ever-enlarging availability of **mortgage funds** at constantly lowered rates.

seller's market
A real estate market characterized by high homebuyer demand and low housing inventory.

These cyclical periods of dropping interest rates, generally around 30 years in duration, are known as **seller's markets**. In a *seller's market*, sellers command a high price for their property. If agents list it, it will sell.

These periods are energized with buyers ready and able to access cheap money continuously available to fund the sopping up of the housing supply. If a property is built and offered for sale, it will invariably be sold since, under the supply side paradigm, a demand for housing always exists. Declining interest rates is the predominant feature supporting supply side thinking.

In real estate markets, the supply of available units for purchase indicates the health and momentum of pricing in the market. Under this market reasoning, so long as there is supply, as a matter of certainty, demand will equal (or likely exceed) it.

And the mantra is continued: list, list, list and build, build, build, facilitated by declining interest rates.

The demand side paradigm shift

However, California is still stumbling over the washboard shaped recovery of what has become the *Lesser Depression***,** forged by a massive and widespread **financial crisis** surfacing in 2008. Interest rates cannot go lower without becoming negative.

Though the speculator-propelled boomlet experienced in 2013 provided a false sense of hope for some supply siders, it was fleeting. It was decidedly NOT a seller's market. The pricing mini-boomlet of 2013 quickly turned into a sales volume and price retreat.

As interest rates rise, which they inevitably will, the supply-side way of thinking becomes ill fit to the forthcoming realities. The half-cycle of rising interest rates we face will likely be in effect for the next two or three decades, producing generally upward mortgage rate movement.

In recovery periods shackled – **trapped** – with zero interest rates as is the decade commenced in 2008, embracing the supply side paradigm is akin to donning a thick, thermal pelt after the ice age has passed. It is discordant to the point of being laughable, and resistant to evolutionary necessities imposed by the liquidity trap placed on sellers by zero-bound interest rates.

Proponents of the confused supply side paradigm claim to witness both multiple listing service (MLS) inventory slipping and prices dropping – two trends which cannot exist concurrently, in violation of the basic theory of supply and demand. If prices are organically going up, supply becomes relevant again as supply tends to control sales pricing. In turn, demand tends to control sales volume.

Real estate sales volume, and thus price indexes going forward are, quite simply, a story of **demand**. Adjust your survival plan accordingly by giving ardent attention to the type of buyers you represent, or prepare for a bitter future ahead.

Organic indicator of demand

Before the level of buyer demand can be properly gauged, the factors which **create demand** need to first be determined.

The proper indicator of long-lived organic demand is the *end user* of property. Every **builder** of subdivision homes knows speculators are the death of their expansion into the next stage of development since they are not users, but **usurpers** who will come to haunt and reduce sales.

The **end user** of a property is a buyer who will take personal possession of the property for a **considerable length of time**, say 15 years, comparable to a collector of coins. Thus, the end user most frequently takes the form of a **buyer occupant**. This buyer purchases property for use as shelter for their family or business, and takes steps to retain the property as a store of wealth for as long as it serves the purposes of their occupancy.

> **end user**
> A buyer who will occupy the property as their residence or own it as income property for long-term investment purposes.

In addition to *buyer occupants*, **long-term investors** are also a key player in demand. *Long-term investors* purchase a property with the intent of renting it out to tenants to produce a steady income flow over the coming years, a process also known as **buy-to-let**. Thus, they are collectors at heart.

> **buyer occupant**
> A buyer who purchases property for use as shelter for their family or business, and retains the property as a store of their wealth for as long as it serves the purposes of their occupancy.

Like buyer occupants, **duration of possession** is the key factor determining whether a buyer is an end user of a property. It is purchases by end users which reflect the level of **organic demand** in a market – most everything else is noise.

Noise includes temporary distractions and fluctuations which work to extract profits from the market and leave no added value behind. They are *transitory activities* devoid of any demand for use of the item offered, i.e., long-term possession.

> **long-term investor**
> A buyer who purchases a property with the intent of renting it to tenants to produce a steady income flow.

Lender's fit this definition, as of course do speculators. The use of a property by the buyer essentially removes the property for a normal holding cycle – around 15 years for single family residences (SFRs) in California.

Let's do the math

What about the obverse side of this ownership coin?

At their peak, **absentee homebuyers**, a group consisting of *speculators* and *renovators* (and true *buy-to-let investors* when the price "caps" out), accounted for 30% of Southern California purchases in 2013.

speculator
A real estate investor who owns property short-term, sandwiching themselves between the seller and end user of the property.

Critically, these percentages do not include the estimated **one half** of all trustee's sales that were also picked up by **speculators**.

Thus, when you combine absentee homebuyers (and subtract buy-to-let investors who are long-term income property owners), then add speculators acquiring title at trustee's sales, approximately **half of all transactions effecting a change of ownership** in 2013 did not go to an end user.

Speculators, who by profession contend with a high degree of risk, come in two basic species:

- **quick flippers,** also known as *hot money handlers***,** who add no value and permanently invest little to no money in a property. Flippers purchase properties (mostly of the low-tier, distressed variety) with the intent of selling them for a higher price at a later date (and renting short-term if necessary to reduce their negative cash flow and provide a temporary rate of return); and
- renovators who add value to a property before attempting to flip it.

flipper
A speculator who purchases real estate at perceived below-market prices and depends on market momentum to sell at a profit.

Flippers rely solely on the upward dynamics of a *momentum market*, pocketing any price appreciation by sandwiching themselves between the seller and the ultimate end user of the property (read: the buyer-occupant or *buy-and-let investor*).

Renovators separate from their flipper brethren

Renovators, on the other hand, add value to a property by rehabilitating it before selling it back into the market. Renovators frequently target damaged low- to mid-tier properties and improve them, bringing the property's amenities and appearance to a level consistent with that of the surrounding neighborhood.

Editor's note – Preferably, the improvements are not to a degree which ***over-improves*** *the property so it becomes the most valuable in the neighborhood, as a renovator will find it difficult to recapture his investment.*

Similar to flippers, renovators do not intend to hold and maintain the property for the long-term. Instead, they want to limit the length of time it is in their possession, typically 75 to 90 days to complete their renovation work, then immediately release it back into the market.

Unlike their quick flipper brethren, renovators contribute **value** to the property by returning it to a state fit for occupancy. Renovators often remove *obsolescence* from a property by replacing fixtures which are out of date, and add inexpensive amenities that have perceived greater value to buyer occupants.

Speculator activity is no part of demand

Speculators are not in the real estate game to acquire property for their long-term investment or shelter. Their needs are quite to the contrary. Like a **day trader**, they have no demand for the use of a property, its only utility being a vehicle to position them for a short-term profit.

Similar to commodities dealers, speculators do not take possession. Their needs are limited to the **temporary use of title** to the property as a tool to extract money from the real estate market when the ultimate end user enters the equation and takes possession.

While the property is temporarily vested in the name of the speculator, it is effectively pulled from the market and unavailable to those who have an organic demand for it. Remember, speculators still have to find an end user buyer to purchase the property. Thus, the property will be returned back to the market for sale, where it was before, though offered at a far higher price. Thus, inventory is **deceptively reduced** below the level of supply thought to be needed to meet demand.

Speculators are much like the unkempt agent who shows up late to a group marketing session, *Twitters* until they make their pitch, then departs, leaving the group having contributed nothing of value in their wake.

Speculators are sellers once removed

In terms of real estate transactions, the role of the speculator acquiring title to property is more genetically similar to the role of a *seller* than that of a buyer. Even though the speculator purchased the property from the seller, what speculators essentially do is step into the shoes of the seller, a title they will officially don as soon as possible (immediately on a quick flip, or within about three months for a renovator).

Thus, the speculator isn't really buying the property from the seller. Here, the seller is in an economic sense **assigning** to the speculator the seller's risk and task of locating the ultimate buyer occupant at a not-too-distant future date. The buyer occupant is the only person with a demand for the property. Thus, the speculator is a surrogate seller.

To get a sense of property demand, look for the percentage of sales volume attributable to end users, not the portion of sales volume maligned by the "parking" of title to property with an intermediary seller. With this rubric in mind, it is the lack of demand for housing, not supply, that is the real long-term obstacle blocking California's definitive ascent out of the economic morass of 2008.

Life-cycle of a speculator

The activities of a *speculator* are not synonymous with **demand** for real estate, and the second shoe of their presence which will further distort the market is yet to fall – their **shadow inventory** of homes that will return for sale.

Speculators rely solely on an upward oscillating market to turn a profit on the positions they take by acquiring title to real estate. Realistically in the *bumpy* *plateau recovery* of the 2010s, flippers will have to wait many years, not just months, before prices rise sufficiently to generate the profit anticipated when acquiring title.

Thus, speculators who bought "cheap property" hoping for a quick flip at a higher price may have to adjust their *modus operandi* now that prices are expected to fall in the recovery from the 2020 recession.

Plan B

These speculators will need to rely on their default fallback plan B: hire a property manager (broker), rent the property and collect some income until they are able to unload the property. Thus, they will become *landlords-by-necessity* (likened to a lender foreclosing on a rented property), a position which is not consistent with their desired purposes for taking title to the property, or their skill set.

However, unlike resales before the Lesser Depression, they will find the market environment produced by the zero-lower-bound interest rate does not provide pricing traction. Unlike during the prior 30 years of constantly declining interest rates up to 2008, the hit-and-run investor will unlikely be able to resell at the significant profit they had become accustomed to realizing.

In their impatience after a couple of years of ownership, and as soon as they sense even the remotest bump in real estate prices, speculators will act in improvised unity, all trying to sell their *investment-turned-sour* properties at the same time.

A sudden flood of failed investment properties will be the second shoe to drop. As supply is increased abnormally, it will exert downward pressure on real estate pricing.

However, **end user buyers** flocked again to the housing market in 2020, soaking up speculator held inventory as it returns to saturate the MLS market.

Chapter 28 Summary

Changes in the availability of real estate inventory, known as supply, inversely affects the price of property. In the recovery era of zero-bound interest rates, the market is not driven by supply – it's driven by demand. Yet, for the past 30 years, real estate sales of all types of property operated under supply side paradigm behavior.

Speculators are not in the real estate game to acquire property for their long-term investment or shelter. While the property is temporarily vested in the name of the speculator, it is unavailable to those who have an organic demand for it. Thus, the property will be returned back to the market for sale, where it was before, though offered at a far higher price.

Real estate price indexes going forward are instead a story of demand. Moreover, the only real indicator of long-lived organic demand is the end user, the buyer who will occupy the property as their residence or own it as income property for long-term investment purposes. It is purchases by these end users which reflect the true level of organic demand in a market.

Chapter 28 Key Terms


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Chapter 29

The demographics forging California's real estate market

Learning Objectives

After reading this chapter, you will be able to:

- appreciate the factors driving real estate sales; and
- articulate why the younger generation of homebuyers is known as a nomadic demographic.

Key Terms

debt-to-income (DTI) ratio **luxury vs. necessity**

financial atrophy

Trends with opportunities for everyone

The *2008 recession*, like all other recessions before it, had the effect of hitting an economic reset button. Real estate trends that crystallized during the cash-flush years of the *Millennium Boom* portrayed in distorted ownership behavior and hybrid financial concepts ceased completely. These trends include:

- the belief in ever-increasing home-asset prices, beyond the rate of consumer inflation;
- the infatuation with suburban living and commuting;
- the arrogance of "as-is" type non-disclosures and in-escrow disclosures; and
- seller's agents' smugness about seller dominance.

In its wake, new market trends have taken root, sprouting in widely different directions like the arms (and eyes) of a newborn starfish. These fresh trends will grow from today's greatly altered real estate market, but will be based on the realities of our present post-Boom era.

In the period since the end of the recession in mid-2009, California's real estate market has settled into a **bumpy plateau recovery**, built on low sales volume, wavering prices, and historically low nominal mortgage rates.

When a full recovery does arrive, it will be thanks to the market's cyclical nature, the state's favorable geography and its more youthful and better educated population. Included are native-born residents and those here by migration.

But what direction will a regenerated real estate market take after short sales, foreclosure sales and *real estate owned (REO)* and speculator-owned resales which now dominate the conversation are fully purged? What geographic regions of California and segments of its population will carry the action and in turn be profitable for the real estate industry's gatekeepers in the coming years?

What part of the real estate market will not survive the demographic shift, and will instead become rightfully extinct?

A housing market geared by Gen Y to accelerate

California agents and brokers — our licensed and entrusted *gatekeepers* — will not likely bank a fortune in 2022. True, home sale prices enjoyed a meteoric rise in 2020, and with them the amount of real estate fees collected per transaction. But a warning: low sales volume coupled with the rise in real estate licensees makes for fewer sales closed per agent each year. Without a more significant sales volume increase, most active full time agents will only generate an income sufficient to support a minimal subsistence, nothing more.

However, many will position themselves by providing various real estate services to acquire great wealth by the end of this decade due to huge increases in turnover rates in rentals and homeownership.

In other words, a collective decline of roughly 66% in personal income for California's real estate licensees handling sales has taken place since the Boom years of 2004-2005. This comes as a devastating financial blow to most.

Agents and brokers engaged in property management have fared much better, especially in residential property. That segment of real estate brokerage is mostly recession proof as it is consistently needed in good and bad times.

However, forward-looking brokers and agents are planning for their future incomes. They are taking the time now to acquire the specialization needed to build their reputations and develop expertise in segments of the real estate market that are beginning to expand (while others are or will be contracting). Rebranded as *stand-alone experts*, they will be in an ideal position to profit when the market definitively rebounds.

The pace and quantity of new jobs in a community will dictate the flow of future real estate sales volume and leasing in that locale. Income is necessary to purchase and carry, or rent, a property, be it used to house employees, business inventory or family. Thus, the future of real estate can be divined in part by:

- looking into employment trends — job creation going forward; and
- *labor force participation (LFP)* rate trends, the percentage of the population currently employed or actively seeking employment.

Like peering into a crystal ball, a critical study of LFP rates predicts the future movement of the California real estate market. However, some knowledge of California's *age demographic* is fundamental to understanding and predicting LFP rates. Simply put, while jobs drive real estate transactions, it is demographics which initially drive job creation and LFP rates — which in turn drive real estate sales and rental occupancies.

Later than their parents

For example, the low LFP rate among this decade's 25-34 years old, known as **Generation Y (Gen Y),** indicates this segment of the population will enter the real estate market as first-time homebuyers much later than prior generations, if at all. *Gen Y* is taking more time than its Boomer parents to accumulate the wealth (down payment) necessary to purchase a home, an amount equal to 20% of the purchase price. They also have massive educational debt which interferes with loan qualification. Their Boomer parents suffered no such indignity.

At the other end of the generational spectrum, a high LFP rate is presently being experienced among the generation aged 55 and above. This indicates this older generation, while growing fast in numbers, will work longer before they retire. Thus, they will delay the sale of their current home (most purchased in the 1985-1991 period), and in turn the ensuing relocation into another home.

LFP rates, by demographic, are the focus of *Labor Force Participation and the Future Path of Unemployment*, an Economic Letter from the Federal Reserve Bank of San Francisco (FRBSF). Though the study deals exclusively with employment and demographic trends, **RPI** extrapolates this data and interprets what it means for California real estate agents, supplemented by data released by the U.S. Census Bureau (the Census).

Gen Y: the nomadic demographic

Gen Y is taking longer to settle down. They are remaining transitory, both economically and physically, longer than prior generations. 36% of young homeowners (averaging 25 years of age) have changed residences in the past two years, compared to 10% of older homeowners (averaging 50 years of age). Further, a whopping 76% of young renters have moved within the past two years, compared to 50% of older renters, according to the 2012 Census.

Gen Y is also professionally untethered. The average person in Gen Y goes through seven jobs before they reach the age of 30 — the median age for first-time homebuyers.

Employment, more specifically an existing job, is the first and most integral step toward real estate acquisition by younger age groups. To purchase a property at age 25-34, the typical age of a first-time buyer, individuals in Gen Y need to borrow against the future income they will receive.

This is a prudent thing, since they benefit from a higher standard of living today, paid for with future earnings (which, presumably, will grow — unlike in the 2000s — and allow an even higher standard of living in the future).

Gen Y's career development, stifled

The Great Recession has stifled Gen Y's career development, permanently stunting the financial well-being of these recent college graduates and delaying their entry into the real estate market. That has been a career killer in other countries experiencing this sort of delayed job recovery since it greatly reduces their future incomes and standard of living — *housing*.

Lower-skilled adults aged 18 to 34 experienced the most pronounced increase in poverty in 2012 versus other age groups, according to the Census. This age group is composed of the Gen Y children of the Boomers. Unacceptable numbers of Gen Y individuals cannot now find any form of employment upon graduating high school or college. Most find it harder yet to get a job in the pre-selected field of study they pursued in academia.

Thus, most in Gen Y settle for a job in a different discipline, *professionally stigmatizing* them for later entry into their industry of choice. At best, this delays the age at which they will attain pay levels consistent with their desired standard of living. The delayed retirement of Boomers only adds to the lack of jobs for Gen Y.

Additionally, due to the lack of long-term professional experience among Gen Y, many shell-shocked employers are spooked by the recessionary cycle. They retain and hire only experienced workers since they have already proven themselves proficient at the jobs available.

Ineligible for financing

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

Without an income flow from employment to develop savings, Gen Y has no immediate access to funds for a down payment on their first home, let alone the financial resources necessary to service the continuing costs of ownership and mortgage financing.

Similarly, without a job, the inverted **debt-to-income (DTI) ratio** of Gen Y will render them ineligible for purchase-assist financing, a condition referred to as **financial atrophy**.

This diminished economic standing of Gen Y has temporarily reduced the demand for housing. Many unemployed members of Gen Y have been forced to move back in with their parents in the suburbs, or to cohabitate with friends or romantic partners.

California's jobs market finally achieved a full recovery in 2019 when accounting for the working-aged population increase of roughly 1.8 million since the Great Recession took hold in 2008. The continual entry of more working age adults into the labor market makes it harder for aspiring first time homebuyers to successfully find the gainful employment necessary to enter the market for a home.

financial atrophy
The continuing inability to qualify for purchase-assist financing due to outstanding consumer debt.

What does this mean for California real estate agents and brokers?

The future will bring buyers, and with them the demand needed to bring about a full real estate recovery. However, for agents it will take patience to wait until Gen Y is in an economic position to enter the housing fray. For California agents and brokers to position themselves to be of service to the home buying Gen Y, real estate professionals need to learn about and understand the psychological, social and financial conditions of this first-time buyer age group.

RPI predicts Gen Y will suddenly "get it." They will come to understand that homeownership is a socially, if not financially, advantageous thing to do — the **luxury versus necessity** debate. Once this synchronized realization takes place, the rush will be on, just as it was with their parents in the late '80s. Although this time around, it will be tempered by Gen Y's experience and observation during the 2008 recession.

luxury vs. necessity
Housing as a consumer good that enhances one's social status versus housing as a solution to one's basic need for shelter.

Chapter 29 Summary

The 2008 recession will have the effect of hitting an economic reset button.

When recovery does arrive, it will be thanks to the market's cyclical nature, the state's favorable geography and its youthful and educated population — which includes native-born residents and those here by migration. The future of real estate can be divined in part by labor trends and labor force participation.

Generation Y (Gen Y) is taking longer to settle down and is remaining transitory, both economically and physically, longer than prior generations. This diminished economic standing of Gen Y has temporarily reduced the demand for housing. Many unemployed members of Gen Y have been forced to move back in with their parents in the suburbs, or to cohabitate with friends or romantic partners.

Chapter 29 Key Terms


MORTGAGE
NMLS Provider No. 140005

Chapter 30

Rentiers and debtors: why can't they get along?

Learning Objectives

After reading this chapter, you will be able to:

- distinguish between society's rentier class and debtor class;
- identify the political ideology of the rentier class; and
- specify the beneficiaries of current fiscal and monetary policy.

Key Terms

John Maynard Keynes

trickle-down economics

rentier

The world of passive entitlement

Consider a large and powerful Wall Street investment bank. In the years leading up to the 2008 **financial crisis**, the bank creates $100 billion worth of tranche-complex and high-risk *mortgage-backed bond (MBB)* investments. Designed for public consumption by investors, MBBs are comprised of:

- *residential mortgage-backed securities (RMBS);*
- *collateralized debt obligation (CDO) securities;* and
- *credit default swaps (CDS).*

The bank sells most of the bonds to unsuspecting investors, without disclosing the high risk of loss that accompanies them. Then comes the *financial crisis,* causing homeowners to lose jobs and homes to drop 50% in value. These conditions bring on an unsettling number of mortgage defaults.

To maintain its profits and the fortunes of its MBB investors, the banker advocates public policies such as low inflation, financial bailouts and subsidies, expansive monetary policies (including quantitative easing and depressed interest rates) and fiscal policies socializing/funding private banking losses.

Prolonged suffering

These policies, however, prolong the suffering of the unemployed and mortgaged homeowners while the bankers prosper. This is, of course, the well-known story of *Goldman Sachs*; but, almost every other major Wall Street brokerage and every major bank (and, therefore, every major mortgage lender) has a similar tale to tell.

Mortgage borrowers during the *Millennium Boom* were misled. Bond market investors were defrauded. There were illegal foreclosures, retaliatory FICO scorings, and insider bets against housing mortgage values. The lawsuits are just now becoming reported cases of facts and rules for all to know.

More to the point: Is anybody surprised by the fact borrowers make up a preponderance of the U.S. population and they continue to suffer a reduced standard of living due to high unemployment; that all the while most abusive lenders continue to succeed and even thrive economically?

The fact is, lenders work in their own best interest, and their continued financial success indicates their strategies are effective. Mortgaged homeowners have had no voice until 2011 when the government created the Consumer Financial Protection Bureau (CFPB). It is listening and responding to their voices, and lenders do not like the results.

Different laws for different social classes

In a June 2011 report on *creditslips.org*, the author draws the distinction between:

- the **rentier** class, made up of those who lend money or let real estate; and
- the **debtor** class, comprising those who borrow or rent.

rentier
The class of earners whose income is earned passively, generated from owned tangible and intangible assets rather than through their labor.

The *rentiers* exist *in opposition* to renters; the latter pay, and the former collect.

Rentiers, the report points out, are largely governed by the laws of *large for-profit corporations*. This entitles them to participate in behavior forbidden to individual members of the general public.

At the bottom of the bankers' advantage is a fundamental contradiction. Banks are given access to money at extremely cheap rates by their unique ability to borrow from the Federal Reserve (the Fed), the initial source of all U.S. currency.

To stimulate spending in this recovery, the Fed has consistently lent money to banks at essentially zero percent interest rates. In return, the banks are expected (though not required) to increase their own lending to private borrowers.

It's just corporate business strategy

Meanwhile insolvent bankers are able to escape their excess debts by passing them on to the *Federal Deposit Insurance Commission (FDIC)*. In extreme circumstances, they receive massive government bailouts (recapitalization) funded by the *U.S. Treasury*, as occurred in 2008 under the **Troubled Asset Relief Program (TARP)**.

When banks escape financial obligations they are unable to pay due to their own mistaken calculations and harmful behavior, it is considered a legitimate corporate business strategy. In contrast, mortgage-holding homeowners are left to repay their mortgage debt as bankers steadfastly resist any congressional attempts to make it easier for homeowners to escape (in bankruptcy) even the most egregious amounts of debt.

Homeowners can push for the same right as banks through *cramdowns* orchestrated in bankruptcy court or by walking away from an underwater mortgage. This decision to escape debt is at best a lender and government labeled moral failure; at worst a legal impossibility (although not in California an *anti-deficiency* state).

As a result of bifurcated debt-resolution rules, the nation is divided into two separate and adverse *economic classes*, each of which ironically depends upon the other. **Class warfare** seems to be the inevitable result of this dichotomy, as the economy has not always been as clearly divided as it now is.

In reality, it is not at all difficult to envision a society in which the interests of *rentiers* and *borrowers* are far more closely aligned. To understand how this is possible, a clearer definition of the term "rentier" is required.

Who are the rentiers?

Rather than referring to a "lender class," it might be useful to think of the rentiers as all those who receive fixed income yielded from tangible and intangible assets they own, not their personal efforts. While most of our population derives its income from the direct production or sale of a good or service they provide, rentiers profit by *passively earning income* generated by a possession, not themselves.

For example, a mortgage held by a lender and an apartment/commercial property held by a property investor (as in portfolio and passive income tax category investments) make the owner a rentier.

On the obverse side of the coin are business people, professionals and employees, who are active and earn money for their efforts. There are also speculators (day traders/flippers) who buy and sell property or other assets and profit on the resale. They need to go to work each day if they are to have an income flow, since they have not built up wealth which produces income independent of their efforts.

Lords and serfs we have again become

It is not wholly misguided to think of the rentier class as the *lords* to a set of modern day *serfs*. The serfs work to gain income to pay for their needs. Their standard of living is set by the success of their efforts alone. They depend however upon their lord for resources, especially shelter. Of course, their labors also go to enrich the idle but moneyed property owners who provide land and protection for the serfs.

The arrangement is sometimes necessary for the serf — they needs a safe place to grow their crop — but certainly tends to work out better for the lord. Theories such as **trickle-down economics** suggest that an increase in the strength of the lord will lead to an increase in the serf's well-being. But evidence shows time after time that this is not the case.

trickle-down economics
The economic theory suggesting that an increase in the strength of the wealthy leads to an increase in the well-being of lower classes.

The political success of the rentier regime in the current post-recession, financial crisis economy is indicative of an overall reversal in economic policy from the *Keynesian* economics in force at the close of World War II (WWII) (the biggest stimulus). Those policies lead to 30 years of the greatest expansion the USA has ever experienced.

In that period of constantly rising interest rates to keep growth in check, the dominant group (the U.S. and allied forces) considered demanding overwhelming repayments from the defeated nation of Germany. However, they instead listened to the advice of **John Maynard Keynes**, from Britain. It was his (and Roosevelt's) Bretton Woods monetary system that "emphasized domestic recovery for the defeated as well as the victorious powers." We grow together from the ruins.

John Maynard Keynes
An economist well-known for his stance that governments need to smooth out the effects of expansion and contraction in the business cycle through fiscal and monetary policy.

Thus, "a global monetary system was created at the end of WWII in which private financial speculators were denied the power to compel nations to pursue deflation" to pay war reparations.

Rather than the victors paying their vast war debt with money demanded from the defeated, the Fed tightly regulated the financial markets to reduce speculation and dramatically lower interest rates. The results were economically beneficial for both the defeated and the victorious: a monetary *Marshall Plan*.

Conflicting philosophies

In an ideal government, the conflicting demands of separate political contingencies—the few rentiers and the many debtors—will be balanced to the benefit of the largest contingency.

The **austerity measures** that are most beneficial to rentiers would be voted down by the much larger group of debtors. That debtor group is made up especially of homeowners, who will benefit from economic stimulus and tighter regulation of lenders. Since the debtors are a huge part of the working population that actively creates items and provides services for sale, the government has an *additional incentive* to ensure their continued well-being.

Clearly, this is not the case in the U.S. today. The current political conversation is dominated by calls for reduced benefits to lower-income earners, increased austerity (reduction) in government spending (which means job loss), reduced taxes on the wealthiest and extensive precautions against perceived future inflation (needed to create jobs). Many of these may well be terminated under the political pressures being imposed on Congress.

Entrenched rentier dominance

Nobel laureate *Paul Krugman* is one persistent critic of the extent rentier dominance has taken hold in contemporary U.S. and international politics. Krugman and other salt-water economists submit that establishment economic policy is misguided and even harmful by the tenets of Keynesian economics. Policy is predisposed to ensure that debts of individuals are honored rather than either forgiven or artificially reduced by temporarily high inflation.

After all, the increased purchasing of goods and services and the resale of homes is necessary for the economy to recover. This cannot take place when a vast swathe of the population's income is diverted to repay principal and interest on underwater mortgages.

This is not to say a secret cabal of rentiers controls U.S. politics. We do suggest, however, that the ideology of the rentiers has ceased to be limited to ideology held by a *wealthy elite*. Instead, it has insinuated itself into mainstream political thought like an invasive species conquering the weakest.

Wall Street versus main street

As a result, the rentiers as a class continue to be among the very few to reliably achieve continued financial success in this period of economic stagnation. Stocks have fully re-inflated to their pre-recession levels, but not homes. Thus, *rentier-friendly* policies unavoidably pit Wall Street bankers against the needs of Main Street individuals.

The report compares economic policy in the U.S. and the European Union to the disastrous *punitive reparation* policies of Britain and France toward Germany after the World War I (WWI). Both countries emphasized the unaltered maintenance of debtor obligations (whether they are owed by insolvent homeowners or by bankrupt European nations). The result in that case, as Keynes then predicted, was another war (WWII).

The inadvertent result of current world policy, which sets the interests of debtors against those of creditors, is a different form of conflict: *class warfare*.

Opposing views focus attention

Complicating the issue is a report by *The Economist*, which counters Krugman's description of the current policy situation.

It argues that Krugman's advocated policies of higher government spending, through programs like an expansion of the Fed's recent bond purchases (called *quantitative easing*), are actually no more likely to help debtors than lenders. That is, the distinction between the two from a monetary policy perspective is *illusory*.

The Economist claims "sound money" and "balanced budgets" in times of financial crisis are the defining elements of historical rentier dominance. It supports this claim by reference to the presidency of William McKinley, which was based on maintaining the gold standard and low inflation (Britain did the same after WWI).

The Economist contrasts that period of rentier dominance with the current Administration: "two years of quantitative easing, huge budget deficits and negative real rates. 19th century central bankers would regard this era with anathema."

The effect of quantitative easing

Government projects are advocated as necessary Keynesian stimulus to repair the economy. Federal stimulus projects enacted thus far have indeed done very little to improve the long-term status of homeowners threatened by foreclosure. (Excess speculator liquidity has done much more to inflate home prices.) The recent and ongoing rounds of *quantitative easing* have had the direct, immediate and pronounced effect of bolstering share prices and commodities markets, but not real estate assets.

The sole present beneficiaries are Wall Street bankers and executives — the rentiers. Troubled Main Street homeowners with negative equities and few prospects for more jobs soon do not benefit.

Essentially, these projects are neither properly directed to assist mortgaged homeowners nor sufficiently extensive to make an immediate, measurable difference.

The policies which will be most valuable to all of society's participants are those which lead to *debt forgiveness,* even at the rentiers' immediate expense. These, however, we are unlikely to see.

Foremost among these options is temporarily increased inflation. The Fed easily manages inflation, as was seen by Chairman Volcker's 1980s ending of rampant inflation which the prior Fed management permitted. There is also the much discussed principal cramdown of mortgage debt to the value of the home it encumbers. But addressing this calls for a responsible and focused Congress to reinstate 2005 homeowner bankruptcy rights now only available to property investors – that rentier class distinction again.

A harmful artificial distinction

Debtors and rentiers will always be troubled by **conflicting interests**. The current state of conflicting policies is the result of a peculiar set of regulations that apply to banks. Economic blogger Steve Waldman points out that "banks, after all, are not only creditors. They are also the economy's biggest debtors." All deposits they hold are amounts they alone owe their depositors, although guaranteed by the U.S. government. As such, banks are merely a conduit for flow of the nation's cash.

In a *rational world*, without the assurance (if not implicit guarantee) of government bailouts, bankers will be as concerned about their own risk of insolvency and bankruptcy as are the homeowners whose mortgage debt they hold.

The advocated solution is a removal of policies which grant *artificial security* against loss to bankers while denying similar security to homeowners. Such policies are harmful since they include bizarre accounting regulations and the implied guarantee of bailouts behind the "too-big-to-fail" mentality.

These fiscal policies make it easy for banks to obscure their troubled assets from investors (as well as the lack of regulation that makes abuses, like Goldman-Sachs', possible), which of course they do. That is, rentiers — like homeowners — need to know they are at risk of foreclosure by the FDIC if their debts (held by depositors) are not repayable from the value of the assets that secure them as collateral.

Troubled assets obscured

It is important to remain aware of which class — rentiers or homeowners — stands to benefit from future changes in *fiscal* or *monetary policy*. Included are those changes ostensibly enacted in support of the homeowner. The pace of the economic recovery and the long-term personal financial success of all mortgaged homeowners depend upon the outcome.

The huge debtor class of homeowners (80% of California's homeowners) can preserve its ability to recover from a general financial crisis and create a future for itself collectively. However, it needs to emulate the bankers and rally to advocate political positions which allow mortgaged homeowners the same privileges rentiers take for granted. Perhaps most essential among these privileges is the guilt-free ability to legally walk away from mortgage debt in California. Within their own households, every homeowner is *"too big to fail."*

Chapter 30 Summary

The rentier class is made up of those who lend money or let real estate. The debtor class comprises those who borrow or rent. Both exist in opposition to each other; the latter pay, and the former collect. As a result, the nation is divided into two separate economic classes, each of which depends upon the other.

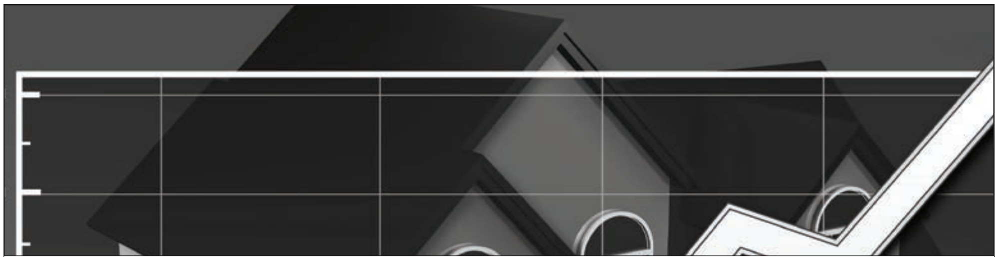
The ideology of the rentiers has ceased to be limited to ideology held by a wealthy elite. Instead, it has insinuated itself into mainstream political thought. The current political conversation is dominated by calls for reduced benefits to lower-income earners, increased austerity (reduction) in government spending (which means job loss), reduced taxes on the wealthiest and extensive precautions against perceived future inflation (needed to create jobs).

Federal stimulus projects enacted thus far have done very little to improve the long-term status of homeowners threatened by foreclosure.

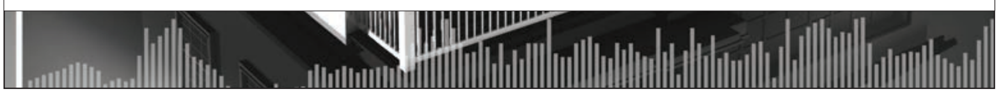
The recent and ongoing rounds of quantitative easing have had the direct, immediate and pronounced effect of bolstering share prices and commodities markets, but not real estate assets.

Chapter 30 Key Terms

Chapter 31



30 years of summer followed by 30 years of winter



Learning Objectives

In this chapter, you will learn about:

- the cyclical pattern of rises and falls of interest rates; and
- the future of real estate pricing shaped by ascending mortgage rates.

Key Terms

10-year Treasury Note	**net operating income (NOI)**
Greenspan Put	**purchasing power**

Bond market cycles

The average monthly **10-year Treasury Note (T-Note)** yield since 1900 is shown in Figure 1. As demonstrated, **interest rates** on the *10-year T-Note* have shown a slow but steady overall decline since 1980. This is following a rise from lows last reached in 1941. [See Figure 1]

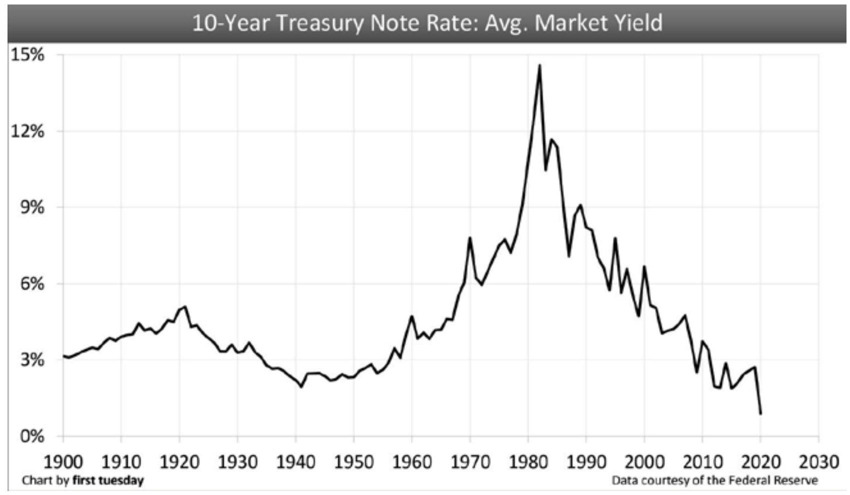
We can now see that 1940-1950 marked the beginning of what has become a *60-year rates cycle*: approximately 30 years of rising rates, followed by 30 years of falling rates. This roughly mirrors the 60-year period prior to 1950, in which interest rates peaked in 1921.

Going forward, **RPI** expects another slow upward run in rates for 20-30 years. After that, there will be a reversal into rate declines as occurred following 1980.

10-year Treasury Note
A leading indicator of the direction of future Freddie Mac rates. Influenced by worldwide demand for the dollar and anticipated future domestic inflation.

Figure 1

10-Year Treasury Note Rate: Avg. Market Yield



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Global economic chaos

The interest rate on the 10-year T-Note averaged 0.89% in October 2021, historically low for the key rate. However, 2020's record-shattering lows were merely a brief dip within the long-term rising trend. Interest rates rise and fall in a cycle, and the current rising trend, which began in 2012, will include two-to-three decades of rising interest rates. This will dampen home price increases, as buyer purchasing power is continually reduced.

Prior to 2017, when chaos was experienced in various international economies, foreign investors saw U.S. Treasuries as a safe haven. However, as the chaos subsides, these foreign investors will return to investing in their home countries, which will remove cash from U.S. Treasuries, lifting the weight which held down Treasury rates for years. We have already seen this in 2017, as the 10-year T-Note has increased dramatically since 2016. This activity has caused fixed rate mortgage (FRM) interest rates to rise.

The 10-year T-note rate, which declined since 1980, seemed to bottom in 2016 — that is until the 2020 recession. Mortgage rates have historically moved in tandem with the 10-year T-note at a *1.5% spread*. The spread represents the lender's additional risk premium, covering potential losses due to mortgage default.

In 2018, real interest rates on 10-year T-Notes rose from their effective zero level as a measure of financial security seemed to return to the economy. Rates of all types are rising, mortgage rates included. [See Chapter 21]

Furthermore, the upcoming years of generally rising rates is likely to last for quite a long time – a two or three decade period.

The last three cycles in bond market rates have been extremely regular. A 29-year downtrend in rates (1920-1949), followed by a 32-year uptrend (1949-1982) and another 31-year downtrend lasting to the present.

Interest rates and asset pricing

In previous interest rate cycles, rates rose for approximately 30 years. They peaked in 1927 and again in 1979 after rising from essentially zero in the late 1940s at the end of the recovery from the **Great Depression**.

In 1947, at the end of World War II, interest rates on the 10-year T-Note were near zero, much as they are today. Then, from 1947 to 1979, rates moved steadily upward.

1947 is a key year for other reasons as well. It marked the end of a recession that began in 1931, and a long-awaited return to prosperity after the *Great Depression* of the late-1930s.

As this interest rate pattern develops legs toward the end of this decade, we will see that today we are at the beginning of a reversal in the real estate pricing. This reversal will be comparable in type, if not in intensity, to the turnaround after 1947.

Greenspan Put
The practice of lowering the Federal Funds Rate to encourage investing during recessionary periods, with an implicit guarantee of continuing interest rate stimulus to keep profits up. Implemented by Fed Chairman Greenspan from 1987 to 2000.

During the post-depression half cycle of rising interest rates from 1947 to 1979, the wealth of investors increased even as interest rates rose. Housing construction was very strong and employment and prosperity increased as well. The *American Dream* of jobs, cars and homes for all was in full bloom during this period. We expect to experience similar stable conditions during the two or three decades leading into the mid-2030s.

What does it mean for the housing market?

For the *housing market*, rising interest rates mean there will be few short-term profits to be had from any increase in pricing. This ought to sound the alarm for speculators to stay away. The notorious **Greenspan Put**, which we have grown accustomed to experiencing after every drop in interest rates engineered by the Fed since 1982, cannot be repeated to artificially generate profits in any asset market. This includes *commodities, stocks, bonds* and *real estate*.

purchasing power
A homebuyer's ability to purchase property based on a standard 31% of their gross income and current interest rates.

Mortgage rates are inextricably tied to bond market rates. Every increase in bond and mortgage rates means a decrease in a homebuyer's **purchasing power**. *Purchasing power* is the amount a buyer can borrow based on 31% of their income. Thus, a buyer will experience a decrease in the amount they can pay for a home in 2013 dollars unless their annual pay raises exceed the rate of consumer inflation.

Less money borrowed by homebuyers translates to a lower price received by sellers. Thus, like in the period of rising bond and mortgage rates from 1949-1980, prices will be held down. Prices will rise only in response to:

- *consumer inflation* as permitted by the Fed; and
- *asset price appreciation* due to the property's location and local demographics of density and income.

Interest rates in the modern era

For the first time in sixty years, interest rates have once again reached zero. 10-year T-Note rates remained near 2% from late-2011 to mid-2013. This rate is considered approximately equivalent to a *zero real rate*. Why? A sustained *actual rate* of lower than 2% will be too low to cover the standard 2% rate of *core inflation*. Rates below inflation leave investors with slightly more dollars but less purchasing power as occurs with the short-term treasuries during this recovery.

The next three decades

When bond yields hit their bottom in the late 1940s, they remained low for a period of eight years. Bond yields and thus mortgage rates reached a low in actual (nominal) rates in late 2012, establishing a 30-year run to a peak in homebuyer purchasing power (due to reduced interest rates). Since that peak in buyer purchasing power, mortgage rates rose abruptly in mid-2013 to put an end to the 30-year streak in rate-induced price increases.

Higher 10-year T-Note rates indicate that any upward movement in this rate will result in higher FRM rates. These interest rate events will usher in a parallel increase in capitalization (cap) rates. All this rate movement will depress market prices of income producing property assets as well.

When rates rise, agents will quickly learn to cope with an unfamiliar set of investment and pricing challenges, not unlike the rise in rates seen mid-2013. These include:

- different income multiplier ratios (lower) and **capitalization rates (cap rates)** (higher);
- long-term holding periods before profits on resale will be experienced; and
- due-on sale clause assumption issues on attempts to takeover low interest rate mortgages originated during the recovery.

The key lesson to remember: real estate is most properly priced and held for its *inherent rental value*. Those who buy property for *speculative gain*, not rental income, will see little success in gains from a flip in the coming 30-year regime of rising interest rates. Their gains will be similar to those who invested in the real estate market from 1950 to 1980. During that 30-year period, mortgage rates moved slowly upward until they exceeded 18%.

The next peak in rates will take another 30 years or so to arrive. Our past cycle's years of steadily decreasing interest rates and increasing prices (and profits) have run their course. The *Greenspan put* is no longer available to deliver profits until interest rates again peak, heralding in the half cycle of lowering rates.

Long-term ownership to increase wealth

In the long run, investors in real estate need to increase their wealth. Profits will not be achieved by flipping properties for profit. Rather, by generating rental income over the course of *long-term ownership*.

Income property will be bought to be operated and managed for an annual **net operating income (NOI)**. A resale then will deliver up real estate's other financial aspect as a hedge against inflation. Nothing much more will take place without serious upward demographic change in the locale of the property.

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.

In boom times, property owners were accustomed to cap rates of 6% or less. For the upcoming years, 10% may be more normal as an annual return on the investment, not speculation, becomes the standard for ownership.

What are the keys to success?

- prudent property selection;
- careful research;
- forward-looking cap rates; and
- a long-term commitment to real estate ownership.

Chapter 31 Summary

The U.S. economy appears to function on a 60-year rates cycle. There are 30 years of rising rates, followed by 30 years of falling rates. Every increase in bond and mortgage rates equals a decrease in the amount a buyer can borrow to pay for a home. Less money borrowed translates to a lower price received by sellers.

Rates are rising gradually. For speculators, this increase in rates will eliminate profits from a flip. Going forward, long-term holding periods will be needed before profits can be taken.

Chapter 31 Key Terms

Chapter 32

Secular stagnation – our long-lived recovery

Learning Objectives

After reading this chapter, you will be able to:

- explain secular stagnation and its relevance to the current economic recovery;
- understand how speculators contribute to asset bubbles and create temporary illusions of recovery; and
- comprehend the use of aggressive fiscal stimulus to revive jobs in the economy when interest rates are essentially at zero.

Key Terms

Abenomics
bumpy plateau
Lesser Depression
purchasing power
secular stagnation

A sobering truth about failure to act

The buzz for the next several years surrounds the technical economics term, "**secular stagnation**." It was referenced in a presentation at the International Monetary Fund (IMF) research conference in late 2013 by Larry Summers, President Emeritus of Harvard University and Secretary of the Treasury under President Clinton.

secular stagnation
An abnormally lengthy period of sluggish economic growth.

The ears of elite economists and business owners perked all over the world when one of the most well-respected voices in economic policy finally mentioned the dreaded phrase.

Secular stagnation is a lengthy period of stagnant (read: slow) economic growth. For example, think of the lethargic wake of the **Great Depression** which ended by the economic stimulus provided by jobs during WWII. Also think of Japan's lost decade of the 90s — now a generation long — produced by their Bubble collapse and financial crisis.

Today, "secular stagnation" is being used to describe present economic realities closer to home: the dire economic situation playing out in the U.S. right now.

Referring to dashed recovery expectations, Summers said:

> "The share of men, or women, or adults in the United States who are working today is essentially the same as it was four years ago. [. . .] GDP has fallen further behind potential as we would have defined it in the Fall of 2009 [and] it does seem to me that four years after the successful combating of the crisis, there is really no evidence of growth that is restoring equilibrium."

purchasing power
A homebuyer's ability to purchase property funded by mortgage money based on 31% of their gross income for mortgage payments and current interest rates.

In other words, we have no recovery in terms of real **purchasing power**. We've been treading water, in the parlance of negative equity homeowners.

Predictions come to fruition

Larry Summers is just now sharing what we at **RPI** observed and stated in the fall of 2009. Back then we called it the **abortive checkmark recovery**, and discussed it at length.

Lesser Depression
The period from 2009–2016 following the Great Recession and financial crisis of 2008, characterized by persistent slow job growth and a low, flat annual home sales volume.

bumpy plateau
A recovery period characterized by a long-term pattern of recurring short-term increases followed by negating short-term decreases in home sales volume and pricing, producing a recovery trend with little upward movement.

In 2011, as pundits and real estate professionals discussed the inevitable double-dip, we introduced another term of art to describe our economic situation. Economist Paul Krugman was, by this time, calling it the **Lesser Depression** — a term we embraced and employed where fitting. But we named the protracted period of post-recession false starts the **bumpy plateau recovery**. Think of a washboard, riddled with a series of hills and valleys.

By mid-2012, when the prevailing wisdom euphorically held the real estate market was headed into a full recovery and resurgence, **RPI** made clear that speculators were the sole source driving a temporary mini-bubble.

Instead of increased prices from an organic demand by end users stemming from a jobs recovery, it was becoming clear that we were merely in another rise on the bumpy plateau — an illusion of recovery generated by *cash-in-hand speculators* looking for a place to park their funds in a bet that short-term profits were to be had.

Finally, in the summer of 2013, we announced the mini-bubble had fully arrived and will burst. And, well, it has.

Call it a "liquidity trap," opened by inflation

Typically, in the wake of financial crises and economic downturns, we first look to the Federal Reserve (the Fed) to restore balance.

One of the Fed's two mandates is to **maximize employment** (the other is to keep consumer prices under control). The Fed accomplishes a growth in jobs by lowering short-term interest rates. Lower rates mean lower costs of operations, which encourages private business expansion, stimulating hiring. Soon, more incomes become more spending, culminating in the purchase of a home.

But the Fed crippled itself. The Fed necessarily dropped interest rates to zero in 2008. Thus crippled, the Fed could not lower rates further to stimulate jobs growth without going negative — impossible in the current political environment, but an effective step available to the Fed. However, rates have risen above this **zero lower bound** and are expected to continue for the next few decades.

So what Summers is saying, and what we at **RPI** have been arguing since the fall of 2009, is that, absent aggressive **fiscal stimulus** from the employer of last resort, the economy simply cannot and will not timely "fully recover."

This recession and accompanying financial crisis is not your typical garden-variety business recession.

Until a great length of time passes and huge permanent damage is done to our working age population whose time, talent and energy has been left dormant, a full recovery will not come about.

As the mainstream, elite economists increasingly become conscious of the data signifying this reality, the notion of what has recently been referred to as a "recovery" is being entirely thrown into question.

Saltwater economist have gotten it right; their *freshwater* brethren have not, convinced capitalism free of government intervention is best (which is the same argument for financial deregulation which engineered the crisis).

Let's put this all in the context of *California real estate*. Then perhaps it will be clear how your practice is dramatically affected by what otherwise might be considered **economic noise**.

Appearances are deceiving

At the distant dawn of 2012, **RPI** observed an unreasonable spike in California real estate sales volume. A corresponding, unreasonable spike in prices followed. We use the term "unreasonable" since the world was in the midst of a **global credit crunch**.

Historically, the middle class has never been able to purchase a home outright and thus has always relied on lender-provided purchase-assist financing to make the American Dream a reality.

This means the vast majority of post-WWII real estate purchases were mostly accomplished through *leveraging*. As credit was simply unavailable to the average California household in 2012-2013, it was clear that this anomalous spike in prices was coming from elsewhere, not end users of the property.

As it turns out the ensuing 2013 mini-bubble was purely the result of *real estate speculation*. Private investors, both institutional and small, have been snapping up properties the instant they are listed, using their large sums of cash reserves amassed during the recession and earning those not-so-stimulating, zero lower bound interest yields.

It is well-documented that corporations amassed huge cash reserves during the *Great Recession,* spending nothing on hiring and equipment needed in a recovery since they do not see one. After widespread downsizing and increased "efficiency" measures (and stock buybacks), corporate profits skyrocketed in the years following the recession.

Rather than invest in growth, big businesses saved and sat on their cash. To wit, in 2011, non-financial companies saved over $2.1 trillion in cash and liquid assets. To put this into perspective, this amount of corporate cash reserves had not been seen since records set in the 1960s.

Arrested development

The fundamentals of this recent trend in real estate speculation require **real demand** to occur in order for investors to realize a return.

Speculators cannot day-trade properties into perpetuity and expect a quick, tidy profit. It is a Ponzi scheme without a schemer but a horde of followers. *Someone* needs to eventually buy the home and keep it, the defined *end user*.

As it becomes clear that credit availability and mortgage rates remain insufficient to stimulate growth in end user demand, the speculative activity will die down. Further, many investors who were late to the party and ignorant of what price to pay for property will realize a significant loss.

Here's the basic equation that ought to bring you, as a practicing real estate agent in California today, some alarm.

California real estate sales volume and sympathetic pricing were entirely propped-up by an unsustainable credit bubble involving mortgage originations from roughly 2000 to 2006. This is undisputable and now a matter of history.

The propped up market

Less clear to some, our real estate market has since been propped up first by a tax credit stimulus. The fleeting support provided by the 2009 tax credit stimulus saw sales volume, and then prices, rise by the end of 2009, and then drop during 2010 and into early 2012.

The market was then propped up again by an unsustainable speculation bubble from early 2012 through 2013.

Thus, the cash reserves amassed during the recession due to savings have largely been sunk into the non-performing *black hole asset* of California single family residences (SFRs) by speculators rather than end users. What's left is being romanced away by record-breaking stock market gambles. Both are highly volatile in reaction to any increase in short-term interest rates, and those rates can only go up.

Worse, prices of assets go down as interest rates and capitalization rates rise and price-to-earnings (P/E) ratios drop, like on opposing sides of a teeter-totter. If an asset bubble has developed in real estate or stocks, as it presently seems with the stock market, it will inevitable burst as a bet gone awry.

Austerity as the poison, spending as the antidote

A population boom of historic proportion, followed by the aggressive fiscal stimulus of the New Deal, arrested the secular stagnation of the Great Depression between 1937 and 1946. Japan's economy continues to suffer from a 20-year period of secular stagnation, though they are finally working hard today on assertive fiscal and monetary stimulus, known as **Abenomics**.

Abenomics
An economic plan introduced by Japanese Prime Minister Shinzo Abe to revive their 20 years of stagnant economy through aggressive fiscal stimulus, monetary easing from the central bank and employment reforms.

The U.S., on the other hand, has confronted our current predicament with growth-stifling austerity performed with devastating results to workers by the federal government.

Mr. Summers was quick to point out in his speech that government's immediate response to the 2008 financial crisis was quick and effective. The potential global market meltdown was stopped in its tracks. But the following years of what was to be sustained fiscal stimulation have instead been five years of counterproductive federal political brinksmanship.

As former Fed Chairman Bernanke has repeatedly said, and as Fed Chairperson Janet Yellen has echoed: we need **fiscal stimulus** now to reverse course, which only Congress can provide since the Fed cannot lower interest rates to induce the same result. Otherwise, California real estate is just now settling into a very long lost decade — maybe two in this ring of fire.

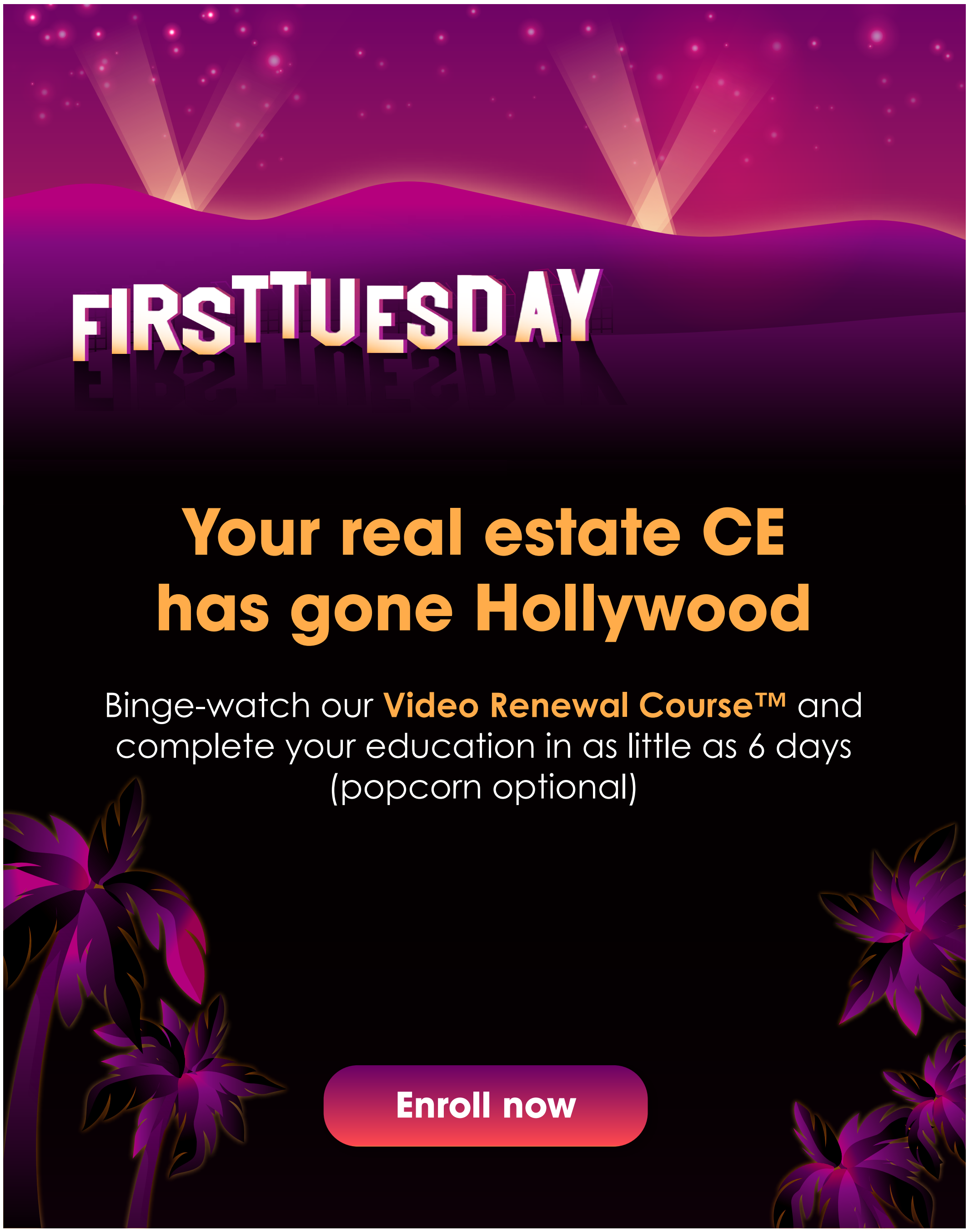
Chapter 32 Summary

Secular stagnation, a lengthy period of stagnant, slow economic growth, is used to describe the dire economic situation playing out in the U.S. right now.

There has been no recovery in terms of real purchasing power. Instead of increased prices from an organic demand by end users stemming from a jobs recovery, we were merely in another rise on the bumpy plateau — an illusion of recovery generated by cash-in-hand speculators looking for a place to park their funds.

In the wake of such economic downturns, we look to the Federal Reserve (the Fed) to restore balance. Absent aggressive fiscal stimulus from the federal government, the economy cannot fully recover. Instead of sustained fiscal stimulation, the U.S. has thus far confronted our current predicament with growth-stifling austerity performed with devastating results.

Chapter 32 Key Terms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Chapter 33

"Reassessing" California's property tax

Learning Objectives

After reading this chapter, you will be able to:

- understand the history of California's Proposition 13 "Welcome Stranger" law; and
- recognize the economic consequences of a tax system which discourages home sales, misallocates personal wealth and keeps homeowners fastened to their property.

Key Term

Proposition 13

A failing policy

Are California's communities getting the most they can out of their property taxes?

The average wealthy nation raises less than 5% of its total federal and local tax revenue from property taxes. Emerging middle-income economies collect even less — just 2% of total tax revenue comes from property taxes.

In the U.S., 17% of all government revenue collected comes from property tax. Although near the top of the property-taxing ranks, this figure is still *de minimis* when you consider how much of America's wealth is stored in real estate. Of course, local governments in the U.S. take nearly 70% of total property tax revenue.

Why not tax property more? Despite the volatility of the real estate market, property taxes have proved an incredibly stable source of revenue for local governments. During the **financial crisis** and **Great Recession**, U.S. state and local governments saw lesser declines in property taxes than in income and sales tax, which are immediately affected by job loss and a soft economy.

While there are many reasonable arguments for increasing property taxes, the greatest barrier to reform is political will. Property tax is one of the most visible forms of taxation, especially since homeowners pay them in annual lump sums, not monthly (with the exception of impounded tax payments).

With so many real estate related industries motivated to keep home buying attractive, even the most firebrand politician will not touch such a proposal with a 10-foot pole.

Welcome stranger!

Proposition 13
A 1979 California state constitutional amendment restricting property tax increases in years following acquisition by limiting annual increases in assessed value of real estate to no more than 2%, or the rate of consumer inflation if less.

Proposition 13 (Prop 13) is the holiest of all of California's sacred cows. To propose reforming Prop 13 is political suicide – there are too many older property owners. Well, since editors are not politicians, allow us to make the unpopular claim: Prop 13 was bad for California in the 1970s, and it's still bad for California now.

For starters, Prop 13 is a regressive and unequal tax regime, not progressive and equal calling for all to pay their fair share of community operating costs. Prop 13 allows the rich to take and keep a larger percentage of total incomes in California, but shifts the cost of that benefit to the newcomer, usually a young and budget constrained family.

The constitutionality of Prop 13 was upheld in 1992 by the U.S. Supreme Court, finding that the tax conformed to the doctrine of **equal taxation**. Of course, property taxes in California are not equal. It appears the court erred in the logic of its decision, and history now suggests the same.[1]

There is a reason why Prop 13 has been deemed the *"Welcome Stranger" law*. New members to a community, who are also typically less wealthy than established community members, are most welcomed by those that preceded them in homeownership. The newcomer to the neighborhood essentially subsidizes community services by paying a disproportionately higher property tax than those longer-standing property owners sheltered by Prop 13.

Economic consequences

Consider the vicious cycle this creates in the California real estate market. Rather than encouraging mobility, home sales and the best use of property through a proper allocation of national wealth, Prop 13 rewards those who stay put. And the longer a homeowner owns their home, the more encouraged they are to remain seated.

This says nothing of Prop 13's greater economic impact. It overburdens new homeowners, who are usually young families. This demographic already shoulders the bulk of the tax responsibility via sales tax impositions since they are most likely to need to spend their entire earnings to support their family.

1 **Nordlinger** v. **Hahn** (1992) 505 US 1

But backwards taxation under Prop 13 has them busy also funding public education (a *future* payoff for the community) as well as paying for today's street sweeper, a service all homeowners demand, regardless of their date of purchase.

All laws have an economic impact. Someone benefits, usually those most likely to vote, and someone absorbs the costs, which is why laws come into existence. Wealth is nearly always shifted by each new enactment.

One of the most popular claims of Prop 13 proponents is that it encourages community stability and longevity. In truth, our economy no longer favors workers who have set down deep roots, hence the rise in rentals as shelter, not ownership. Rather, those with the greatest agility and adaptability – the most mobile among us – are rewarded with the most high-paying jobs.

Our present property tax system discourages home sales and keeps homeowners fastened to their property in a misuse of their wealth for fear of upgrading their home and upgrading their tax bill. Thus, for lack of a natural turnover in homeownership, a vast contingent of the labor force is rendered unable to compete in the homeownership game and all the more likely to rent.

Employer of last resort

Recall that the federal government is by mandate the employer of last resort – if businesses will not hire, the government, as part of this country's social contract with its people, fills the vacuum created until jobs return organically.

If revenues fall too low, the state cannot hire workers to provide necessary social services that support the standard of living each California resident has come to enjoy. Government employment is a type of safety net in recessionary times.

Creating these jobs sets off a *virtuous cycle* of:

- employment with incomes to spend;
- consumer spending which provides for more employment; and
- eventual homeownership for a majority of the employed.

Prop 13 inhibits the development of this virtuous cycle, keeping it from getting off the ground (pun intended).

Neighbors and equals, sort of

Prop 13 was passed during a moment in our economic history of soaring inflation and an out of control **Federal Reserve** — now 35 years past and counting.

One demographic in particular — homeowners over the age of 55 (who also happen to be the demographic that votes) — was getting hit hard by continually rising property values and property tax reassessments.

Rather than waging war against the boom/bust cycle in the real estate market, homeowners took it to the tax code. Thus, the demographic divide of inequality has continued to grow ever more entrenched since the '70s. The longer you own, the greater your benefits from Prop 13. The *shift in wealth* here is reduced costs for prior owners versus increased costs of new owners.

A multitude of legitimate justifications exist for differences in taxation, including:

- ability to pay;
- the type of property;
- the use of property; and
- whether the taxpayer is an individual or a business entity producing employment.

However, it is decidedly arbitrary to determine taxation based on the *date* a person becomes a property owner.

Equal services, equal share of the cost

Prop 13 was tailor made to suit a particular demographic, subsidizing their standard of living at the cost of future real estate sales. The result: established owners paying less annually for their share of local services.

It's quite straightforward: as property values increase in any given community, the cost to maintain the standard of living increases in turn. Historically, California real estate trends upward at around 3.5% annually after all the highs and lows are averaged over the years.

Under Prop 13, homeowners are expecting to maintain their standard of living at a continuously *cheaper price* — paying less for the same things from year to year — as their assets grow in dollar value and their tax bill remains the same, but for a 2% annual assessment increase.

As long as a property owner is equally enjoying the benefits of a community, they ought to be paying an **equal share**.

The only way to do this is to match property taxes to current **fair market values (FMV)** for all homeowners in California. Then watch the freeing up of homes suddenly available for the newcomers to buy.

Chapter 33 Summary

Despite the volatility of the real estate market, property taxes have proved an incredibly stable source of revenue for local governments.

California's Proposition 13 (Prop 13) restricts property tax increases in years following acquisition by limiting annual increases in assessed value of real estate to no more than 2%, or the rate of consumer inflation if less. Prop 13 is a regressive tax and unequal tax regime that allows the rich to keep a larger percentage of total incomes in California. Rather than encouraging mobility and home sales, Prop 13 rewards those who stay put for fear of upgrading their tax bill. This is a burden in an economy where those with the greatest agility and adaptability are rewarded with the most high-paying jobs.

It is arbitrary to determine taxation based on the date a person becomes a property owner. Instead, matching property taxes to current fair market values (FMV) ensures property owners pay equal shares for their community.

Chapter 33 Key Term

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Chapter 34

The MID as a subsidy

Learning Objectives

After reading this chapter, you will be able to:

- identify the arguments for and against the mortgage interest tax deduction (MID);
- distinguish between homeowners who do and do not benefit and to what extent from the subsidy; and
- question the MID's use as a marketing tool by real estate agents and brokers.

Key Terms

capitalization rate

itemized deduction

mortgage interest deduction (MID)

submerged state

Government housing subsidies

Brokers, lenders and builders, the gatekeepers to homebuyer entry into housing market, each contributed in their own way to California's decline in homeownership. California's *homeownership rate* dropped from 61% at the peak in 2005, down to 54.8% in 2019.

Today, these gatekeepers are doing everything they can to encourage an increase in the homeownership rate by fighting to save legislation they believe will support their financial wellbeing.

The allies they claim are the homeowner subsidies imbedded in the tax code, known as:

- the **mortgage interest deductions (MID)**;
- mortgage insurance premiums (MIPs) and private mortgage insurance (PMI) default insurance deduction;
- the property tax deduction; and

mortgage interest deductions (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.

- the principal residence profit exclusion.

Those homeowners who pay income taxes and have mortgages on their primary and second homes are permitted to recover a portion of these expenditures when paying their income taxes.

When preparing their income tax return, they deduct the interest and default insurance premiums (MIP/PMI) they paid on those mortgages, as well as the property taxes they paid on the homes, from their adjusted gross income.

Reduction of taxable income

The **deductions** in turn reduce the amount of their taxable income. The homeowner then pays income taxes on that taxable income amount at the percentage rates set by the tax brackets into which their taxable income falls.

For the mortgaged homeowner, the critical end game is the amount of the reduction in income taxes they pay due to the homeownership deductions. The reduction is the dollar amount they recover – "save" – as a subsidy, a reimbursement for mortgaged homeownership from the government.

The amount saved in taxes is the percentage tax bracket rates that would have been imposed on the deduced amounts had they not been taken.

Further, homeowners who wish to sell and terminate homeownership can permanently exclude up to $250,000 of profit per owner from being taxed on a sale.

The encouragement here is to create **turnover** in ownership. *Turnover* creates more sales transactions for all the providers of real estate services to take earnings: one home is sold and another will likely sell as homeowners who sell tend to purchase a replacement home.

These "housing policy subsidies" were not enacted to induce the population to buy or own a home. However, that hasn't stopped the real estate industry from exploiting them to their *financial advantage*.

The interest deduction's legacy

The players in the real estate industry describe these policies as catalysts of the **American Dream**. They posit these tax policies in the form of a subsidy induce homeownership by making ownership more financially feasible than renting.[1]

Interest deductions took root in the late 19th century. The first federal income tax was established in 1894 and all forms of interest were deductible. However, homeownership was not what motivated Congress to enact an interest deduction policy. An interest deduction was viewed primarily as a *business situation*, and business expansion through borrowing to purchase inventory, equipment and improvements was deemed beneficial for the nation's economy.

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1 Internal Revenue Code §§121; 163(h)

Most people at that time in history paid cash for their homes. Mortgages were generally only taken out by farmers or investors.

Not until the 1950s did the home mortgage gain anything close to its current significance. Since then, the home mortgage has become the going concern of the housing industry. The tax deductions and exclusions have evolved to the point they are considered by many to be entitlements for homebuyers who need to borrow to buy (in the form of expense deductions), and for those who sell (in the form of profit exclusions).

Benefits lost

The true tax benefits of interest rate deductions were lost long ago by homebuyers. They were arbitraged away by increased home pricing and interest rates. Thus, the benefits are passed on to the seller (increased price) and the lender (interest and charges on increased mortgage amounts).

The howl today by industry insiders is that prices will drop if the deductions go away: exactly the **evidence** that shows subsidies go to the seller and the lender, not the buyer/owner who will continue to buy and own.

The personal *interest deduction loophole* costs the Department of Treasury over $70 billion in lost tax revenue annually. However, the majority of debt-encumbered homeowners see little of it. Only half of the tax filers who are homeowners are able to claim the deduction. The half who do claim the deduction receive less than $2,000 in reduced tax liability annually (the rest either have no sufficient income to pay income taxes or have no mortgages and thus no risk of loss).

More than 50% of the tax reduction benefit is taken by those few homeowners with taxable incomes exceeding $100,000. It is fair to say those wealthier homeowners have the least need for a subsidy as inducement to buy a home. Their needs are driven by their earnings, societal expectations and wealth management.

They doth protest too much

Arguments over the MID quickly turn from the evidence to the political. Proponents of the MID argue it:

- stimulates homeownership;
- provides tax relief for the middle-class; and
- limits the government's reach into the taxpayer's pocket.

Advocates for repealing the MID argue it:

- inflates housing prices;
- subsidizes lenders by encouraging greater amounts of mortgage financing;
- the benefits received are mostly by the highest bracket taxpayers who purchase high-tier properties on highly-leveraged terms; and
- provides little to no tax relief for the middle-class.

The submerged subsidy

Studies show many homeowners and real estate agents do not know how the tax deduction works.

57% of Americans initially reported they had never participated in a government-run social program, according to a 2008 study by the Cornell Survey Research Institute. The participants in the survey were then asked to review a list of 21 social programs subsidize by the government, including the MID, and to revise their responses.

Upon their review of the listed government programs, 94% of the group noted they participated in at least one social program. A later study by the same organization revealed that 60% of respondents were unaware that the MID was a social program organized and run by the federal government to encourage homeownership as a subsidy.

submerged state
The subtle operation of many government social programs that collectively promote or discourage a particular activity, such as homeownership.

This fact largely extends from what Cornell analysts call the **submerged state**. The concept refers to the subtle operation of many government social programs that are designed to remain unseen, yet act as an avuncular nudge toward action by the government (read: encourage homeownership).

The MID is government assistance

The MID is an example of a *submerged subsidy* — it takes the form of a rebate. Essentially, the subsidy relies on the generation of tax revenue from other sources to cover the amount of tax the homeowner avoided merely by taking out a mortgage.

First, the fundamental character of the MID needs to be recognized. It is a social program facilitated by federal and state governments and **funded** by taxpayers. While it results in "tax savings" for those who qualify, the revenues elided by the deduction need to be replaced by revenues reaped from someone else (read: others who do not have the subsidy).

This supplemental tax revenue is largely culled from taxpayers who do not qualify for the deduction: *renters and cash buyers*. They need to pay more in taxes than the mortgaged homeowner.

Proponents of the deduction lump it in with the ideology that the subsidy limits government in our lives. In fact, this government subsidy absolutely redistributes personal wealth to mortgaged homeownership to the financial detriment of all other arrangements for shelter, including those homeowners who earn so little as to not owe income taxes.

The standard deduction is, well, standard

Many homeowners opt for the standard deduction, which is $25,100 for a married couple filing jointly going in 2021. Also, 40% of all reporting taxpayers pay no income tax since their earnings are so low. Thus, as homeowners, they receive no MID benefits.

Those who take the **itemized deduction** are financially savvy taxpayers, with a sizable mortgage, in the early years of their amortization schedule.

They also generally have significant housing expenditures that qualify for the deduction and they are more often affluent members of the upper-middle class.

itemized deduction
A deduction from a taxpayer's adjusted gross income (AGI) to set taxable income, consisting of deductions permitted for expenditures for personal items, such as medical and housing.

Given the fact that the MID benefits few *average* homeowners, what is all the hubbub about? Notice that you do not see typical suburban homeowners clamoring in the streets protesting to protect the deduction. Rather, those with the loudest voices are two groups: **builders' associations** and **real estate trade union members**.

Further, mortgage lenders and their lobbyists are in the background doing most of the heavy lifting on this front, since they stand to benefit the most from inflated mortgage principal and increased buyer leveraging.

Subsidizing lenders, benefiting builders

The average tax savings for the owner of a low- to mid-tier *single family residence (SFR)* is around $1,400 a year — and this much savings only applies at the beginning of the amortization schedule. The less a homeowner pays in interest in a year, the less they "save," the politically correct word for the housing subsidy. Cash buyers and tenants simply pay more taxes.

However, the possibility of saving anything by way of the MID requires the homeowner to itemize their tax deductions. Whether or not the homeowner opts to itemize depends on the amount of their income, the total amount of purchase-assist loan principal and whether they have other expenses that qualify for the deduction, such as:

- charitable contributions;
- medical expenses;
- home property tax; and
- home mortgage interest.

Builders have good reason to advocate for the deduction. Their artificially increased profits depend on it. Residential builders have two building options:

- multifamily units, which are occupied by tenants and eventually sold to investors ; or
- SFRs, which may be either detached or multi-family condo units built for sale to owner-occupants.

Builders turn a much greater profit on the sale of SFRs than on multifamily rental units. SFRs are sold exclusively to working individuals and families, satisfying their emotional pride of ownership.

Multifamily units (apartment buildings in particular) are sold exclusively to investors. They are sold to individuals or corporations interested in long-term income and profits — sophisticated professionals in the real estate industry employing the mathematics of **capitalization rates (cap rates)** and investigative analysis.

capitalization rate
The annual rate of return produced by the operations of an income property or sought by an investor. The cap rate is calculated by dividing the net operating income by the price asked or offered for income property.

These investors will not pay a dime over the price they set based on an expected *cap rates*, a price ultimately determined by market rents. Further, homebuilders need the MID to remain firmly in place in order to extract greater profits from the momentum pricing paid by owner-occupants in new SFR sales – it's the mortgage that tops off the price, not the buyer's cash on hand.

Savings are offset by prices

Price inflation resulting from the MID is paid upfront in the purchase price, an arbitrage with the subsidy amount going directly to builders and MLS sellers, and subsidizing lender earnings by way of larger mortgage amounts.

Any and all "savings" that purportedly go to the buyer are spent up front to increase the earnings of:

- builders by an excessive home sales price;
- lenders through holding and flipping more and larger mortgages; and
- MLS real estate brokers/agents with percentage fees paid on excessive prices received on resales.

Thus, everyone is benefiting from the overleveraging, except homeowners who do not have sufficient income to pay income taxes and taxpayers who rent or own a home without a mortgage.

The undisclosed subsidy

Ironically, real estate agents and brokers have long avoided giving tax advice even when known to them about the tax benefits of owning a mortgaged home. Thus, they do not rely on the MID in the counseling of buyers by reviewing the financial benefits for buying a home.

Legally, and ironically, a buyer's broker has no affirmative duty to disclose or discuss the tax aspects of the purchase of one-to-four unit residential property. This holds even if the broker or the agent knows the tax rules and their adverse or beneficial impact on the homebuyer.

Most agents are instructed by their brokers to totally refrain from explaining the tax aspects of a transaction, all part of the unprofessional **dumb agent rules**. Most homebuyers are given no expectation by their agent about the dollar benefit the MIDs provide.

However, the notion is wrongheaded that a licensed real estate agent is not authorized to discuss the tax benefits of a transaction. It is a gross misunderstanding of the agent's fiduciary duties and *legal obligation* to share such information, when known and to the extent known, with their client. The duty is to give the client a "heads up" to prevent surprise in the future.

It is a glaring contradiction to argue that repealing the MID will affect home sales volume when essentially all SFR/MLS agents operate under the misconception that they are not allowed to discuss the tax benefit of ownership during counseling and negotiations, and thus do not.[2]

2 **Carleton** v. **Tortosa** (1993) 14 CA4th 745; Calif. Civil Code §2079.16

Marketing the subsidy or not

An effective litmus test for whether the MID is used by buyer's agents during their counseling sessions with a prospective buyer is to look at the marketing materials used in the industry.

None of the hundred or so so-called "standard forms" published by the real estate trade union provide an opportunity for the client or their agent to calculate the expected tax savings for a review of MID ownership subsidies. Rarely, if ever, does one see a listing advertisement soliciting buyers that touts the tax benefits of purchasing a home.

Real estate professionals, most especially brokers, are educated on the tax benefits of ownership. Most keep abreast of current tax law as a matter of personal curiosity and continuing education. However, this information is cloistered from the client's view.

Instead of functioning as an indispensable marketing tool for SFR broker and agents, the MID is relied upon as a foggy notion of ownership benefits, disseminated among the public as "common knowledge" and unquestioned as an essential component to realizing the American Dream.

If the tax deduction is so crucial to the continued growth and profitability of the real estate market, why then is it not discussed in detail with homebuyers?

Perhaps it is because the MID truth isn't quite so seductive.

Chapter 34 Summary

Interest deductions took root in the late 19th century. However, not until the 1950s did the home mortgage gain anything close to its current significance. Since then, the home mortgage and the mortgage interest deduction (MID) has become the going concern of the housing industry.

Proponents of the MID argue it:

- stimulates homeownership;
- provides tax relief for the middle-class; and
- limits the government's reach into the taxpayer's pocket.

Advocates for repealing the MID argue it:

- inflates housing prices;
- subsidizes lenders by encouraging greater amounts of mortgage financing; and
- provides little to no tax relief for the middle-class.

Ultimately, the true tax benefits of interest rate deductions were lost long ago. They were arbitraged away by increased home pricing and interest payments. The benefits are passed on to the seller in the form of increased prices, and to the lender in the form of increased amounts of interest and charges.

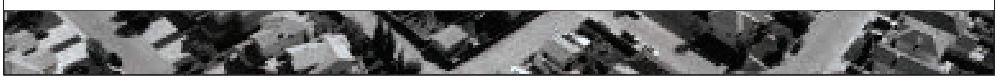
Real estate agents and brokers have long avoided giving tax advice, even when known to them, about the benefits of owning a home. Thus, they do not generally rely on the MID in the counseling of buyers over reasons to buy a home, though they should.

Chapter 34 Key Terms

capitalization rate .... **pg. 291**
itemized deduction .... **pg. 291**
mortgage interest deduction (MID) .... **pg. 287**
submerged state .... **pg. 290**

Chapter 35

The fate of suburbia



Learning Objectives

After reading this chapter, you will be able to:

- recognize the disproportionate effect the Millennium Boom continues to exert on California's suburban communities;
- identify the obstacles and demographic trends challenging suburbia's recovery;
- anticipate how suburbia and the outlying areas will experience an influx of light industry with labor intensive activities to capitalize on cheap labor; and
- understand how suburbia will remain an appealing choice for buyers who value space and cost over the social and cultural allures of urban areas.

Key Terms

Generation Y

Millennium Boom

money-illusion

Suburbia eroded

The **Millennium Boom** hit suburbia especially hard.

Millennium Boom
The years 2000-2007 leading up to the 2008 economic recession, characterized by loose lending practices and unsustainably high real estate sales volume and prices.

Residents in suburban areas are disproportionally vulnerable to shifts in the broader economy as they lack adequate employment centers. That said, consider California's largest centralized influx of population during the past decade, Southern California's *Inland Empire*.

In the Inland Empire, the majority of jobs are related to the construction industry. However, the Great Recession did away with construction starts and construction jobs for years to come. As a result, the Inland Empire suffered from a high unemployment rate. However, Riverside County surpassed its late 2007 peak by 119,400 jobs in 2017.

Without employment after the Boom, defaults soared and **ghost-town neighborhoods** were left behind. The concentration of defaults was consistently higher in lower-priced suburban areas. In turn, the increased vacancies in suburban neighborhoods have resulted in **blight** and **increased crime**.

Much like the inner cities of the '60s and '70s — known for high crime, gangs and poverty — suburbia will become the newest retreat (or jail) for California's economically more desperate.

Suburbs now have the largest poor population in the nation, as reported by the Brookings Institute. Between the years of 1999 and 2008, the legion of suburban poor grew as much as 25%, five times the rate of the poor in urban areas.

This trend mirrors the fall of Moreno Valley and the Lancaster area after the collapse of the economy in the 1990s when jobs failed to support the Boomers who had recently moved in. Just as *short sales* and *distressed property sales* became the norm in 1992-1997, the same trend continues today in newer subdivisions.

Poverty and crime

Crime in blighted suburban areas will similarly swell in future years as a massive swath of latch key children, raised by babysitters and the television, will come of age. The absence of parents while growing up, who were by necessity away from home in the more coastal centers of employment earning a living, will make itself known on a broader societal level as these children grow out of childhood.

This in turn will further drive out the educated elite who will escape to a more gentrified urban city. In their place, their sprawling suburban houses will be rented out to less educated, lower-income tenants or sold to owners (if the price is right), who will likely perpetuate the cycle.

Obsolescence and diminished social services

Schools and **public services** in suburbia will worsen. While the suburbs may have been cheaper in the short-term for suburban purchasers, numerous long-term hidden costs will present themselves as benefits lost for living there.

The suburban tax base — fed during the Millennium Boom by new development and the rising property values which existed — has and will continue to erode based on resale prices one decade forward. However, the *price* communities pay for services do not erode.

Costs inherited by the suburban taxpayers will include:

- the cost of maintaining and building roadways, mass transit and all variety of infrastructure for those stranded in the suburban inlands who commute to earn a living;

- the long-term expense of cleaning up the environmental side-effects of suburbia's encroachment into natural habitats and the steps taken to mitigate devastating wildfires in areas that were considered remote just years ago; and
- the cost of providing new amenities and social services to suburbia's growing population of geriatric and lower-income individuals.

Similarly, **physical deterioration** will be increasingly problematic. The Golden Arches of the McMansions will lose their luster as the rapidly mass-produced properties constructed by national builders in distant locations will begin to show their age and poor construction materials.

The bane of the commute

Long commutes from suburbia to employment centers:

- contribute to pollution and global warming;
- add precious hours to an already long workday; and
- perpetuate American reliance on fossil fuels.

Simply, it is an unsustainable cultural habit compelled by urban sprawl and suburbia's dependence on automobiles to function without a more centralized employment hub and high coastal density permitted in developed countries.

The average commute of an employed Inland Empire dweller has gotten longer in the aftermath of the Great Recession, according to 2009 Census data. A third of the residents commute outside of their region for employment, such as to Los Angeles, and only 5% use public transportation.

People tend to put up with longer commutes during periods of economic turmoil, as they are unable to sell their homes and relocate. They are willing to drive further afield for any type of employment and the income needed to keep the family going. However, once jobs return, these death-march commutes will no longer be much tolerated.

Fuel prices are higher than a commuter can justify – a reality that will more likely worsen with time. This condition will also encourage Californian suburbanites to relocate and live closer to their places of employment situated closer to the coast and large cities.

Is suburbia gone for good?

Does this mean the McMansion stuffed cul-de-sacs will be bulldozed to the ground to make way for multi-family units or industrial projects? Can the private ownership interests tied up in a suburban neighborhood be unwound and the buildings unbuilt?

Despite the coming sea-change toward urban living, suburbia will not go the way of the dodo.

Similar to a vestigial organ, it will lose its original function but not disappear. Suburbia will be an appealing choice for those who value *space* and *cost* over the social and cultural allures of the city.

Suburban areas in close proximity to employment opportunities in nearby cities, especially if they are connected via mass transit, will likely continue to garner the interest of future homebuyers.

To mirror the movements of the labor force, basic industry will migrate to low pay areas to cut their costs as they have done in the upper deserts of Los Angeles and San Bernardino Counties. Thus, suburbia and the outlying areas will experience an influx of light industry with labor intensive activities to fill up on cheap labor. The best paying jobs in these central California districts will be:

- government employment;
- health care services; and
- education.

Will the "hip-illusion" continue to entrance Gen Y?

Generation Y
The forthcoming generation of first-time homebuyers, consisting of individuals born in the 1980s and 1990s.

money-illusion
The illusion that a property's past dollar value and the amount a current homebuyer will pay are the same.

Additionally, not all of **Generation Y (Gen Y)** will flee to the "hip" allure of the cities. Though a majority of Gen Y may presently profess a desire to move to the cities when they are young and not tethered by the three M's (marriage, mortgage, maternity), it is unknown whether they will continue to hold this same aspiration ten to fifteen years hence when they are in a financial position to purchase.

Much like a **money-illusion**, will the *"hip-illusion"* still entrance the members of Gen Y when they have middle-age paunch, halitosis and a receding hairline? Or, like their parents, will Gen Y retreat back to the bastions of suburbia (now with family in tow) when homeownership becomes a financial possibility?

Though suburban landscapes will always be part of the California geography, their days of dominance are behind us. Thus, agents and brokers need to anticipate this massive demographic shift into urban areas, specifically multiple-housing projects with security and relatively high prestige.

Take steps to prepare now: Gen Y and the Boomers are starting to leave the long commutes, chaparral, sage and property maintenance of suburbia behind as they go to live where they work.

Chapter 35 Summary

The Millennium Boom hit suburbia especially hard, as residents in suburban areas are disproportionally vulnerable to shifts in the broader economy as they lack adequate employment centers. Suburbs now have the largest poor population in the nation, as reported by the Brookings Institute. Between the years of 1999 and 2008, the legion of suburban poor grew as much as 25%, five times the rate of the poor in urban areas.

Though suburban landscapes will always be part of the California geography, their days of dominance are behind us.

Agents and brokers need to anticipate this massive demographic shift into urban areas, specifically multiple-housing projects near areas of employment.

Chapter 35 Key Terms

Chapter 36

Immigration's impact on the housing market

Learning Objectives

After reading this chapter, you will understand how the immigrant population:

- will contribute to California's real estate recovery; and
- will not take jobs from U.S.-born workers.

Key Term

entrepreneurial spirit

The old role of immigrants in the new real estate paradigm

The California real estate market for 2021 continues to recreate itself as jobs make a slow comeback. As it does so, brokers and agents will be forced to break out of the mold of long-held misconceptions and practices.

Among other things, the new real estate paradigm requires a rigorous forward-looking examination of the past beliefs held about immigrant employment in California. This immigrant labor force will affect the future of the real estate industry, both in terms of construction employment and as a high-level demographic driving rental occupancy and homeownership, all needed to continue our real estate recovery.

Immigrant labor increases the rate of employment

Despite misleading arguments to the contrary, **immigrant labor** increases both the long-term rate of employment and income for the native-born workers, according to a study completed by the Federal Reserve Bank of San Francisco (the Fed). This is the result of the difference in the types of jobs taken by the two types of workers.

The less-educated, less English-proficient sector of the immigrant workers typically work in the personal service and agriculture industries. They perform manual labor jobs with low pay. In contrast, the less-educated native-born workers are typically more English-proficient than their immigrant counterparts. They thus specialize in jobs requiring greater communication skills, such as those found in customer service and retail sectors, and pay more than manual labor jobs.

Thus, the less educated natives and immigrants among us do not compete with one another based on their immigrant- versus native-born status.

Two spheres of labor

The split between types of jobs does not restrict itself to less-educated workers. More-educated native-born workers tend to be *managers, teachers* and *nurses,* occupations requiring better communication skills. More-educated immigrant workers tend to work as *engineers, scientists* and *doctors*.

The two types of workers exist in two separate spheres of labor. These spheres are not in competition with one another. Rather, they support and contribute to each other's growth. They are complimentary.

Having a readily-available labor base is a good thing for California. Over time, the increased labor force available through the influx of immigrants allows businesses to increase productivity. And they are able to do so without crowding out the native-born population.

In turn, business expansion creates additional communication-based job opportunities (i.e., management or supervisory positions). Job growth in the private sector is the result, which is much needed in California to continue the momentum of the recovery.

Innovative fuel for the economy

Greater productivity in employment translates to more money in the California economy. Both immigrant and native-born workers contribute to the economy by using this money on consumer goods and services. This further fuels growth in productivity and employment. These activities are all part of a **virtuous cycle** again getting a foothold.

entrepreneurial spirit
Individuals exhibiting creativity and ingenuity. Willing to adopt new, innovative techniques to succeed.

Consider also the positive effects of the type of individual who comes to California to improve their economic and social situations. They are risk-takers. The **entrepreneurial spirit** which led them to California is the same spirit that fosters innovation and new businesses. Many of these new businesses will grow to employ thousands.

Real estate's gray industry

Adult immigrants create an *immediate demand* for housing when they arrive in California (as opposed to the native-born population – births – which need to grow into their role). This is the case whether they are immigrants from other states or other countries. Either way, they are all new consumers of California housing and goods.

However, the complex process of buying a home is especially daunting to members of immigrant communities who do not understand written English. Thus, they are often vulnerable to the phenomenon of *asymmetry* *of information* due to their inability to understand first-hand what they are contracting to do, except as they are told by those who represent them, the brokers and agents as the gatekeepers to rentals and ownership.

Editor's note — The California legislation has made some progress in bridging this gap in information. Loan agreements for mortgages are now required to be translated into the language in which negotiations were completed.

Chapter 36 Summary

Immigrant labor positively affects the California economy. Immigrant labor increases both the long-term rate of employment and income for the U.S.-born workers. Immigrant and native-born workers exist in two separate spheres of labor which support and contribute to each other's growth.

Immigrants create an immediate demand for housing when they arrive in California. They are thus all new consumers of California housing and goods.

Chapter 36 Key Term

Chapter 37

Energy efficiency 101: for California real estate agents

Learning Objectives

In this chapter you will learn about the basics of energy efficiency in homes, including:

- efficient lighting;
- sealing around doors and windows;
- proper insulation;
- energy efficient appliances;
- whole house fans; and
- solar panels.

Key Terms

building envelope	**energy efficiency**
energy audit	**home energy score**

Energy efficiency: what's the big deal?

Being **green** isn't just about being trendy. *Going green* means saving on long-term property operating expenses. It also translates to a lower chance of default. Homeowners with energy efficiency improvements are up to 33% less likely to default on their mortgage, according to a study by the University of North Carolina.

More importantly, *nine out of ten* homebuyers say they prefer to purchase a home with built-in energy efficient improvements, even if the purchase price is two-to-three percent higher than a home lacking these improvements, according to the National Association of Home Builders. The prospect of a comparatively low utility bill makes spending more on the purchase attractive for prudent homebuyers.

The Golden State goes green

So what constitutes "going green"? Going green means using building materials, appliances or methods which are:

- environmentally friendly;
- responsibly and/or locally sourced;
- recycled; or
- renewable.

Unless they're wealthy or extremely energy conscientious, most homebuyers are interested in how green improvements can save them money. Watch your labels, here: "green" doesn't always mean long-term savings.

Some green improvements are driven primarily by social intentions, and can end up costing quite a lot. To reap the financial benefits of going green, green improvements need to be **energy efficient**. *Energy efficiency* aims to reduce the amount of energy used by the homebuyer, thereby reducing their energy costs. The goal is to match up the savings on utility cost reductions with the cost of the improvements.

energy efficiency
Using building materials, appliances or methods to reduce the amount of energy used by the homebuyer, thereby reducing their energy costs.

Therefore, it's important for you to be able to differentiate between a purely "green" improvement and a truly energy-efficient one. Once that's done, make it your goal to know the ins-and-outs of energy-efficient improvements:

- how to make them; and
- how much they will cost (and save) your homebuyer clients.

Energy efficiency: all the options

First, start with an **energy audit**, formally known as a *Home Energy Rating System (HERS)* audit. It is prepared by a HERS auditor. Your seller or your homebuyer can order an energy audit of the property. The audit report is then included in the home marketing package and if not, part of a buyer's due diligence investigation (which then leads to renegotiations of the price).

energy audit
An inspection which pinpoints a home's energy-efficient improvements and features in need of energy-efficient improvements.

A HERS audit pinpoints existing energy-efficient improvements, and lists the home's features in need of energy-efficient improvements. HERS auditors also give each home audited a HERS score based on the home's energy saving abilities.

home energy score
A rating system established by the Department of Energy quantifying the energy performance of a home.

For sellers who have made energy-efficient improvements, the official **home energy score** provided by the HERS audit gives them a meaningful way to toot their energy-efficient horn to justify higher pricing. [See **RPI** Form 150, §11.h]

On the other hand, for homebuyers contemplating the purchase of an energy-inefficient home, the audit provides ammunition for setting the purchase price in line with the improvement costs or long-term operating costs.

The six most common energy-efficient improvements are:

1. efficient lighting;
2. sealing around doors and windows;
3. wall and ceiling insulation;

4. energy efficient appliances and venting;
5. whole house fans; and
6. solar panels.

1. Lighting

The easiest low-cost way a homeowner can save money is by trashing energy-sucking incandescent light bulbs and upgrading to *light emitting diode (LED) light bulbs*. LED light bulbs last up to 25 times longer than incandescent bulbs, and consume 3-30% of the energy incandescent bulbs consume. They also don't give off heat like other bulbs do, helping reduce air conditioning costs.

Lighting costs can also be reduced by installing dimmers in place of traditional light switches (although not all LED bulbs work with dimmers – make sure your homeowner checks). A homeowner can do a self-install for the cost of the dimmer ($20-$50).

2. Sealing

Properly sealing the home's **building envelope** (doors, windows, foundation, roof and walls) can dramatically reduce the costs of cooling and heating the home. Sealing materials include caulk, weather-stripping and expandable spray-foam.

building envelope
The doors, windows, foundation, roof and walls of a property. Sealing these areas can dramatically reduce the costs of cooling and heating the property.

The areas around doors and windows are the most obvious spots to check for sufficient sealing. An energy audit can discover the not-so-obvious spots. The auditor will perform a blower door test to discover any leaks. The homeowner can do seal leaks themselves for the cost of the sealing materials, or have a professional do it.

The cost to seal a home ranges from $300 for a do-it-yourself project to $2,000 for a professional job. The savings average 20% of the annual heating and cooling costs along with 10% of the home's total energy costs, according to the Environmental Protection Agency (EPA).

3. Insulation

Adding more **insulation** will, in most cases, reduce the energy bill. An energy audit will also identify where more insulation needs to be added.

A quick way for your homeowner to find out whether they have insulation in a particular area is to turn off the power and unscrew an electrical outlet. They'll be able to see clearly whether or not there is insulation present (though a flashlight might help).

4. Appliances

An obvious, but slightly more costly energy fix is to replace old appliances with new, energy-efficient appliances. These come branded with the EnergyStar label of approval. Appliances to consider upgrading include:

- refrigerator / freezers;
- washer / dryers ;

- air conditioners;
- water heaters;
- computers;
- televisions; and
- dishwashers.

The EPA determines the qualifications required for appliances to earn the EnergyStar label. If the appliance costs more than a similar energy-inefficient appliance, the owner will recover the additional cost through the energy savings accrued by the *EnergyStar* appliance (within a reasonable time period).

5. Whole house fans

Whole house fans are on their way to becoming as commonplace as microwaves in California homes. Chances are you're already familiar with this product.

The fan (usually installed in an attic) pulls cool air from outside through the interior of the home at night, pre-cooling the home for the hotter daytime hours. This augments the homeowner's air conditioning system, reducing cooling costs on average 50%-90% a year.

The cost to purchase and install a whole house fan varies from $300-$1,500. The investment will usually begin paying off in one-and-a-half to two years.

6. Solar panels

Solar energy is very quickly making its mark on California's landscape. However, the cost of solar panels can be prohibitive for individual homeowners. The average cost to purchase and install solar panels on a California residence is $34,800. That amounts to 15-20 years of use before the investment begins to pay off.

Large commercial businesses are more likely to have the cash to install solar improvements. Lancaster, California recently became the first city in the world to vow to produce more energy (harnessed with solar panels) than it uses each day. The city is expected to save over $7 million in energy costs over the next 15 years.

Lancaster partnered with *SolarCity*, which offers homeowners (as well as businesses and governments) the ability to acquire electricity from solar panels owned by SolarCity for up front deposits. This option allows homeowners to benefit from solar energy without actually making an investment. The homeowner then pays SolarCity a reduced, set rate for the electricity they use for the length of the contract, which is typically 20 years.

California stays FiT

Los Angeles customers of the Department of Water and Power (DWP) have the opportunity to sell back excess solar energy (which is what SolarCity does since they own the panels) to defray energy costs, known as a **feed-in-tariff**

(FiT) program. Under the program, the DWP pays customers (SolarCity) 17 cents per kilowatt hour of solar energy returned to the grid (1 kilowatt hour can power a 100-watt incandescent light bulb for 10 hours).

Homeowners need to have large rooftops to participate. These types of property can include:

- multi-family properties;
- warehouses;
- school buildings; and
- parking structures.

Solar panel rebate and financing options

For homeowners who wish to directly own their solar panels, government-sponsored rebate or financing programs are available. See GoSolar's website at www.gosolarcalifornia.ca.gov for additional information.

Editor's note — Solar leasing has its drawbacks. In fact, signing a solar lease clouds title and have unpriced buy-out options which have the potential to derail a sale down the line. To avoid these complications:

- *ask the solar leasing company about the requirements for a solar lease assumption by a homebuyer before leasing the equipment;*
- *do the math, figure out if the monthly savings are worth the complications on an eventual sale; and*
- *if you decide to go with a solar lease, disclose the solar lease to all potential homebuyers upfront to make sure it will not become an issue affecting the sales price before closing.*

Remember, homebuyers want the best home for the smallest cost. With energy-efficient improvements, they can get both – with some complications included or a direct investment.

Chapter 37 Summary

Installing energy efficient improvements means saving on long-term property operating expenses. Make it your goal to know the ins-and-outs of energy-efficient improvements: how to make them, and how much they will cost (and save) your homebuyer clients.

Some common energy efficient improvements include installing:

- efficient lighting;
- sealing around doors and windows;
- proper insulation;
- energy efficient appliances;
- whole house fans; and
- solar panels.

Chapter 37 Key Terms

Chapter 38

Renting and owning across counties

Learning Objectives

After reading this chapter, you will learn about:

- the future of rental vacancies across California; and
- how homeownership rates vary across California counties.

Key Term

Generation Y (Gen Y)

Are rentals the future of California real estate?

As **homeownership** and **rental vacancy** rates decline in counties across the state, a change in the housing market is on the horizon. The future of this recovery from the wake left by the nation's financial and governing crisis will be determined by jobs, construction and foreclosure rates.

Figures 1 and 2 track the rate of change in homeownership both statewide and in the largest counties. The remainder of households rent.

Figure 3 tracks the rate of *rental vacancies* by county since 1993. Rental vacancies tend to rise in times of increased homeownership and excessive residential construction. Dark bars indicate periods of recession.

Future vacancy rates will be influenced by:

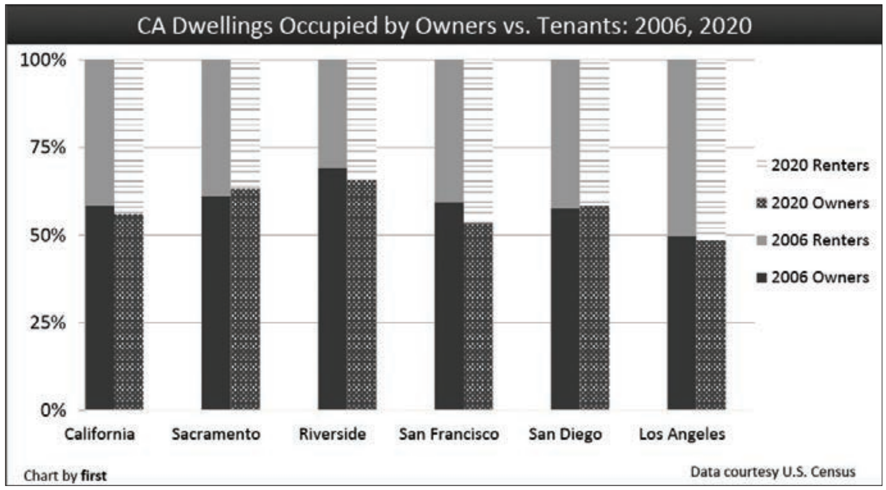
- current vacancy rates;
- regional foreclosures;
- regional job performance; and
- residential construction numbers.

Renting into the future

Though slowing, 10% of California homeownership in 2005 has shifted from homeownership to rental property for their shelter. The drop off in ownership has returned near to its level before its run up during the Millennium Boom, but will trend downward for a few years.

Figure 1

California Renters vs. Owners: 2006, 2020



This chart compares the percentage of homeowners versus renters in California in 2006 and 2020.

Data collected and published by the U.S. Census Bureau.

ONLINE UPDATE
Visit realtypublications .com/charts for the most recent chart data.

This increased reliance on rentals follows on the heels of the historic spike in homeownership during the Millennium Boom.

Favorable public attitudes about homeownership climbed for about 60 years into the early 2000s. Then, in quick succession, we experienced a punch up in sales volume, a pricing bubble, a recession and a once-in-a-lifetime financial crisis.

In the aftermath, homeowners have found a home cyclically fails to be a reliable piggy bank (or ATM). They are slowly learning their losses were brought on by deregulated and thus unregulated mortgage lending and the lack of adequate consumer protections by governments.

Today, many homeowners (former and current) have ended up in financial chaos, their balance sheets literally destroyed. The renter population has swelled, as fewer prior homeowners are able to buy after losing their homes. And fewer renters desire to be homeowners due to the negative taste left by the financial crisis. Eventually, in the next decade, all these negative aspects of homeownership will be generally forgotten.

Recovering from foreclosure: to own or to rent

Consider a former California homeowner who lost their property to foreclosure in the days following December 2007, the beginning of the *2008 recession and crisis*. This owner, like 900,000 others since 2006, suffered a loss of income due to a job loss. Others were simply unable to make payments when the time came to fully amortize inherently deceptive hybrid *adjustable rate mortgages (ARMs)*.

Financially unable to buy a replacement home to house their family, our homeowner moves into a comparably-sized SFR rental property in the same school district. The rental rate is one-third of the family income. Better yet, the rent is less than half their prior mortgage payment, a typical condition. Their credit score is now too damaged by the foreclosure (or short sale) to qualify for purchase-assist financing to buy a replacement home even if they wanted to return to ownership.

So, for the next years the family will live in a rented home without the responsibilities imposed by ownership. This owner and others subjected to foreclosure or short sale have forfeited the tattered American Dream of homeownership for the convenience, peace of mind and financial security (deleveraging) of renting.

This situation is now a full blown reality for homeowners across California. As of 2019, California has nearly the lowest homeownership rate in the nation at 54.8%.

Rentals as a percentage of all housing are highest within high-density metropolitan areas, especially in cities like San Francisco and Los Angeles. On the other hand, there are areas of traditionally high homeownership, like Riverside/San Bernardino and Sacramento. These regions have maintained a lifestyle focused on suburban housing, even in the difficult years following the 2008 recession. However, signs indicate that housing habits are changing even in these homeownership outposts.

Jobs' impact on homeownership

Future homeownership rates depend largely upon the coming wave of *first-time homebuyers*. These homebuyers are typically aged 25-35. Often, they will purchase a low-tier or mid-tier SFR for their first homes. Looking forward, the coming generation of first-time homebuyers is made up of members of **Generation Y (Gen Y)**.

Generation Y
The forthcoming generation of first-time homebuyers, consisting of individuals born in the 1980s and 1990s.

Severe *job loss*, however, has changed the timing of homeownership in almost every region of California, exceptions being San Francisco and very wealthy zip code locations. First-time homebuyers are declaring themselves financially unable, or just plain unwilling, to purchase a home in spite of cyclically low prices and mortgage rates. The more realistic age of today's typical first-time homebuyer is 30-40 years.

When jobs do return, they are likely to come first and fastest in city centers. After the distressing behavior of the housing market on Boomers in the recent recession, more of their newly employed children will be renting than owning.

Future rental construction will increase

An increase in rental activity is naturally followed by an increase in rental construction. As vacancy rates slip below historic norms (generally near 5%) and rents rise beyond the rate of inflation, multi-family construction will return to keep rents and prices down. Again, zoning limitations may interfere, which will cause rents to rise more quickly than the rate of consumer inflation (and wages). This will squeeze out tenants needed for the jobs in intercities and slow the rise in the absorption rates for office and industrial buildings.

Apartment and condo construction was at its lowest in 2009. Multiple family construction has now begun to increase in coastal regions more rapidly than statewide SFR construction due to high occupancy rates. Thus, builders have little competition from existing rentals to meet the increasing demand for centrally located rental units of higher quality.

Construction for SFRs, on the other hand, has increased much more slowly. Builders have little incentive to build, as SFR vacancies were level with their historical average of around 1.2% for years. However, homeowner vacancies are now below this historical level, at .07% in 2020.

The continued high SFR vacancy rate is due to:

- speculator acquisitions with interim tenants before flipping the properties; and
- high credit score standards imposed on lenders by re-regulation.

Homeownership by county

Counties like Riverside were at the center of California's housing boom in the early 2000s. During the so-called Millennium Boom, homes were built and sold faster than was sustainable in the long term. Riverside's homeownership rate jumped almost 6% in 2000-2005, pulling the state's rate of homeownership up with it.

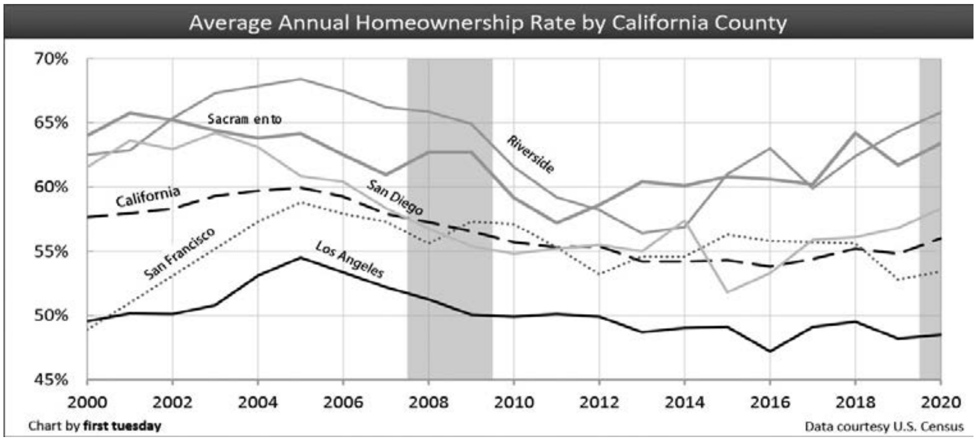
As we now know, those homeownership gains were illusory. Since 2005, Riverside's rate of homeownership has dropped to 64%, still below its level at the peak of the boom. The gains made in the last decade have been entirely erased and the decline continues, but at a slowing rate.

With every statewide trend, of course, there are exceptions. In California, one exception to homeownership and rental trends is *San Francisco County*. San Francisco experienced a less noticeable dent in homeownership during the recession, at around 57.2% in 2021. [See *Figure 2*]

San Francisco's consistent albeit low homeownership rate is due to the general lack of SFR construction and prevalence of high-tier properties in much of the West Bay Area. Further, their population has been less susceptible to foreclosure due to strong bubble-like local employment in the information technology industry.

Interestingly, the rate of homeownership has fallen most consistently in highly urbanized San Diego. San Diego has demonstrated a downward trend in homeownership since 2004. Los Angeles, likewise, has had a declining proportion of homeowners since 2005.

Many large southern coastal cities remain examples of past suburban sprawl and inefficient zoning. They have, however, begun to reorganize to a more sustainable, centralized model of higher density urban living. The charts above suggest the rest of the state is following suit.



This chart shows the homeownership rate of California and its major counties.

Data collected and published by the U.S. Census Bureau.

Figure 2

California Homeownership Rate by Counties: 2-year Moving Average

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.

Homebuyer demand shifts

Those who willingly choose to rent now find they have competition from *renters-by-necessity*. With this shift in housing demand, residential rental properties are now dominating the housing market.

Renters-by-necessity are foreclosed-out homeowners and forced-out short sellers. Presently, they are left financially unable to purchase a home. They have no savings, damaged credit scores and an enduring emotional aversion to homeownership — at least in the foreseeable future.

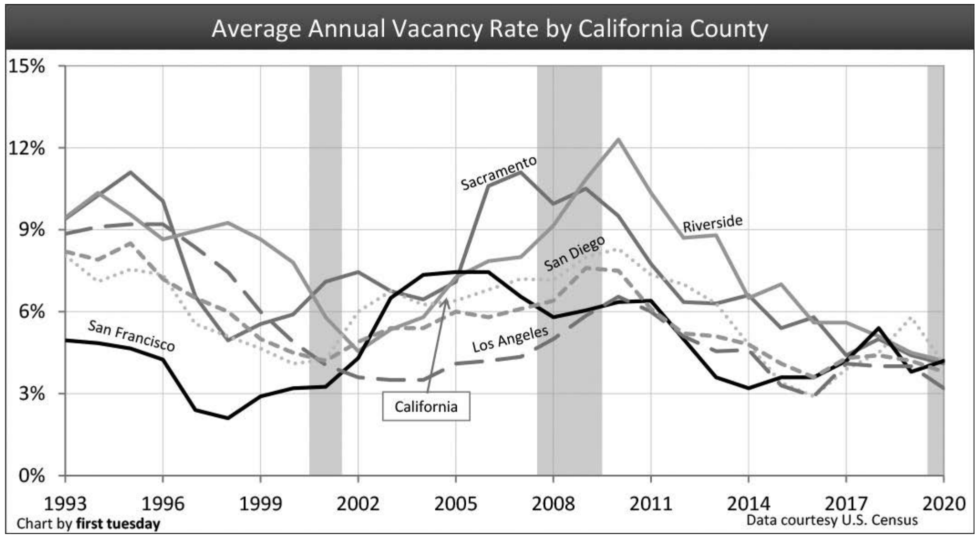
Some who were burned by short sale or foreclosure will eventually return to the homeownership, but not likely more than 10-15% within 10 years. They will be joined by first-time homebuyers who have put off homeownership. This return will occur when their jobs, savings, deleveraging, credit scores and confidence in the economy permits them to do so.

Meanwhile, bedroom cities in the suburbs are replete with vacant SFRs and apartments, as those who lost their home are most likely to end up renting in urban centers closer to their jobs. Homes in all price tiers are being acquired by buy-to-let investors who are intent on collecting them solely for the value they present in long-term monthly rental income.

On the other hand, *speculators* acquiring real estate generally do so only for growth in value. They prefer to sell, as do *day traders*, for a quick profit and without the inconvenience of a tenant. In the absence of willing homebuyers, many syndicators and speculators have altered their resale expectations, hybridizing their holding plans to include renting the properties to cut their carrying costs as they wait longer to sell.

Figure 3

California Annual Vacancy Rate



This chart shows the residential rental vacancy rate for California and its major counties.

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.

Vacancies by county

Rental vacancies are driven by varying local demand. The key factors influencing vacancies are the local jobs situation and the local attitude toward SFR homeownership and renting, which change over time.

For instance, Sacramento experienced massive vacancies during 2006 into the early days just before the beginning of the 2008 recession. Since then, the area has seen rental vacancies drop dramatically. The many foreclosed homeowners in that region have taken up available rental inventory.

Meanwhile, Riverside has had progressively higher rental vacancy rates from 2006 to present. This is due to insufficient new renters to fully occupy the vastly overbuilt SFRs in these areas.

Future rental vacancies

Most of the counties in Figure 3, particularly those near the coast, are likely to see a continued decrease in vacancies. However, Sacramento and Riverside and other inland counties will see the smallest decreases. Here, ongoing foreclosures and exceptionally high unemployment add to the renter population.

Employment in Riverside finally exceeded the number of jobs held prior to the Great Recession at the end of 2014, though it barely caught up with post-2007 population gain before the 2020 recession hit and more jobs were lost.

The rise of rental property

Trends point to an increase in rental demand in upcoming years throughout California. While some regions, especially Riverside, will take a longer time to shift from the 1950's standard of suburban SFR homeownership, rental property is poised to lead the real estate recovery. Even in counties with higher than average homeownership rates, rentals will emerge as significant profit centers for landlords and property managers.

Agents in urban areas need to consider adding *property manager* to their title, as demand for this skill will undoubtedly rise throughout this decade. Also, keeping informed about the local construction and job trends will help agents prepare for future demand in their communities.

SFR homeownership is nowhere near becoming obsolete. But its 30-year dominance into 2005 is definitely a relic of the past.

Chapter 38 Summary

Increasingly, Californians are turning to rental property for their shelter. Today, California's homeownership rate is among the lowest in the nation. Future homeownership rates depend largely upon the coming wave of first-time homebuyers. However, trends point to an increase in rental demand in upcoming years throughout California.

Chapter 38 Key Term

Generation Y .... **pg. 313**


HOLLYWOOD
PRODUCTION VRC
DIRECTOR firsttuesday
CAMERA
DATE SCENE TAKE
3/22 22 1
Want an exclusive
behind-the-scenes look at
firsttuesday's new
Video Renewal Course™?
Click here for a sneak
peek at your next renewal.

Glossary

#

1-year Treasury Bill 202
One of several indices reference by lenders to adjust the rate of an adjustable rate mortgage. This index is one of the most volatile.

10-year Treasury Note 269
A leading indicator of the direction of future Freddie Mac rates. Influenced by worldwide demand for the dollar and anticipated future domestic inflation.

A

Abenomics 279
An economic plan introduced by Japanese Prime Minister Shinzo Abe to revive their 20 years of stagnant economy through aggressive fiscal stimulus, monetary easing from the central bank and employment reforms.

acceleration 215
When a lender or carryback seller makes a demand for immediate payment of the amounts remaining due on a loan or extension of credit. Also known as “calling the loan.”

agency relationship 28, 36
The scope of conduct imposed on a broker arising out of the representation undertaken by employment as a licensee.

all-inclusive trust deed (AITD) 233
A note executed by the buyer in favor of the seller for payment of the amount remaining due on the purchase price after deducting the down payment, the seller remaining responsible for payment on one or more underlying trust deed obligations. It is also referred to as a “wraparound” or “overriding” note.

anti-deficiency 223
A limitation placed on a mortgage lender’s ability to recover losses on a default when the secured property’s value is insufficient to satisfy the mortgage debt.

applicable federal rate (AFR) 204
Rates set by the Internal Revenue Service for carryback sellers to impute and report as minimum interest income when the note rate on the carryback debt is a lesser rate.

arbitration 63
A form of dispute resolution voluntarily agreed to in contracts authorizing a third-party arbitrator to issue a binding award which cannot be reviewed and corrected by a court of law.

arbitrator 64
A neutral third-party appointed to hear a dispute who is authorized to make a final decision awarding judgment in favor of one of the parties.

attorney fee provision 68
A provision in a contract specifying the prevailing party to a dispute is to receive attorney fees if litigation results from the contract.

authorization-to-extend provision 77
A purchase agreement provision granting authority to extend performance dates before the transaction may be cancelled.

B

bad faith waste 224
Reckless or malicious injury to property causing a drop in its fair market value.

broker price opinion (BPO) **127**
An agent's opinion of a property's fair market value (FMV) based on recent comparable sales.

building envelope **307**
The doors, windows, foundation, roof and walls of a property. Sealing these areas can dramatically reduce the costs of cooling and heating the property.

bumpy plateau **276**
A recovery period characterized by a long-term pattern of recurring short-term increases followed by negating short-term decreases in home sales volume and pricing, producing a recovery trend with little upward movement.

buyer occupant **249**
A buyer who purchases property for use as shelter for their family or business, and retains the property as a store of their wealth for as long as it serves the purposes of their occupancy.

C

California Home Energy Rating System (HERS) **22**
California state system used to create a standard rating for energy efficiency and certify professional raters.

call option **89**
An agreement giving a buyer the right to buy property within a specified time or upon an event at a specified price with terms for payment.

capitalization rate (cap rate) **291**
The annual rate of return produced by the operations of an income property or sought by an investor. The cap rate is calculated by dividing the net operating income by the price asked or offered for income property.

commingling **156**
The mixing of personal funds with client or other third-party funds required to be held in trust.

comparative negligence **194**
An injured person's share of the negligence causing their injury when the injured person's lack of care for themselves contributes to the injury.

condition concurrent **51, 82**
A purchase agreement provision requiring performance of an activity by a buyer or seller without concern for the performance of the other party.

condition precedent **51, 82**
A purchase agreement provision requiring the occurrence of an event or performance of an act by the other party before the buyer or seller is required to further perform.

conflict of interest **28**
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.

Cost of Funds Index **201**
One of several indices referenced by lenders in adjustable rate mortgage notes to adjust the note's interest rate. This index is one of the steadiest.

D

debt-to-income (DTI) ratio **258**
Percentage of monthly gross income that goes towards paying debt.

demand **248**
The amount of housing inventory desired by buyer occupants.

discount rate **199**
The interest rate the Federal Reserve charges banks and thrifts who borrow funds directly from the Fed to maintain reserve requirements.

due-on clause **214**
A clause in a trust deed, triggered by the transfer of any interest in the real estate, which allows the lender to call the loan.

E

end user **249**
A buyer who will occupy the property as their residence or own it as income property for long-term investment purposes.

energy audit **306**
An inspection which pinpoints a home's energy-efficient improvements and features in need of energy-efficient improvements.

energy efficiency **306**
Using building materials, appliances or methods to reduce the amount of energy used by the homebuyer, thereby reducing their energy costs.

entrepreneurial spirit **302**
Individuals exhibiting creativity and ingenuity. Willing to adopt new, innovative techniques to succeed.

equity purchase (EP) **97**
When a seller-occupied, one-to-four unit residential property in foreclosure is acquired for dealer or rental investment purposes.

equity purchase (EP) investor **98**
The buyer of an owner-occupied, one-to-four unit residential property in foreclosure who will not occupy the property as their primarily residence.

event-occurrence contingency provision **50**
A purchase agreement provision requiring an event or activity to take place which is not subject to the approval of the buyer or seller.

excluded debts **240**
Extensions of credit by sellers of real estate creating a debt obligation in sales transactions.

exclusive right-to-sell listing **38**
A type of listing used by a seller's broker when employed by a property owner for a fixed period of time to diligently market a property for sale and locate a buyer to acquire it, for which the broker is due a fee regardless of who locates the buyer.

exempt debts **240**
Private party transactions involving the origination of a loan that is made or arranged by a real estate broker.

F

federal funds **200**
Overnight funds lent to banks with insufficient reserves by the Federal Reserve and other banks with excess reserves.

fiduciary duty **1, 36**
The licensee's obligation as an agent to act with the utmost good faith and diligence for the benefit of the principal who employs them.

final inspection **169**
An inspection of the premises conducted by the landlord within 21 days after a residential tenant vacates the property.

financial atrophy 259
The continuing inability to qualify for purchase-assist financing due to outstanding consumer debt.

five-business-day right to cancel 98
An owner-occupant seller of a one-to-four unit residential property who has entered into a purchase agreement with an EP investor has the right to cancel the agreement during a five-business-day period commencing on notice of the right to cancel.

flipper 250
A speculator who purchases real estate at perceived below-market prices and depends on market momentum to sell at a profit.

for sale by owner (FSBO) 28
A property owner's method of marketing property for sale without the use of a DRE-licensed broker or agent to locate a buyer.

further-approval contingency 50
A purchase agreement provision requiring the approval of information, data, documents or reports by the buyer or seller.

G

general agency duties 30
The duty of a licensee acting as an agent in a real estate transaction owed to all parties in the transaction to be honest and avoid deceitful conduct.

general duty 2
The duty a licensee owes to non-client individuals to act honestly and in good faith with upfront disclosures of known conditions which adversely affect a property's value.

Generation Y 298, 313
The forthcoming generation of first-time homebuyers, consisting of individuals born in the 1980s and 1990s.

Greenspan Put 271
The practice of lowering the Federal Funds Rate to encourage investing during recessionary periods, with an implicit guarantee of continuing interest rate stimulus to keep profits up. Implemented by Fed Chairman Greenspan from 1987 to 2000.

H

hardship letter 128
A statement detailing a distressed homeowner's financial situation, delivered to the lender to determine if the homeowner qualifies for a short sale.

home energy audit 22
An audit conducted by a Home Energy Rater evaluating the energy efficiency of the home.

home energy score 306
A rating system established by the Department of Energy quantifying the energy performance of a home.

home inspection report 19
A report prepared by a home inspector disclosing defects in improvements on a property and used by the seller's agent to assure prospective buyers about actual property conditions.

home inspector 20
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 Affordable Foreclosure Alternatives (HAFA) 126
A government program aimed at assisting homeowners to avoid foreclosures by offering incentives for homeowners and lenders to complete short sales.

Home Affordable Modification Program (HAMP) 129
A government program aimed at assisting homeowners to receive a loan modification in lieu of foreclosure.

I

illiquid assets 45
An asset that cannot be converted into cash quickly without cost.

inter vivos trust 220
A property owner's title holding arrangement designed for probate avoidance on death. Also known as a "living trust."

itemized deduction 291
A deduction from a taxpayer's adjusted gross income (AGI) to set taxable income, consisting of deductions permitted for expenditures for personal items, such as medical and housing.

itemized statement of deductions. 170
A document accounting for the tenant's security deposit, delivered by the landlord to a residential tenant after the tenant vacates.

J

John Maynard Keynes 264
An economist well-known for his stance that governments need to smooth out the effects of expansion and contraction in the business cycle through fiscal and monetary policy.

joint pre-expiration inspection 165
An inspection conducted by a residential landlord to advise a tenant of the repairs the tenant needs to perform to avoid deductions from the security deposit.

L

late charge notice 140
A written notice demanding payment of a late charge by a set date.

late payment clause 135
A provision in a lease agreement specifying late charges paid by the tenant on delinquent rent.

Lesser Depression 276
The period from 2009–2016 following the Great Recession and financial crisis of 2008, characterized by persistent slow job growth and a low, flat annual home sales volume.

liability 44
A financial debt or obligation owed to others.

listing agreement 36
An employment contract used to retain a broker to render real estate transactional services as the agent of the client.

long-term investor 249
A buyer who purchases a property with the intent of renting it to tenants to produce a steady income flow.

loss mitigation 127
A strategy to lessen the amount of loss a lender incurs due to a default by the property owner.

luxury vs. necessity 259
Housing as a consumer good that enhances one's social status versus housing as a solution to one's basic need for shelter.

M

material defect **24**
Information which will affect the price and terms a prudent buyer is willing to pay for a property.

material fact **3**
Information which would likely affect the price and terms a buyer is willing to pay for a property.

mediation **69**
An informal, nonbinding dispute resolution voluntarily agreed to in which a third-party mediator works to bring the disputing parties to their own decision to resolve their dispute.

Millennium Boom **295**
The years 2000-2007 leading up to the 2008 economic recession, characterized by loose lending practices and unsustainably high real estate sales volume and prices.

money-illusion **298**
The illusion that a property's past dollar value and the amount a current homebuyer will pay are the same.

mortgage commitment **208**
A lender's commitment to make a mortgage, enforceable only when written, unconditional and signed by the lender for consideration.

mortgage interest deductions (MID) **287**
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.

N

negative equity **112**
The condition of a property owner owing more on a mortgage than the current fair market value (FMV) of the encumbered property.

net operating income (NOI) **273**
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.

non-exempt private lenders **239**
A lender subject to usury limitations when making a loan.

nonrecourse **132, 235**
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.

nonwaiver of rights provision **177**
A commercial lease or rental agreement provision containing the landlord's reservation of rights.

Notice of Cancellation **75**
A notice from either the buyer or seller given to the other party cancelling the transaction.

notice of change in rental terms **182**
Written notice provided by the landlord of any changes in the conditions of a month-to- month rental agreement.

notice of intent to vacate **185**
A tenant's notice to the landlord signifying their intent to vacate the leased property.

notice of rescission **103**
Notice given by a seller-in-foreclosure to an equity purchase (EP) investor to exercise the seller's two-year right of rescission and restoration on a sale.

O

open listing **40**
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.

oppression **105**
When no real negotiations occur between an equity purchase (EP) investor and a seller-in-foreclosure and are not realistic due to a "take it or leave it" environment created by the EP investor's abuse of the inequality in bargaining power.

option period **89**
The specified time period during which the tenant can exercise their right to buy under an option agreement.

option to buy **88**
An agreement granting an irrevocable right to buy property within a specific time period.

option to extend **88**
An agreement granting a tenant the right to extend possession under the original lease agreement on terms set out in the option to extend.

option to renew **89**
An agreement granting a tenant the right to continue in possession upon expiration of the existing lease under a new lease agreement on the same conditions as the expiring lease agreement on terms for payment of rent set out in the option to renew.

P

partial payment agreement **173**
An agreement by a landlord and a tenant which acknowledges receipt of the partial rent paid, and specifies the amount of deferred rent remaining due and unpaid and the date by which it is to be paid.

portfolio category income **231**
Unearned income from interest on investments in bonds, savings and trust deeds notes; dividends on stocks; profits on the resale of these investments and land held for profit; and income from management-free long-term income property ownership.

post-closing surprise **105**
The post-closing discovery of negative terms and conditions which are hidden in the wording of an equity purchase (EP) agreement or escrow instructions.

preliminary title report (prelim) **4**
A report furnished by a title insurer constituting an offer to issue title insurance based on property vestings and itemized encumbrances presented in the report.

prime rate **202**
A base rate used by banks to price short-term business loans, set 3% above the federal funds rate.

private mortgage insurance (PMI) **231**
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios higher than 80%.

pro rata rent **185**
Rental payment amounts which vary based on the portion of the rental period for which a change has been made.

property profile **147**
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

Proposition 13 282
A 1979 California state constitutional amendment restricting property tax increases in years following acquisition by limiting annual increases in assessed value of real estate to no more than 2%, or the rate of consumer inflation if less.

prudent investor standard 145
A property management standard exemplified by investor standards requiring the efficient and effective management of rental income and expenses.

public policy 142
A system of laws upheld by local, state or federal government.

purchase-money debt 224
A mortgage which funds the purchase or construction of a one-to-four unit owner-occupied residence, also called a nonrecourse debt.

purchasing power 271, 276
A homebuyer's ability to purchase property based on a standard 31% of their gross income and current interest rates.

put option 113
The option built into the provisions of every trust deed allowing the buyer to force the lender to buy the property for the remaining mortgage amount.

R

rate lock 210
A lender's conditional, unsigned commitment to fund a mortgage at a quoted interest rate, origination fee and fixed number of points, regardless of whether interest rates rise or fall prior to funding the mortgage.

real demand 243
The demand of end-user buyer-occupants in the real estate market.

recourse 133
On default on a debt secured by real estate, a lender may pursue a homeowner for a loss due to a deficiency in the value of the secured property if the lender forecloses judicially.

rent 160
Compensation received by a landlord in exchange for the tenant's use, possession and enjoyment of the property.

rentier 262
The class of earners whose income is earned passively, generated from owned tangible and intangible assets rather than through their labor.

reservation of rights clause 174
A clause in the nonwaiver of rights provision in commercial rental and lease agreements stating acceptance of late rent does not waive the landlord's right to enforce remedies for any remaining breach of the lease agreement by the tenant.

restricted real estate loans 240
All loans made by private party lenders which are neither made nor arranged by a real estate broker.

right of first refusal 88
A pre-emptive right to buy a property if the owner decides to sell.

risk reduction 17
Office procedures implemented and actively overseen by a broker to mitigate risk and ensure the broker's agents are conducting themselves as intended.

S

secular stagnation 275
An abnormally lengthy period of sluggish economic growth.

security deposit 159
Security against the tenant's default on obligations agreed to in the rental or lease agreement.

seller-may-cancel provision 77
A purchase agreement provision authorizing the seller to cancel if a specified condition or event does not occur, whether or not the agreement contains a time-essence provision.

seller financing 229
A note 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 market 248
A real estate market characterized by high homebuyer demand and low housing inventory.

short payoff 225
A sale in which the lender accepts the net proceeds at closing in full satisfaction of a greater amount of mortgage debt.

speculator 250
A real estate investor who owns property short-term, sandwiching themselves between the seller and end user of the property.

start-up fee 154
A flat, one-time fee charged by a property manager for the time and effort taken to become familiar with the operations of the property to be managed.

statement of deficiencies 167
A document the landlord presents to the tenant specifying any repairs or cleaning which need to be completed by the tenant to avoid deductions from the security deposit.

statement of financial position 44
A balance sheet prepared by a homeowner which lists the dollar amounts of all the homeowner's assets of value and liabilities.

sticky pricing 13
A seller's irrational reliance on past home pricing as a basis for setting current pricing.

strategic default 112, 122
The intentional default on a mortgage, forcing the lender to foreclose and acquire the property in satisfaction of the mortgage debt.

submerged state 290
The subtle operation of many government social programs that collectively promote or discourage a particular activity, such as homeownership.

subprime mortgage 120
A mortgage made to a borrower based on loose underwriting standards and resulting in a high risk of default.

supply 247
The available inventory a local real estate market is able to offer.

T

time-essence provision 74
A purchase agreement provision establishing that dates for performance of any activity or occurrence of an event are to be strictly enforced as essential to the continuation of the transaction.

title conditions 4
Encumbrances such as liens, conditions, covenants and restrictions (CC&Rs) and easements which affect title to property.

Transfer Disclosure Statement (TDS) 2
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.

treble damages 241
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 nonexempt private lender loan.

trickle-down economics 264
The economic theory suggesting that an increase in the strength of the wealthy leads to an increase in the well-being of lower classes.

trust account 144
A bank account used to hold trust funds.

trust funds 154
Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.

turnover rate 12
The rate at which a broker loses and replaces agents.

U

unconscionable advantage 104
When an equity purchase (EP) investor exploits an element of oppression or surprise to exact unreasonably favorable terms.

usury 238
A limit on the interest rate charged on nonexempt real estate loans.

W

waiver agreement 221
An agreement in which a lender consents to the owner's present or future transfer of an interest in the secured property as a waiver of the lender's due-on rights. Also known as an "assumption agreement."